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Taxation: Valuation of Farmland for Estate Tax Purposes, Qualifying for I.R.C. § 2032A Special Use Valuation

by

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I. INTRODUCTION

"Those who labor in the earth are the chosen people of God."[1] These words, written by Thomas Jefferson, reflect the traditional philosophy our nation has held regarding its farmers.[2] Indeed, our nation has its roots in the soil as democracy in America originated with the small farmers who settled the new frontier and did the actual fighting in the Revolutionary War.[3] The historical model is the farmer and his family owning the land and prospering

1. THE COMPLETE JEFFERSON 678 (S. Padover ed. 1943).

2. For example, one author has recently written:

> Is there anyone "with soul so dead" that he or she is not moved to patriotic fervor by the incomparable drama starring the indomitable people who founded this nation and extended its boundaries to the Pacific, all the while wresting their sustenance from the perilous, stubborn, but bountiful wilderness?

W. EBELING, THE FRUITED PLAIN xii (1979).

3. "[A]griculture [is] one of the main supports of American democracy because it is an occupation embracing millions of freemen who own property and cultivate land on a somewhat equal basis . . . ." Taylor, *Public Policy and the Shaping of Rural Society*, 20 S.D.L. REV. 475, 477 (1975) (quoting J. SCHAFFER, THE SOCIAL HISTORY OF AMERICAN AGRICULTURE 289-90 (1936)). *See* F. TURNER, THE FRONTIER IN AMERICAN HISTORY (1920) (discusses the westward expansion and settlement of the United States). *See generally* W. COCHRANE, THE DEVELOPMENT OF AMERICAN AGRICULTURE (1979) (traces the history of the American farmer and the United States).

from the fruits of their labor in the earth.[4] The ideal of the "family farm"[5] remains the goal of American agricultural policies in spite of pressures to alter the structure of modern agriculture.[6] Even though farming has become a complex business enterprise, the fact remains that the family farm is still the most efficient means of producing our nation's food.[7]

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4. Earnest appeals to save the tradition of the "patriotic, democratic, hard-working farmer" and grass roots America generates such an appeal to the emotions that farmers are still able to exert a political influence far greater than their numbers. As one author has stated, "When a system poses a threat to a group which can generate such an emotional appeal, the system is usually changed to remove the threat." Begleiter, *Section 2032A: Did We Save The Family Farm?*, 29 DRAKE L. REV. 15, 25 (1979).

Indeed, throughout our nation's history farmers have affected the political system in their constant battle to achieve economic justice. Notable examples of farmers' influence include Shay's Rebellion of 1786, the Populist movement at the turn of the twentieth century, and the American Agriculture Movement's tractorcade to Washington, D.C. during the winter of 1978-79. *See* J. GARRATY, THE AMERICAN NATION A HISTORY OF THE UNITED STATES 129-30, 578-81 (3d ed. 1975); 1 S. MORISON, H. COMMANGER & W. LEUCHTENBURG, THE GROWTH OF THE AMERICAN REPUBLIC 241-42 (1969); 2 S. MORISON, H. COMMANGER & W. LEUCHTENBURG, THE GROWTH OF THE AMERICAN REPUBLIC 143-47, 169-74 (1969); R. RICHMOND, KANSAS A LAND OF CONTRASTS 174-81, 302, 304 (1980). *See generally* W. COCHRAN & M. RYAN, AMERICAN FARM POLICY, 1948-1970 (1976); C. TAYLOR, THE FARMER'S MOVEMENT, 1620-1920 (1953); Heady, *Externalities of American Agricultural Policy*, 7 U. TOL. L. REV. 795 (1976).

5. The term "family farm" has been defined several ways. The Jeffersonian ideal of the family farm was one in which the farmer was basically a subsistence operator, the farmer did his or her own work, the farmer made his or her own managerial decisions, and he or she owned the land. During the 1940's the United States Department of Agriculture (USDA) defined the family farm as "a farm on which the operator, devoting substantially full time to operations, with the help of other members of his family and without employing more than a moderate amount of outside labor, could made a satisfactory living and maintain the farm plant." Wadley, *Small Farms: The USDA, Rural Communities and Urban Pressures*, 21 WASHBURN L.J. 478, 481 (1982). The USDA definition has since been changed to read as follows: "The family farm is a primary agricultural business in which the operator is a risk-taking manager, who with his family does most of the farmwork and performs most of the managerial activities." *Id.* at 482 (quoting STAFF OF SENATE COMM. ON AGRICULTURE, NUTRITION AND FORESTRY, 96TH CONG., 2D SESS., CHANGES IN THE FAMILY FARM CONCEPT FARM STRUCTURE: A HISTORICAL PERSPECTIVE ON CHANGE IN THE NUMBER AND SIZE OF FARMS 21 (Comm. Print 1980) (statement of David Brewster)).

6. Between 1957 and 1974 the number of sole proprietors and partnerships declined by 165,000 and 27,000, respectively, while the number of farm corporations increased by almost 29,000. 2 J. JUERGENSMEYER & J. WADLEY, AGRICULTURAL LAW 130 (1981). In such areas as timber and poultry production, the individual farmer has in effect been replaced by the integrated corporation. F. MORRISON, AGRICULTURAL LAW-RESTRICTIONS ON CORPORATE AND ALIEN OWNERSHIP AND OPERATION OF FARMS 120 (J. Davidson ed. 1981).

As a result of the corporate threat to the family farm, many states have imposed restrictions on the formation of farm corporations. For example, in 1981 Kansas enacted KAN. STAT. ANN. § 17-5904 (1981) which states: "No corporation, trust, limited corporate partnership or corporate partnership, other than a family farm corporation, authorized farm corporation, family trust, authorized trust or testamentary trust shall, either directly or indirectly, own, acquire or otherwise obtain or lease any agricultural land in this state." *Id.* KAN. STAT. ANN. § 17-5903 (1981) defines the above permissible entities. *See* Morrison, *State Corporate Farm Legislation*, 7 U. TOL. L. REV. 961, 977 (1976) (The author discusses the constitutionality of such statutes and concludes they will be able to withstand a challenge.).

7. Corporate involvement in agriculture to date has not produced better or cheaper food. And, there is little evidence that increased corporate farming would be more productive or efficient than the family farm. Taylor, *supra* note 3, at 498. "America does not become a healthier, more diversified, more self-reliant society by reducing farmers to the status of corporation dependents . . . ." *Id.* at 487 (quoting N.Y. Times, Dec. 27, 1971, at 26, col. 1-2 (editorial)). *See* 122 CONG. REC. 25,944 (1976) (remarks of Senator Gaylord Nelson regarding § 2032A); *see also* Heady, *supra* note 4, at 832 ("bigger" is not always "better," large industrial farms are often counterproductive and inefficient).

The family farm is also vital to the survival of rural communities. In the early 1970's a study was made comparing two communities: one community was based on small family farms, and the other was based on large corporate farms. The study found that in the family farm community

A healthy agricultural sector is not only vital to Kansas, it is also an indication of the economy of our nation.[8] When many farmers began to leave their farms in the late 1960's and 1970's, three major studies were conducted to investigate the problems facing American agriculture.[9] The studies found that the public policy of protecting the family farm was being thwarted by the sale of farmland for non-agricultural use.[10] Increasingly, farmland was being sold in order to pay the federal estate taxes due on the decedent farmer's estate.[11] Forced sales of family farms were a result of the combination of four factors:[12] (1) the increased value of farmland;[13] (2) the increase in size of farms;[14] (3) the lack of liquidity due to the low rate of return on agricultural assets;[15] and

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there were twice as many businesses, there was 61% more retail trade, and 20% more people. In addition, the standard of living in the small farm community was higher; there were more newspapers, churches, schools, parks, and civic organizations. Taylor, *supra* note 3, at 489-90. *See* Heady, *supra* note 4, at 829 (non-farm income in a rural community declines when the size of farms increase); Wadley, *supra* note 5, at 497-98 (the stability and welfare of rural communities is directly linked to agriculture).

The average farmer in the United States produces enough food to supply 78 persons for a year. U.S. NEWS & WORLD REP., Aug. 15, 1983, at 57.

8. Farmers make up our nation's largest industry. With total assets greater than one trillion dollars, agriculture is bigger than the automobile, steel, and housing industries combined. The 22 million people that work in agri-business comprise the nation's largest labor force. In addition, agriculture exports account for the greatest share of the foreign exchange. U.S. NEWS & WORLD REP., Aug. 15, 1983, at 57.

Kansas' 76,000 farms brought in gross receipts of $6.1 billion in 1981 to yield a net farm income of $403.8 million. Atchison Daily Globe, June 15, 1982, at 1. Farm assets in Kansas for 1981 totaled $35.7 billion. However, it should be mentioned that total farm debt exceeded $6.4 billion. STATISTICAL DIVISION OF THE KANSAS DEPARTMENT OF AGRICULTURE, 65th ANNUAL REPORT AND FARM FACTS 241 (1982).

Rural communities suffer when the farm economy is bad. It is estimated that one small town business closes for every six farmers that quit farming. Taylor, *supra* note 3, at 487 (quoting N.Y. Times, Dec. 28, 1971 at 28, col. 1-2 (editorial)).

9. D. KAHN & L. WAGGONER, FEDERAL TAXATION OF GIFTS, TRUSTS AND ESTATES 8 (1978). These studies were done by the American Law Institute, the Treasury Department, and the American Bankers Association. These studies are printed, respectively, in American Law Institute, *Federal Estate and Gift Taxation: Recommendations and Reporters' Studies* (1969); JOINT PUB., HOUSE COMM. ON WAYS AND MEANS AND SENATE COMM. ON FINANCE, 91ST CONG., 1ST SESS. 10 (Comm. Print 1969); *Federal Estate and Gift Taxes: Public Hearings and Panel Discussions Before the House Committee on Ways and Means*, 94th Cong., 2d Sess. 63 (1976).

10. *See supra* note 9.

11. *See* Bock & McCord, *Estate Tax Valuation of Farmland Under Section 2032A of the Internal Revenue Code: An Analysis of the Recently Proposed Treasury Regulations*, 1978 S. ILL. U.L.J. 145, 147 (estates were forced to sell out because the tax value of the land did not bear a reasonable relationship to the earning capacity of the farm); Childs, *Valuation of Real Property Based on Farm or Other Business Use: How Well do the Proposed Regulations Trace with the Internal Revenue Code Provisions and Existing Case Law?*, 25 S.D.L. REV. 528, 529 (1980) (I.R.C. § 2032A was added to the estate tax provisions to stop the forced sale of farmland to pay the federal estate taxes).

12. *See* Begleiter, *supra* note 4, at 18-19.

13. Nationally, from 1972 to 1977 the average value per acre of farmland rose 112%. The average value of Kansas farmland per acre for that same time period increased 132%. U.S. NEWS & WORLD REP., Feb. 7, 1977, at 61. In 1977 the average value per acre of cropland in Kansas was $406; by 1981 that same acre was worth $676. Pasture land rose from $258 per acre to $372 per acre. STATISTICAL DIVISION OF THE KANSAS DEPARTMENT OF AGRICULTURE, 65TH ANNUAL REPORT AND FARM FACTS 242 (1982).

14. For example, the average farm size in Kansas in 1982 was 638 acres. This compares to an average of 574 acres in 1970, 456 acres in 1960, and 374 acres in 1950. STATISTICAL DIVISION OF THE KANSAS DEPARTMENT OF AGRICULTURE, 65TH ANNUAL REPORT AND FARM FACTS 115 (1982).

15. In addition to the low earnings-to-asset ratio, land and machinery make up a large percentage of a farmer's assets. The unavailability of liquid assets has meant that many estates must sell the land to obtain cash in order to pay the estate taxes. *See* Begleiter, *supra* note 4, at 21-22;

(4) the traditional method of valuing real property at its fair market value.[16] As a result of the studies and the pressure placed on Congress to alleviate the estate tax burden on farmers, an Internal Revenue Code (I.R.C.) section was created by the Tax Reform Act of 1976[17] to provide a special method to value real property used in farming.[18] The purpose of this Note is to describe the requirements and procedures that must be met in order to qualify for § 2032A Special Use Valuation.

II. BACKGROUND OF § 2032A

Section 2032A provides that farmland[19] is to be valued for estate tax purposes on the basis of its current farming value rather than on the basis of its fair market value at its highest and best possible use.[20] Congress enacted this

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Hartley, *Final Regs. under 2032A: Who, What, and How to Qualify for Special Use Valuation*, 53 J. TAX'N 306-07 (1980).

However, it has been asserted that liquidity is not a major problem in paying farm estate taxes. A study in Iowa concluded that there was not a liquidity problem "among the 64 *probate* estates which were examined. There was a *potential* liquidity problem among *living farmers*, however . . . the difference in liquidity appears to show merely that farm operators generally acquire greater amounts of liquid assets between retirement and death." Begleiter, *supra* note 4, at 22-23 n.39 (quoting *Contemporary Studies Project: Large Farm Estate Planning and Probate in Iowa*, 59 IOWA L. REV. 794, 928-29 (1974) (emphasis in original)). *See* Hjorth, *Special Estate Tax Valuation of Farmland and the Emergence of a Landholding Elite Class*, 53 WASH. L. REV. 609, 619 (1978).

16. *See* I.R.C. § 2031(a) (1954). *See also infra* note 20.

17. Pub. L. No. 94-455, § 2003, 90 Stat. 1520 (1976).

18. In effect, § 2032A was a result of the evolving judicial response to the overvaluation of agricultural estates. The courts began to view valuation like that of the appraisers, rather than that of the "highest and best use." *E.g.*, United Virginia Bank v. United States, 74-1 U.S. Tax. Cas. (CCH) ¶ 12,972 (E.D. Va. 1974) (the court agreed with the executor's value; the property was not suitable for subdivision and the acreage was not great enough to be used for successful farming purposes); Estate of Chloe A. Nail, 59 T.C. 187 (1972) (the Tax Court considered the taxpayer's income capitalization approach as well as the comparative sales approach in valuing farmland; the court was reluctant in accepting the full speculative value as determined by the I.R.S.); Estate of J.S.A. Spicer, 33 T.C.M. (CCH) 45 (1974) (the court relied heavily on the sale of comparable properties to determine the estate's fair market value); Estate of Ethel C. Dooley, 31 T.C.M. (CCH) 814 (1972) (the I.R.S. appraiser relied only upon the sale of comparable property to determine the fair market value of ranchland). For the history of the judicial response to the valuation of farm estates at fair market value, see Kelley, *Valuation of Farm and Ranch Land after the Tax Reform Act*, 1979 AGRIC. L.J. 75, 78; Kelley, *Estate Tax Reform and Agriculture*, 7 U. TOL. L. REV. 897, 911-14 (1976).

Introduced in Congress at the same time as the special use valuation were a number of other bills that would have increased the estate tax exemption amount for farmers. *See* Kelley, *Estate Tax Reform and Agriculture*, 7 U. TOL. L. REV. 897, 902-11 (1976).

19. I.R.C. § 2032A (1954) also allows an estate to elect special use valuation for small, closely held businesses. *See* J. KASNER, POST MORTEM TAX PLANNING 6-55 (1982) (defining what constitutes a trade or business other than farming). Treas. Reg. § 20.2032A-3(b) (1981) states that "the term trade or business applies only to an active business such as manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities, as distinguished from passive investment activities." *Id.* This regulation further provides that the term is not as broad as the definition under I.R.C. § 162 (1954) (trade or business expenses), and does not include non-profit activities. *Id.*

20. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. One of the most important factors used in determining fair market value is the highest and best use to which the property can be put.

STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 536 (Comm. Print 1976) [hereinafter cited as JOINT COMM.].

Three methods of appraisal have been used to determine the highest and best possible use: (1) the market data approach (value is based on recent arms-length sales of similar property); (2) the capitalization of income approach (value is based on the interest rate and the return neces-

code section to attack the problem of forced sales due to high estate taxes and liquidity problems.[21] In valuing farmland on the basis of its *use*, inflationary and speculative value is eliminated.[22] The value of the gross estate from

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sary to recover the investment); and (3) the cost of production or replacement (used where the property is of a unique purpose). *See* Kelley, *Farmland Values for Estate Tax Purposes*, 22 PRAC. LAW. 11 (1976); Tucker, *Estate and Income Tax Planning for Real Property Ownership*, 4 NOTRE DAME EST. PLAN. INST. 159, 162-63 (1980).

Section 2032A is available only to the estate of decedents dying after 1976. *See* Estate of Hawkins v. Commissioner, 42 T.C.M. (CCH) 229 (1981).

21. *See supra* note 15 and accompanying text. In spite of the tax relief afforded to farmers and the general acclaim special use valuation has received, § 2032A has also been severely criticized. Professor Roland Hjorth of the University of Washington maintains that special use valuation will create a landholding class because only the wealthy will benefit. Section 2032A "will contribute to the decline and possible demise of the family farm" because it discourages land sales. The demand for land will increase, and the supply of land in the market is reduced. As a result, the price of land will be driven up so that only those with independent sources of wealth will be able to purchase realty. Hjorth, *supra* note 15, at 612-13, 658-59.

However, data prepared by Steven Matthews and Randall Stock shows that the average farmer, and not the wealthy, realizes the most savings from § 2032A:

Taxable Estate*	Estate Tax Bracket on Top Dollar	Estate Tax Savings	Savings as Percent of Taxable Estate
$ 750,000	37%	$177,500	24%
1,000,000	39%	190,000	19%
1,250,000	41%	200,000	16%
1,500,000	43%	210,000	14%
2,000,000	45%	225,000	11%
2,500,000	49%	245,000	10%
3,000,000	53%	265,000	9%
3,500,000	57%	285,000	8%
4,000,000	61%	305,000	8%
4,500,000	65%	325,000	7%
5,000,000	69%	345,000	7%
Over 5,000,000	70%	350,000	7%

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

Matthews & Stock, *Section 2032A: Use Valuation of Farmland for Estate Tax Purposes*, 14 IDAHO L. REV. 341, 356-57 (1958). In addition, it is often disadvantageous for large farm operations to elect special use valuation. *See infra* note 27.

Section 2032A is also criticized in that as more farms stay intact and there are fewer land transfers, young farmers and tenant farmers will not have many opportunities to purchase land. Only those young persons who have landholding parents will be able to farm. Matthews & Stock, *supra* at 356-57. Persons over fifty years of age own almost 70% of the farmland, and about 80% of the beginning farmers inherit all or part of a farm. Wadley, *supra* note 5, at 499.

22. The joint committee succinctly summarizes the purpose of § 2032A as follows:

> Valuation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming . . . not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes. Also, where the valuation of land reflects speculation to such a degree that the price of land does not bear a reasonable relationship to its earning capacity, the Congress believed it unreasonable to require that this "speculative value" be included in an estate with respect to land devoted to farming . . . .

JOINT COMM., *supra* note 20, at 536-37. In Private Letter Rul. 8041016 (June 30, 1980) the Treasury Department stated that the two primary purposes of § 2032A were (1) to encourage the continuation of the family farm by basing its value at its use value, and (2) provide a relief measure so

which estate taxes are calculated is thus substantially reduced.[23] The intent of Congress is clearly reflected in the General Explanation of the Tax Reform Act. "[W]hen land is actually used for farming purposes . . . it is inappropriate to value the land on the basis of its potential "highest and best use" especially since it is desirable to encourage the continued use of property for farming . . . ."[24]

While the concept of § 2032A is simple, its application is complex.[25] Premortem tax planning is necessary in order to comply with the numerous re-

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that the estate does not have to sell the farm due to the lack of liquidity. *See* Childs, *supra* note 11, at 529; Hartley, *supra* note 15, at 306.

Speculative value especially occurs where farmland is located near a metropolitan area and the "highest and best use" of the realty would be its value as residential property. *See* Matthews & Stock, *supra* note 21, at 341; Comment, *Valuation of Farmland For Estate Tax Purposes: A Consideration of Section 2032A and the New Treasury Regulations*, 27 LOY. L. REV. 140, 142 (1981).

It has been suggested that the policies pursued by the USDA tend to promote large farms instead of the traditional small farm. *See* Wadley, *supra* note 5, at 500. It appears that the Agriculture and Treasury Departments may be pursuing conflicting goals.

The Treasury Department under the Carter Administration contended that special use valuation was only meant to apply to those instances where non-agricultural use caused inflation of the farm fair market value. Thus, special use valuation could only be elected by those small number of farms located in metropolitan areas. The expansive amendments to § 2032A liberalizing its requirements indicate that Congress intended special use valuation to apply to farms across the board. *See* Bellatti, *Special Use Valuation: How Will it be Affected by the Tax Act?*, 120 TRUSTS & EST., Dec. 1981, at 44. *See also* Comment, *Taxation: The Economic Recovery Tax Act of 1981: Its Estate, Gift, and Business Planning Implications for the Agricultural Sector*, 35 OKLA. L. REV. 721, 738 (1982) (section 2032A is especially valuable for land located near large cities, but because of the valuation methods used, farmland in rural areas also realize significant estate tax savings).

Other factors in addition to urbanization that are not connected with agricultural profitability but have inflated the price of farmland include investment in land by non-farmers as an inflation hedge, and the purchase of land for psychological satisfaction. *See* Kelley, *Valuation of Farm and Ranch Land after the Tax Reform Act*, 1979 AGRIC. L.J. 75.

In addition to preventing forced sale of farmland due to pay federal estate taxes, § 2032A may have been enacted because of the growing concern of the loss of America's prime farmland to nonagricultural use. A reduction in estate taxes provides an incentive to keep the farm in the family rather than selling out to urban developers. Over twelve square miles of U.S. farmland are paved over *each day*. U.S. NEWS & WORLD REP. Feb. 2, 1981, at 47. This means that approximately five million acres of agricultural land are lost each year. At this rate, "prime farmland equivalent in area to the entire state of Indiana may be withdrawn from agricultural production between the years 1980 and 2000." 1 J. JURGENSMEYER & J. WADLEY, *supra* note 6, at 67. *See generally id.* at 65-130; Duncan, *Toward a Theory of Broad-Based Planning for the Preservation of Agricultural Land*, 84 NAT. RESOURCES J. — (1984).

23. The average discount on fair market values in Kansas is 39%. Hartley, *supra* note 15, at 308; Matthews & Stock, *supra* note 21, at 346. For example, the estate fair market value of realty for the average size Kansas farm at the average value per acre would be $431,288.00 (638 acres x $676 per acre). *See supra* notes 13 & 14. Under the current estate tax tables, the value of the land alone would yield a tax burden of $132,437.92. I.R.C. § 2001(c) (1954). The average Kansas use value savings is 61% of the fair market value. If § 2032A is elected in the above example, the federal estate tax due is $80,787.13.

24. JOINT COMM., *supra* note 20, at 536-37.

As an alternative to special use valuation to eliminate the speculative value from farmland, it has been suggested that non-profit land trusts be created to protect agricultural land. The trust could acquire the development rights to the land "thereby removing the potential for development and guaranteeing the continued use of the land for agriculture." Barnes, *An Alternative to Alternate Farm Valuation: The Conveyance of Conservation Easements to an Agricultural Land Trust*, 1981 AGRIC. L.J. 308, 309. Removal of development rights to the land located near growing areas would reduce the land's value from its fair market value to its agricultural use value. *Id.*

25. Some of the more complex aspects of § 2032A include the formula used for determining value, finding comparable property, and defining the exact nature of material participation. *See infra* notes 127, 230, & 231 and accompanying text. One author has commented that § 2032A is so complex that "[i]t may have created more problems for farmers than it solved." Begleiter, *supra* note 4, at 111.

quirements and procedures that must be met for the estate to qualify for tax savings.[26] In spite of its complexity, § 2032A is a most valuable estate tax-savings device, and its applicability should never be overlooked.[27]

III. Qualification Requirements

A. *Citizen or Resident*

The first requirement that must be met in order for an estate to qualify for § 2032A special use valuation is that the decedent must have been a citizen or resident of the United States at the time of death.[28] This requirement is a reflection of the basic policy of discouraging foreign investors from purchasing farmland.[29]

B. *Qualified Real Property*

The statute provides that only "qualified real property" of the decedent is eligible for use valuation.[30] Qualified real property is defined as real property

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26. If the estate is not properly planned during the pre-mortem stage, the estate may be unable to qualify for special use election. If the requirements are not followed after election in the post-mortem stage, the recapture estate taxes may be triggered. *See infra* notes 255-64 and accompanying text.

27. Several cases of malpractice, including at least one in southeast Kansas, have been brought against attorneys for their failure to advise, or as executors to elect § 2032A.

There are three general situations in which it may not be advantageous to elect special use valuation. First, if it is reasonably anticipated that recapture will occur, the resulting additional estate and income taxes may outweigh any special use benefits. *See infra* notes 250-52 and accompanying text. Secondly, with the increasing amount of uniform credit available; a small estate may not be liable for any estate taxes even with the farm valued at its fair market value. For example, after 1986 when the uniform credit will be $192,800, a $600,000 estate will escape taxes. *See* I.R.C. § 2010 (1954). Coupled with the unlimited marital deduction, taxes can be deferred on an additional $600,000. *See* I.R.C. § 2056 (1954). Finally, since the estate is limited to a $750,000 reduction in value, very large estates probably would not benefit enough from the tax savings to justify complying with the many restrictions imposed by § 2032A on the disposition and management of the property. *See infra* note 217 and accompanying text.

28. Treas. Reg. § 20.0-1(b) (1958) gives the definition of a "resident decedent."

> A resident decedent is a decedent who, at the time of his death, had his domicile in the United States . . . . A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

Id.

While resident aliens are taxed for estate and gift purposes on property located both in the United States and in other countries, *see* I.R.C. §§ 2001(a), 2501(a), 2511(a), nonresident aliens are taxed only on property located in the United states, *see* I.R.C. §§ 2010, 2103, 2511.

29. To allow foreigners the same estate tax benefit would defeat the purpose of encouraging the continuance of the "American family farm." In November 1979 "foreigners owned nearly 10 million acres of U.S. farmland, an area slightly larger than the combined states of Delaware, Connecticut, and New Jersey." 1 J. JUERGENSMEYER & J. WADLEY, *supra* note 6, at 132. The fear of foreign investment and control of agriculture has resulted in laws passed by both state and federal governments designed to restrict foreign ownership of American farmland. *See id.* at 131-64.

30. I.R.C. § 2032A(b) (1954). *See* Thomas, *Special Use Valuation Checklist*, 1981 AGRIC. L.J. 28, 37-41 (1981) (checklist of requirements to be qualified real property). For a general discussion of the requirements needed to constitute qualified real property, see H. DUBROFF & D. KAHN, FEDERAL TAXATION OF ESTATES, GIFTS, AND TRUSTS 181 (3d ed. 1980); R. STEPHENS, G. MAXFIELD, & S. LIND, FEDERAL ESTATE AND GIFT TAXATION 4-45, 4-46 (5th ed. 1983); Comment, *Valuation of Farmland for Estate Tax Purposes: A Consideration of Section 2032A and the New Treasury Regulations*, 27 LOY. L. REV. 140, 144 (1981).

located in the United States[31] which was "acquired from or passed from"[32] the decedent to a "qualified heir."[33] The realty must have been used for a "qualified use"[34] at the time of death by the decedent or by a "member of the decedent's family."[35]

1. *"Acquired from or passed from" the Decedent*

In order to elect § 2032A, there must be a transfer of the property from the decedent to a qualified heir.[36] Property acquired as a result of a bequest, devise, inheritance, or passing to the qualified heir as a beneficiary of a revocable trust meets this transfer requirement.[37] Property received in satisfaction of a pecuniary bequest[38] and property included in the estate under sections 2035,[39] 2036,[40] 2037,[41] and 2038[42] is also treated as having "passed from the decedent." As part of the Economic Recovery Tax Act of 1981 (ERTA),[43] Congress retroactively amended § 2032A(e)(9) to provide that property purchased from the decedent's estate or from a trust that is included in the decedent's gross estate is considered to have passed from the decedent.[44] Ex-

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31. I.R.C. § 2032A(b)(1) (1954).
32. *See infra* notes 43-45 and accompanying text.
33. *See infra* note 46 and accompanying text.
34. *See infra* notes 96-117 and accompanying text.
35. *See infra* notes 46-66 and accompanying text.
36. I.R.C. § 2032A(b)(1) (1954). In addition, a requirement of both the 25 percent and 50 percent tests is that the property must be acquired from or passed from the decedent to a qualified heir. *See infra* notes 67-95 and accompanying text.
37. I.R.C. § 2032A(e)(9)(A) (1954) provides that "property shall be considered to have been acquired from or to have passed from the decedent if such property is so considered under section 1014 . . . ." I.R.C. § 1014 (1954) relates to the basis of property acquired from a decedent and includes the means of conveyance listed.

In addition, I.R.C. § 2032A(e)(9)(C) states that this requirement is met if the property is acquired from a trust. *See generally* J. CLARK, HOW TO SAVE TIME & TAXES IN HANDLING ESTATES, 12-A-3, -4 (1982).
38. In Private Letter Rul. 8117181 (Jan. 30, 1981), a will provided that the property was to be sold and the proceeds divided among the family. The beneficiaries agreed that the property should not be sold and should be divided in kind. The I.R.S. held that the acquisition was the same as their right to receive a pecuniary bequest, and hence was "acquired from the decedent." It must be kept in mind that private letter rulings are the I.R.S.'s opinion on a certain situation presented to it, and pursuant to I.R.C. § 6110(j)(3) (1954) may not be used or cited as precedent.
39. I.R.C. § 2035 (1954) (transfers made within three years of death).
40. I.R.C. § 2036 (1954) (transfers with retained life estates).
41. I.R.C. § 2037 (1954) (transfers taking effect at death).
42. I.R.C. § 2038 (1954) (revocable transfers).
43. Pub. L. No. 97-34, 95 Stat. 172 (1981).
44. This statutory change not only allows the decedent to give a qualified heir an option to purchase the property, but also allows the executor to sell the property to a qualified heir even if not so mandated by the decedent's will. M. WEINBERGER, ESTATE AND GIFT TAXATION AFTER ERTA 56 (1982).

Prior to this amendment, the I.R.S. in Private Letter Rul. 8110023 (Nov. 28, 1980) said that property in which the qualified heir took subject to payment of estate obligations and subject to a charge to make certain cash payments to third persons did not "pass from" the decedent because of the necessity of furnishing consideration. This ruling prevented the common practice of giving the heirs who remained on the farm the option of purchasing the land and other assets from the estate.

If a qualified heir purchases the property from the estate, the qualified heir's adjusted income tax basis is the use value increased by the amount of gain recognized by the estate. I.R.C. § 1040(c) (1984). *See also* Osach, *Economic Recovery Act Changes Enhance the Benefits of Electing Special Use Valuation*, 9 EST. PLAN. 90, 93 (1982). The estate recognizes no gain on the sale except to the extent that the sale price exceeds the fair market value of the property on the day of decedent's death. H.R. REP. NO. 201, 97th Cong., 1st Sess. 170, 177 (1981). An important plan-

pansion of the concept of "passing from" gives the decedent a means by which one heir can receive the family farm and the other heirs are compensated.[45]

2. *Member of the Family*

The definition of "member of the family" is important under § 2032A for two reasons. First, a "qualified heir" is defined as a member of the decedent's family.[46] Thus, members of the decedent's or qualified heir's family are eligible to receive the real property for which use valuation is to be elected and can purchase real property from a qualified heir without recapturing use value benefits.[47] Secondly, the definition of a "member of the family" is important for determining who can satisfy the qualified use[48] and the material participation tests.[49] In satisfying these tests there are two different family groups to be considered, depending on whether the point in time is pre-death or post-death. In the period preceding the decedent's death, those persons who can satisfy the qualified use and material participation tests are the decedent or the members of the decedent's family.[50] In the post-death recapture period, individuals who meet the tests are the qualified heir or the members of the qualified heir's family.[51]

Substantial changes in the definition of family members were made by ERTA.[52] For deaths occurring after 1981, the decedent's "family" now includes his or her spouse, parents, siblings, children, stepchildren, grandchildren, as well as the lineal descendants of any of those persons and the spouse

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ning choice must be made. If the on-farm heirs purchase the property from the estate, they have a low income tax basis for the property for the purposes of depreciation, cost recovery deductions, and for calculating gain or loss on a later sale. If the estate is settled and the property passes to all family members as qualified heirs, their tax basis is equal to use value. If the property is later sold to the on-farm heirs, the selling family members would have a substantial amount of gain from the sale, and the purchasing on-farm heir's tax basis would be equal to the purchase price. *See* Comment, *Taxation: The Economic Recovery Act of 1981: Its Estate, Gift, and Business Planning Implications for the Agricultural Sector*, 35 OKLA. L. REV. 721, 742 (1982).

45. This is frequently the case where, for example, just one of the farmer's sons wants to continue farming. The farmer wishes to pass on the land to that child, yet equally compensate his other children. The amended "passing from" requirement allows that child to purchase from the estate, and the proceeds can then be distributed to the children. *See supra* note 44. In addition, there is some leeway in the manner in which the farmland can be purchased. For instance, in Private Letter Rul. 8206050 (Oct. 21, 1981) (written after the amendment), the I.R.S. stated that the farmland on which the qualified heirs had assumed a mortgage obligation imposed by the executor in order to distribute cash to the other heirs met the "passing from" test.

Several other rulings have dealt with the passing requirement. In Private Letter Rul. 8145031 (Aug. 11, 1981) the I.R.S. took the position that a family settlement which eliminated the requirement of the executor selling the land did not preclude the election of § 2032A. The Service in Private Letter Rul. 8140008 (June 24, 1981) stated that the fact that Indiana had a state law that title to realty passed immediately to the heirs subject to being retaken by the estate representative to pay debts and costs did not disqualify the realty from special use valuation.

46. *See* I.R.C. § 2032A(e)(1) (1954).

47. *See* I.R.C. § 2032A(b)(1) (1954).

48. *See infra* notes 96-117 and accompanying text.

49. *See infra* note 119 and accompanying text.

50. In the pre-death period there must be a qualified use and material participation by the decedent or member of the decedent's family for five of the eight years prior to decedent's death. *See infra* notes 111 & 122 and accompanying text.

51. *See infra* note 256 and accompanying text.

52. ERTA amended § 2032A "in an effort to broaden its scope, cause it to operate more fairly and make it administratively more workable." Kelley, *Rosemary's Baby, or the Rape and Rehabilitation of Section 2032A*, 6 NOTRE DAME EST. PLAN. INST. 813, 815 (1981).

of any lineal descendant.[53] This new definition of family member may require existing wills to be changed in order to qualify for § 2032A. Since the definition is now limited to the lineal parents instead of lineal grandparents, property left to the decedent's aunts, uncles, or first cousins no longer qualifies for special use valuation.[54]

This new definition is broader in that it includes the lineal descendants of a spouse of the decedent or lineal descendants of a spouse of the qualified heir.[55] It should be noted that this change can be used in those situations where the decedent has been married twice and leaves the farm to the second spouse while the descendants of the decedent's first spouse are the material participants.[56] As a result of the amendment, the material participation of the descendants of the first spouse will be attributed to the second spouse so that the latter spouse may qualify for special use valuation and avoid recapture.[57]

Even though the definition of "family member" has been expanded, there are still several situations that must be avoided in order to qualify for § 2032A.[58] For example, the Internal Revenue Service has held that sale

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53. 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 of a parent of such individual, or
(D) the spouse of any lineal descendant described in subparagraph (C).
For purposes of the preceeding sentence, a legally adopted child of an individual shall be treated as the child of such individual by blood.
I.R.C. § 2032A(e)(2) (1954). *See* Uchtmann & Fischer, *Agriculture Estate Planning and the Economic Recovery Act of 1981*, 27 S.D.L. REV. 422, 429-30 (1982) (describing the changes in the definition). *See also* Estate of Cowser v. Commissioner, 80 T.C. 783 (1983) (A grandniece of decedent's predeceased spouse is not a qualified heir. In addition, the "family member" definition is not an arbitrary classification of persons in violation of the fifth amendment to the Constitution.); Rev. Rul. 236, 1981-2 C.B. 172 (the Service has taken the position that the spouses of decedents' children are qualified heirs even if only the spouse, and not the child, survives the decedent); Private Letter Rul. 8304123 (Oct. 28, 1982) (spouse of a lineal descendant of a grandparent was a qualified heir); Private Letter Rul. 8047010 (Aug. 18, 1980) (children of brother and sister of decedent are qualified heirs).
For deaths occuring before 1982, member of the family with respect to an individual included:
(1) Ancestor of such individual;
(2) Spouse of such individual;
(3) Lineal descendant of such individual;
(4) Lineal descendant of grandparent of such individual;
(5) Spouse of lineal descendant of such individual; and
(6) Spouse of lineal descendant of grandparent of such individual.
I.R.C. § 2032A(e)(2) (1954) (prior to amendment by ERTA). For a discussion of the pre-1982 "members of the family" requirement, see 5 N. HARL, AGRICULTURAL LAW 43-163 to 43-165 (1983); Hartley, *supra* note 15, at 307-08; Comment, *An Analysis of the "Actual Use" Valuation Procedure of Section 2032A*, 56 NEB. L. REV. 860 (1977).

54. *But see supra* note 53 and accompanying text.

55. I.R.S. § 2032A(e)(2) (1954).

56. *See* Bellatti, *supra* note 22, at 48.

57. *Id.* Under the prior law the second spouse would not be able to qualify for § 2032A if that spouse or her descendants had not been the active farmers. This amendment was not retroactive, it applies only to the estates of those descedents dying after December 31, 1981. *Id.*

58. One situation that could cause disqualification could arise if the decedent left the farmland to the surviving spouse for life, then to the only son for life, then to son's widow for life, with remainder interest to the grandchildren. If the son is alive at decedent's death, the above named individuals would be members of the decedent's family, and thus be qualified heirs. But if the son predeceased the decedent, the son's wife would not be considered a member of the decedent's family after remarriage. *See* 5 N. HARL, *supra* note 53, at 43-166 n.103.6.

transactions with in-laws will not qualify as family members so as to avoid the recapture tax.[59] In addition, a surviving spouse cannot rely on the farming activities of an in-law to satisfy the material participation requirement.[60]

The definition of "child" has been the subject of various I.R.S. interpretations. The Internal Revenue Code states that a legally adopted child is to be treated the same as a child by blood.[61] However, the 1981 changes did not alter the I.R.S.'s position that a mutually acknowledged child is not included within the definition of family member.[62]

It is important for the practitioner to remember that these definitional changes of the term "family member" apply only to the estates of decedents who die after December 31, 1981.[63] This means that, until 1996 when the 15 year recapture period expires on 1981 estates,[64] two definitions of family members must be complied with.[65] The old definition still applies to the recapture period for those estates of decedents who died before 1982, and the revised definition applies to the estates of those who die after 1981.[66]

C. *Percentage Tests*

1. *The Fifty Percent Test*

Special use valuation can only be elected to reduce the valuation of farm real estate.[67] However, for an estate to qualify for special use valuation, the value of the qualifying realty and related personal property, such as machinery and livestock, must equal at least fifty percent of the adjusted value of the

59. In Private Letter Rul. 8133012 (Apr. 16, 1981) the I.R.S. held that a sale by decedent's widow of specially valued property to decedent's brothers constituted a disposition of the property giving rise to the recapture tax because a sale to the widow's brother-in-law does not qualify as a transfer to a member of the qualified heir's family.

60. *See infra* notes 122 & 188 and accompanying text. As one author has pointed out, it is not an uncommon situation for a farmer to leave the farm to his wife while the decedent's brother or nephew continues the farming operation. Under the current status of the law, these activities by in-laws will not be attributable to the decedent's wife for purposes of the recapture requirements on the decedent's estate or for qualifying the wife's estate for § 2032A. It has been suggested that the definition of family members be amended to include not only the spouse's descendants, but *all* of the spouse's relatives. *See* Bellatti, *supra* note 22, at 48, 50.

61. I.R.C. § 2032A(e)(2) (1954). *See* Private Letter Rul. 8044018 (July 30, 1980) where the I.R.S. held that there was material participation by a family member even though the property was managed by the stepdaughter of the decedent.

62. Private Letter Rul. 8032026 (Apr. 30, 1980). This position was followed in Rev. Rul. 179, 1981-2 C.B. 172 in which the Service held that an acknowledged child under Illinois law was not a qualified heir under § 2032A. The Service has made it clear that there must have been a formal adoption of the child. *See also* Private Letter Rul. 8032026 (Apr. 30, 1980) (a niece of the widow's sister acknowledged as a child of the decedent was not a qualified heir); Private Letter Rul. 8033018 (Apr. 30, 1980) (children of a foster son were not qualified heirs); Private Letter Rul. 8032024 (Apr. 24, 1980) (a child "always recognized as a member of the family" was not a qualified heir because there were no formal adoption proceedings).

63. Pub. L. No. 97-34, § 421(i), 95 Stat. 172, 312 (1981).

64. *See infra* note 256 and accompanying text.

65. This has been criticized by authorities as being unnecessarily complicated. They also argue that all revisions made by ERTA should have been retroactively applied. *See* Bellatti, *supra* note 22, at 48, 50.

66. For excellent sources diagramming family members under the old and new definitions, see 2 ALI-ABA, TAX PLANNING FOR AGRICULTURE 406-08 (1983); [1983] SECTION 2032A—SPECIAL USE VALUATION—TAX PORTFOLIO (BNA) No. 445, at worksheets 7-12.

67. "[T]he value of qualified *real property* shall be its value for the use under which it qualifies . . . ." I.R.C. § 2032A(a)(1) (1954) (emphasis added).

gross estate.[68] In addition, two other requirements must also be met.[69] The real or personal property must have been used for a qualified use[70] by the decedent or a member of the decedent's family[71] on the date of death, and acquired from or passed from[72] the decedent to a qualified heir.[73]

Calculation of whether the fifty percent test is met is based on a simple fraction. The numerator is the adjusted value of certain qualified use real and personal property, and the denominator is the adjusted value of the gross estate.[74] The value of the gross estate[75] must be computed as the fair market value of the property at the date of death based upon the property's highest and best use.[76] After the fair market value of the property is determined by the usual valuation methods,[77] the value of the property in both the numerator and denominator is reduced by the allowable unpaid indebtedness[78] attributable to that property to arrive at its "adjusted value."[79] If only a portion of the

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68. I.R.C. § 2032A(b)(1)(A) (1954). Several Private Letter Rulings have dealt with the question of what is considered to be real or personal property. *See* Private Letter Rul. 8221005 (Feb. 16, 1982) (the balance due on a land contract cannot be considered as real property, and is not eligible for special use valuation); Private Letter Rul. 8223004 (Feb. 10, 1982) (the value of a remainder interest in farmland or personal property, where the life interest is not being valued, cannot be considered in determining whether the percentage tests are met); Private Letter Rul. 8115015 (Dec. 19, 1980) (a note receivable that is secured by farmland is not considered as real or personal property for purposes of meeting the fifty percent test).

69. (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.

I.R.C. § 2032A(b)(1) (1954).

70. *See supra* note 69; *infra* notes 96-117 and accompanying text.

71. *See supra* note 69 & notes 46-66 and accompanying text.

72. *See supra* note 69 & notes 36-45 and accompanying text.

73. *See supra* notes 46 & 69. *See also* Thomas, *supra* note 30, at 41-44 (checklist of items to meet the fifty percent test).

74. The fraction can be expressed as follows:

$$\frac{\text{adjusted value of qualified real and personal property}}{\text{adjusted value of gross estate}}$$

75. "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." I.R.C. § 2031(a) (1954). For items included in the gross estate see I.R.C. §§ 2032-2046 (1954).

76. *See supra* note 20. *See also* M. WEINBERGER, *supra* note 44, at 51.

77. *See supra* note 20.

78. To determine the adjusted value of the gross estate and the adjusted value of the qualified real and personal property, the value of such property is "reduced by any amounts allowable as a deduction in respect to such property under paragraph (4) of Section 2053(a)." I.R.C. § 2032A(b)(3) (1954).

I.R.C. § 2053(a)(4) (1954) provides:

[T]he value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate.

Id.

79. The term "adjusted value of the gross estate" does not mean the same as "adjusted gross estate." The latter means the gross estate reduced by funeral expenses, administrative expenses, decedent's obligations, indebtedness against the estate, taxes, casualty and theft losses, and medical expenses. *See* N. HARL, *supra* note 53, at 44-1.

Liens and encumbrances such as mortgages, deeds of trust, and mechanics' liens are deducted

property is included in the decedent's estate, then only that portion of the encumbrance is deducted.[80]

If the adjusted value of the real and personal property used as a farm or for farming purposes is equal to at least fifty percent of the adjusted value of the gross estate, this test has been met.[81] Some planning may be necessary to insure that the gross estate will contain the requisite property to qualify. For example, the farmer may want to shift from secured to general unsecured debts which are not deducted from the value of the property.[82] Another strategy is to purchase land or related farm personalty with cash or with the proceeds from the sale of non-farm assets.[83] Still unanswered is whether inventory held for consumption or sale, such as livestock or stored grain, is to be considered as qualified personal property.[84] It is also important to remember that growing crops are generally not valued with the qualified farm land.[85]

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against the value of the realty. Since the numerator of the fifty percent test also includes personalty, encumbrances such as chattel mortgages against equipment and pledges against personal assets to secure business loans should be deducted. Large encumbrances may so reduce the value of the qualified use property in the numerator to fail to equal at least fifty percent of the adjusted value of the gross estate. *See* J. KASNER, *supra* note 19, at 6-60.

80. In Estate of Fawcett v. Commissioner, 64 T.C. 889 (1975), the decedent signed a note secured by a deed of trust against his ranch. The decedent then conveyed a life estate in one-half of the ranch equally to his four children, remainder in trust for their children, keeping an undivided one-half interest in the realty. The decedent's estate deducted the entire outstanding balance of the note from the gross estate as a mortgage owned by the estate. The court held that since only one-half of the mortgaged property was included in the estate, the gross estate could be reduced by only one-half of the outstanding debt.

In Rev. Rul. 302, 1979-2 C.B. 328, the decedent and spouse owned property as joint tenants with right of survivorship and were jointly liable for a mortgage on the property. The I.R.S. ruled that the decedent's estate could deduct one-half of the balance due on the unpaid mortgage, despite the fact that the decedent had made all the payments prior to death.

In Private Letter Rul. 8120017 (Feb. 3, 1981) the Service explained how to calculate the estate tax deduction for a mortgage on estate property where the property has been specially valued. The deduction allowed under § 2053(a) for debt in respect of specially valued property is limited to the amount of the total unpaid mortgages and other indebtedness on that property which bears the same ratio to the total debt as the special use value bears to the fair market value of the property.

81. *See supra* note 79. While trades or businesses other than farming may qualify for special use valuation, *see supra* note 19, the properties of separate businesses cannot be aggregated to determine if the farmland in the estate qualifies for special use valuation. In Estate of Geiger v. Commissioner, 80 T.C. 484 (1983) the decedent's hardware store and farm property combined constituted 53 percent of the adjusted value of the gross estate. The court held that only the farm property and not the property of the unrelated business could be used to determine whether the estate met the 50 percent test to specially value the farmland. In this case the value of the farm property comprised only 42 percent of the adjusted value of the gross estate.

82. Shifting to unsecured debts increases the value of the property required to meet the fifty percent test. In Rev. Rul. 302, 1979-2 C.B. 328 and Private Letter Rul. 8108179 (Nov. 28, 1980) the I.R.S. ruled that the deduction for secured indebtedness is reduced proportionally to that reduction in value from fair market value to special use value. *See* 5 N. HARL, *supra* note 53, at 43-161; J. KASNER, *supra* note 19, at 6-59.

83. Purchasing qualified real and personal property increases the numerator in the fifty percent fraction to yield a greater percentage of the adjusted value of the gross estate. *See supra* note 74. The same result could be achieved by making gifts of the nonfarm property. However, the value of these gifts is pulled back into the gross estate under I.R.C. § 2035(d)(3)(B) (1954) if the decedent dies within three years after making the gifts.

84. *See* ALI-ABA, TAX PLANNING FOR AGRICULTURE 654 (1981) (article author Orville W. Bloethe believes that farm inventories are considered as qualified personal property). Treatment of inventories as qualified personal property would enable more estates to meet the fifty percent test. In view of the 1981 amendments liberalizing the requirements for § 2032A election, it is likely that courts will consider farm inventories to be qualified personal property.

85. *See* R. STEPHENS, G. MAXFIELD, & S. LIND, *supra* note 30, at 4-52 to 4-53. The value of growing crops should, however, be included as personal property. *Id.*

2. *The Twenty-Five Percent Test*

After the fifty percent hurdle has been cleared, it must be shown that at least twenty-five percent of the adjusted value of the decedent's gross estate[86] consists of the adjusted value of real property.[87] This real property must have been acquired from or passed from[88] the decedent to a qualified heir[89] and owned by the decedent or a member of the decedent's family[90] during at least five of the eight years immediately preceeding the decedent's death.[91] In addition, during that period the property must have been used for farming purposes[92] in which there was material participation[93] by the decedent or a member of the decedent's family.[94] While the fifty percent test considers both the real and personal property that was devoted to the qualifying use, the twenty-five percent test mandates that at least a quarter of the decedent's estate must be comprised of realty for farming purposes.[95]

D. *Qualified Use*

In order to meet the fifty and twenty-five percent tests the qualifying real and personal property must have been used as a farm[96] or for a farming pur-

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86. *See supra* notes 75 & 79.

87. I.R.C. § 2032A(b)(1)(B) (1954). The "adjusted value" for purposes of the twenty-five percent test is the same as for the fifty percent test. *See supra* notes 78 & 79 and accompanying text.

88. *See supra* notes 36-45 and accompanying text.

89. *See supra* note 46 and accompanying text.

90. *See supra* notes 46-66 and accompanying text.

91. I.R.C. § 2032A(b)(1)(B), (C) (1954). The purpose of the five of eight years pre-death requirement is to prevent farmers from acquiring land just to take advantage of the special use valuation benefits. *See* 5 N. HARL, *supra* note 53, at 43-187. For property acquired in like-kind exchanges or as a result of an involuntary conversion, see *infra* notes 242 & 243 and accompanying text.

92. *See infra* note 97 and accompanying text.

93. *See infra* note 119 and accompanying text.

94. I.R.C. § 2032A(b)(1)(C)(ii) (1954). *See* Thomas, *supra* note 30, at 44-45 (checklist to meet the twenty-five percent test).

95. Treas. Reg. § 20.2032A-8(a)(2) (1981) states that the election need not include all the real property in the estate, but must include only that amount of realty sufficient to satisfy the twenty-five percent requirement. This regulation is an important planning device for especially those estates which have a high percentage of qualifying realty compared to the gross estate. For instance, if the qualified heirs are likely to dispose of certain parcels of land within the recapture period, these parcels can be excluded from the election, thus avoiding recapture tax, if the remaining realty satisfies the twenty-five percent test. *See* J. KASNER, *supra* note 19, at 6-83. *See also* Private Letter Ruls. 8049014 (Aug. 28, 1980), 8045017 (July 30, 1980), 8041016 (June 30, 1980) (an election may be made for less than all of the qualified real estate so long as the twenty-five percent requirement is met).

It has been suggested that the twenty-five percent minimum election requirement be eliminated, because "[i]f the estate qualifies for special use valuation, then the executor should be permitted to elect special use valuation on any part or all of the qualifying real property." Bellatti, *supra* note 22, at 51.

96. A farm is broadly defined as including "stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses, or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands." I.R.C. § 2032A(e)(4) (1954). It is interesting to compare this definition to the definition of farming in KAN. STAT. ANN. § 17-5903(g) (1981).

> "Farming" means the cultivation of land for the production of agricultural crops, the raising of poultry, the production of eggs, the production of milk, the production of fruit or other horticultural crops, grazing or the production of livestock. Farming does not include the production of timber, forest products, nursery products, or sod, and farming does not include a contract to provide spraying, harvesting, or other farm services.

Id.

pose. The term "farming purpose" is defined under the statute to include cultivation of the soil, raising or harvesting any agricultural or horticultural commodity, and the raising, shearing, feeding, caring for, training, and management of animals.[97] The handling, drying, and packing of agricultural and horticultural commodities in an unmanufactured state are also considered to be farming purposes.[98] Finally, this section was amended by ERTA to include within the definition the planting, cultivating, caring for, and cutting of trees for market.[99] The qualified use requirement envisions activity rather than passive income derived from farming.[100] However, Congress has specifically stated that farmland removed from production under the Payment-in-Kind (PIK) program[101] is to be treated as used in an active farming, qualified use.[102]

In addition to land, qualified use realty may include a residence on the qualified land if three requirements are met.[103] First, the residential building is located on or contiguous to qualified real property;[104] secondly, the real property on which the residence is located is qualified real property;[105] and finally, the residence was occupied on a regular basis by the owner or lessee, or

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97. I.R.C. § 2032A(c)(5) (1954).

98. However, the owner, tenant, or operator must regularly produce more than half of the commodity being treated. *Id.*

99. I.R.C. § 2032A(e)(13)(C) (1954). Prior to ERTA the I.R.S. in Private Letter Rul. 8046012 (Aug. 8, 1980) took the position that merchantable timber and young growth were not qualified real property, but were to be valued at fair market value as growing crops.

For decedents dying after 1981, the executor can now elect to have the trees growing on qualified realty treated as part of the qualified use property rather than as a growing crop. I.R.C. § 2032A(e)(13) (1954). To be a qualified woodland, the woodland must be an identifiable area used as a timber operation for planting, cultivating, caring for, and cutting trees, or preparing them for market. Once made, this election is irrevocable. I.R.C. § 2032A(e)(13)(B), (D) (1954). *See* J. CLARK, *supra* note 37, at 12A-S.

100. Under Section 2032A, the term trade or business applies only to an active business such as a manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities, as distinguished from passive investment activities. The mere passive rental of property will not qualify. The decedent must own an equity interest in the farm operation.

Treas. Reg. § 20.2032A-3(b)(i) (1981). *See* 2 ALI-ABA, TAX PLANNING FOR AGRICULTURE 414 (1983). It has been said that to have an equity interest the decedent must in some way be involved in risk-taking. *See* Hartley, *supra* note 15, at 309.

For example, cash rental to an unrelated party in the pre-death period or to someone other than the qualified heir in the post-death period is considered to be passive and not a qualified use. *See* 5 N. HARL *supra* note 53, at 43-154 to 43-15; *infra* notes 113 & 116. *See also infra* notes 184-92 and accompanying text (present interest requirement).

101. Under the Payment-in-Kind (PIK) program, farmland which would be used to produce certain crops is diverted from production. As compensation, producers are provided a quantity of a commodity for diverting acreage normally planted in that commodity. *See* H.R. REP. No. 14, 98th Cong., 1st Sess. 6 (1983).

102. *See id.* at 22. Farmland diverted under PIK is also considered as qualified use property to meet the percentage tests. *Id. See supra* notes 68 & 86 and accompanying text.

103. *See* I.R.C. § 2032A(e)(13) (1954); R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 30, at 40-50 to 40-51.

104. The report by the Committee on Ways and Means states that "residential buildings or related improvements shall be treated as being on the qualified real property if they are on real property which is contiguous with qualified real property or would be contiguous with such property except for the interposition of a road, street, railroad, stream, or similar property." H.R. REP. No. 1380, 94th Cong., 2d Sess. 24 n.2, *reprinted in* 1976-3 C.B. 744, 758 n.2.

105. I.R.C. § 2032A(b) (1954). In addition, the decedent or a member of decedent's family must have owned the property, used it for a qualified use, and have been involved in material participation. *Id.*

employee of either, for the purpose of operating or maintaining the property for farming use.[106] Also included as qualified realty are roads, buildings, and other structures and improvements that are functionally related to the qualified use.[107] However, it has been made clear that mineral rights and oil leases are not considered to be functionally related to the purpose of farming and therefore cannot be considered for qualified use.[108]

The qualified use test is essentially two tests: there must be qualified use for two points in time[109] for a certain length of time.[110] Qualified use of the property must exist at the time of decedent's death and for at least five of the last eight years prior to death.[111] In addition, there must be continuous qualified use of the property during the ten year post-death recapture period.[112] A two-year grace period is allowed after death before continuous qualified use by the qualified heir must begin.[113] The recapture period is then extended for the length of time between the decedent's death and before commencement of use not exceeding two years.[114]

ERTA also amended the qualified use section by providing that the qualified use test in the pre-death time period can be satisfied by the decedent or a member of the decedent's family.[115] As a result of this change, the decedent is able to cash rent the farm to a materially participating family member and still meet the qualified use test.[116] However, it must be noted that the continuous

106. I.R.C. § 2032A(e)(3) (1954). If the residence was occupied by the owner, the owner need not have been materially participating in the operation of the farm for the residence to be qualified use property. Treas. Reg. § 20.2032A-3(b)(2) (1980) states that if the decedent occupies a residence it is to be considered to be "occupied for the purpose of operating the farm" even if a family member, and not the decedent, is the person who is materially participating in the operation of the farm. *Id.* However, if the owners retired and moved to town and the farmland was rented to tenants, the tenants must be involved in the operation of the farm for the residence to qualify for special use valuation. For example, Private Letter Rul. 8128017 (Apr. 14, 1981) held that rental of a farmhouse on half an acre of land could not qualify for special use valuation because that half acre was not being used for farming purposes. *See* 5 N. HARL, *supra* note 53, at 43-131; J. KASNER, *supra* note 19, at 6-54 to 6-55.

107. I.R.C. § 2032A(e)(3) (1954); Treas. Reg. § 20.2032A-3(b)(2) (1981).

108. *See* H.R. REP. NO. 1380, 94th Cong., 2d Sess. 24, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 3356, 3378. Hunting rights are not related to farming and must be valued for estate tax purposes at their fair market value. *See* Hartley, *supra* note 15, at 309.

109. *See* I.R.C. §§ 2032A(b)(1)(A)(1),(c)(1) (1954).

110. *See* I.R.C. § 2032A(b)(1)(C) (1954).

111. *See* I.R.C. §§ 2032A(b)(1)(A)(i), (c)(i) (1954). There must also be material participation by the decedent or a member of decedent's family for five of the eight years prior to the decedent's death, retirement, or disability. I.R.C. § 2032A(b)(1)(C)(ii) (1954). *See infra* note 122 and accompanying text.

112. I.R.C. § 2032A(c)(6)(A) (1954). Cessation of use triggers the recapture provisions. *See infra* notes 246-52 and accompanying text. The recapture period is ten years after the commencement of the qualified heir's qualified use, or until the qualified heir's death. I.R.C. § 2032A(c)(1) (1954).

113. I.R.C. § 2032A(c)(7) (1954). It is stated that the purpose of the two-year grace period is to allow a sufficient amount of time to convert a cash rent lease to a family member to a crop-share lease. A cash rent to a family member in the pre-death period satisfies the qualified use test. However, in the post-death recapture period a qualified heir must an equity interest in the farming operation in order to satisfy the qualified use requirement. *See* Private Letter Rul. 8408020 (Nov. 21, 1983) (cash renting to an unrelated party prior to death was not a qualified use); [1983] SECTION 2032A—SPECIAL USE VALUATION—TAX PORTFOLIO (BNA) No. 445, at A-11. *See infra* notes 116 & 117 and accompanying text.

114. I.R.C. § 2032A(c)(7)(A)(ii) (1954).

115. I.R.C. § 2032A(b)(1) (1954). This provision is retroactive to decedents dying after 1976. *See* J. CLARK, *supra* note 37, at 12A-3.

116. This statutory change followed Treasury Department News Release R-147, Apr. 27, 1981,

qualified use in the post-death period must be by the qualified heir.[117]

E. *Material Participation*

1. *In General*

The "material participation" requirement is the means by which Congress limited the applicability of § 2032A so as to carry out its purpose.[118] Material participation is the method by which active involvement by the decedent or a member of the decedent's family, or by the qualified heir is measured.[119] This requirement is not clearly defined, and its application is a primary cause of failure for those estates that do not qualify for special use valuation.[120]

Like the qualified use requirement, material participation is a condition precedent and a condition subsequent.[121] First of all, to qualify for special use election the decedent or a member of the decedent's family must materially participate for at least five of the eight years preceeding the decedent's death, disability, or retirement.[122] Secondly, in order to avoid recapture of the estate tax benefits during the ten year post-death period,[123] there must not be periods aggregating more than three years during any eight year period[124] ending after

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which announced that qualified use could be made by the decedent or a member of decedent's family. Prior to this time the I.R.S. indicated that to meet the qualified use test the decedent must have an "equity interest" in the farm operation. Thus, cash renting the family farm to the decedent's child did not satisfy the qualified use requirement as there was no equity interest present. *See supra* note 100 and accompanying text.

117. *See supra* notes 106 & 113. It has been recommended that the regulations be amended to provide that "qualified use after the decedent's death can be made by either the qualified heir or a family member of the qualified heir." Bellatti, *supra* note 22, at 50. *See also* Bravenec & Guyton, *Special Use Valuation Regulations to be Amended*, 1982 AGRIC. L.J. 356, 358 (discussion of equity interest requirement for pre-death qualified use).

118. Special use valuation was designed for estates in which the decedent's trade or business was farming. Material participation eliminates those estates from qualifying in which farmland is a mere passive investment. *See supra* note 100 and accompanying text.

119. *See supra* notes 46-66 and accompanying text.

120. *See* Thomas, *supra* note 30, at 45-55 (general checklist of things to do to meet material participation).

121. *See supra* notes 111 & 112 and accompanying text. An example of the connection between the condition precedent and condition subsequent participation requirements follows. Assume the following facts: Farmer purchases land on January 1, 1975 and operates it through 1980 (six years). On January 1, 1981 farmer leases it to a non-family member for a three-year term, and then dies on January 1, 1983. On the date of decedent's death the condition precedent is satisfied because there will have been material participation for six of the eight years preceding death. However, since the farmer or a member of his family will not be involved in the farming operation from 1981-1984, there is a period of three years out of an eight year period ending after the decedent's death during which there is no material participation. Thus, the condition subsequent will not be met unless the lease is broken a year early and a family member operates the farm. Hjorth, *supra* note 15, at 629. *See infra* note 124 and accompanying text. For a discussion of farm leases see *infra* notes 157 & 158 and accompanying text.

122. *See* I.R.C. § 2032A(b)(1)(C)(ii), (b)(4) (1954). Short periods of time, 30 days or less, in which there was no material participation are ignored if there were substantial periods of time, 120 days or more, of uninterrupted participation both preceeding and following the period of inactivity. Treas. Reg. § 20.2032A-3(c) (1981). Thus, if the farmer becomes ill or takes a vacation, during which time a family member does not fill in, the farmer may still qualify for special use valuation. *See* Comment, *supra* note 30, at 165.

123. *See* I.R.C. § 2032A(c)(1) (1954); *see infra* note 256 and accompanying text.

124. The time of estate administration is counted in determining whether there is material participation for at least five years of any eight year period ending after the decedent's death. Since "the clock keeps running," this period of time could be important in retaining qualification if the executor is not a family member and the farm during the time of administration is not being run by a family member. *See* 2 ALI-ABA, TAX PLANNING FOR AGRICULTURE 413 (1983).

the decedent's death during which there was no active involvement. Material participation must be by the decedent or a member of the decedent's family in the periods in which the property was held by the decedent,[125] or by the qualified heir or a member of the qualified heir's family in the periods during which the property was held by any qualified heir.[126]

2. *Definitions*

a. *I.R.C. § 1402(c)(1)*

Material participation is not defined in § 2032A itself. Instead, the section provides that material participation is to be determined in a manner similar to the method used in I.R.C. § 1402(a)(1).[127] That section defines net earnings from self-employment for the purposes of computing the tax on self-employment income.[128] There is a presumption that if no self-employment taxes were paid, material participation is presumed not to have occurred.[129]

Section 1402(a)(2) provides that rental income may be characterized as earnings from self-employment[130] subject to the § 1401 tax if the decedent materially participated under a lease agreement.[131] For a farmland owner to qualify as a material participant in a rental relationship, there must be a written or oral arrangement that contemplates actual material participation and

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125. *See* I.R.C. § 2032A(c)(6)(B)(i) (1954).

126. A member of the qualified heir's family can satisfy the post-death material participation requirement, § 2032A(c)(6)(B)(ii), but not the post-death qualified use requirement, § 2032A(c)(1)(B). As can be seen, § 2032A is at times unnecessarily treacherously complex. For an excellent summary of the similarities and differences in pre-death and post-death material participation, qualified use, and active management tests, *see* 2 ALI-ABA, TAX PLANNING FOR AGRICULTURE 417 (1983).

127. I.R.C. § 2032A(e)(6) (1954).

128. The self-employment tax is imposed by I.R.C. § 1401 (1954).

In announcement 83-43, I.R.B. 1983-10, at 29, the I.R.S. stated that farmers must pay self-employment taxes on cash and payments in kind received for participating in and diversion or Payment-in-Kind programs.

129. Treas. Reg. § 20.2032A-3(e)(1) (1981) states that payment of self-employment taxes is not conclusive evidence of material participation. However, if no such taxes were paid, the executor must explain why the tax was not paid and demonstrate that material participation did in fact occur. If self-employment tax was due, all tax, interest, and penalties must be paid. *See* J. CLARK, *supra* note 37, at 124-27; Osach, *supra* note 44, at 91. This presumption may be overcome by showing that the factors listed in the regulations were met. *See infra* note 163 and accompanying text. *See also* Thomas, *supra* note 30, at 93 (example of affidavit of activities constituting material participation).

130. Rentals are considered as self-employment income if:

> (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and furbearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined with and regard to any activities of an agent of such owner of tenant) in the production or the management of the production of such agricultural or horticultural commodities . . . .

I.R.C. § 1402(a)(1) (1954).

131. Thus, in pre-mortem tax planning the farmer must evaluate to determine whether the rental property is needed to meet the 25 percent requirement. *See supra* note 95. If this property is needed, the farmer must assert material participation and include the rentals in calculating self-employment taxes in order to qualify for § 2032A. If this property is not needed for the 25 percent requirement, the farmer can collect the rentals and pay no self-employment taxes. *See* Comment, *supra* note 30, at 161 & n.85.

For a discussion of lease arrangement and material participation, see *infra* notes 157 & 158 and accompanying text.

imposes an obligation to produce an agricultural or horticultural commodity.[132] Material participation results where there is actual participation in the production[133] or the management of production[134] of agricultural or horticultural commodities.[135] Section 1401(a)(1) states that material participation cannot be by an agent, such as a farm manager.[136] However, the regulations under § 2032A suggest that a landowner who is independently involved in decision making may meet this requirement even though a farm manager is employed.[137] The Farmer's Tax Guide, an I.R.S. publication, provides further guidance of what the Service considers to be material participation.[138]

b. *Social Security Act*

The Social Security Act[139] provides for the distribution of benefits, financed by the tax imposed on wages and self-employment income, to those

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132. Treas. Reg. § 1.1402(a)-4(b)(2) (1963); Treas. Reg. § 1.1402(a)-4(b)(3) (1963); *see also* Treas. Reg. § 20.2032A-3(e)(1) (1981).

133. The term "production" . . . refers

> to the physical work performed and the expenses incurred in producing a commodity. It includes such activity as the actual work of planting, cultivating and harvesting crops, and the furnishing of machinery, implements, seed, and livestock. An arrangement will be treated as contemplating that the owner or tenant will materially participate in the "production" of the commodities required to be produced by the other person under the arrangement if under the arrangement it is understood that the owner or tenant is to engage to a material degree in the physical work related to the production of such commodities . . . .

Treas. Reg. § 1.1402(a)-4(b)(3)(ii) (1963).

134. "Management of Production" is defined as follows:

> Services performed in making material decisions relating to the production, such as when to plant, cultivate, dust, spray, or harvest the crop, and making managerial decisions as to matters such as rotation of crops, the type of crops to be grown, the type of livestock to be raised and the type of machinery and implements to be furnished.

Treas. Reg. § 1.1402(a)-4(b)(3)(iii) (1963).

135. *See* Treas. Reg. § 1.1402(a)-4(b)(2), (b)(3) (1963). *See also* R. STEPHENS, G. MAXFIELD, & S. LIND, *supra* note 30, at 4-59.

136. This precludes investors who do not intend to be involved in farming from taking advantage of special use valuation. However, non-farmer investors may meet the material participation requirement if a family member operates the farm. *See* 5 N. HARL, *supra* note 53, at 43-203.

137. Material participation can be satisfied despite the presence of an agent, just so it is not *through* an agent. *See* Treas. Reg. § 20.2032A-3(g) (1981). For example, *H*, an attorney who is a qualified heir with specially valued property, works in town 15 miles from the farm and hires *M* to manage the farm. If *H* supplies all the equipment, pays all of the expenses, approves *M*'s crop plan, and inspects the farm, *H* is deemed to have materially participated. Treas. Reg. § 20.2032A-3(g) example 4. *See* Comment, *supra* note 30, at 163. If a farm manager is employed, for the material participation requirement to be met the landowner must "personally advise or consult with the managing party regarding the operation of the business on a regular basis." *Id.*

138. The Farmer's Tax Guide provides that material participation is deemed to have occurred if any one of the following four tests is satisfied:

> Test No. 1. You do three of the following: (1) advance pay, or stand good for at least half the direct costs of producing the crop, (2) furnish at least half the tools, equipment and livestock used in producing the crop, (3) advise and consult with your tenant periodically and (4) inspect the production activities periodically.
>
> Test No. 2. You regularly and frequently make, or take an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.
>
> Test No. 3. You work 100 hours or more spread over a period of five weeks or more in activities connected with crop production.
>
> Test No. 4. You do things, which, considered in their total effect, show you are materially and significantly involved in the production of the farm commodities.

U.S. DEP'T OF THE TREASURY, I.R.S. PUB. NO. 225, FARMER'S TAX GUIDE 49 (1982).

139. *See* 42 U.S.C. §§ 401 to 431 (1935).

individuals whose income is reduced because of an inability to work.[140] The income of farm owners and farm tenants is eligible for replacement if there was material participation by the farm owner or farm tenant in the production or management of production of agricultural or horticultural commodities.[141] Because the theory behind the Social Security Act is to return payments made pursuant to the tax on self-employment income,[142] the provisions of I.R.C. § 1402(a)(1) are almost identical to those of Social Security Act § 211(a)(1).[143] In addition, the regulations under each defining material participation are substantially similar.[144]

The social security regulations suggest that some physical work is necessary to qualify as material participation.[145] However, several cases imply that in landlord-tenant situations the key factor is the sharing by the landlord of the economic risks involved.[146] If the arrangement requires the owner to make a substantial financial contribution, the landowner satisfies the material participation requirement.[147] For instance, the Fifth Circuit Court of Appeals in *Henderson v. Flemming*[148] said:

[W]e know at least today that agriculture is or may be big business.

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140. *See* 42 U.S.C. § 423 (1935).

141. *See* 42 U.S.C. § 411(a) (1935).

142. *See* 42 U.S.C. § 401 (1935).

143. Section 211(a)(1) of the Social Security Act, codified at 42 U.S.C. § 411(a)(1) (1935), provides that rentals are to be excluded from income unless

> (A) Such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant in the production or management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant with respect to any such agricultural or horticultural commodity.

Id. *See supra* notes 132-35 and accompanying text.

144. *Compare* 20 C.F.R. § 404.1057 (1980) *with* Treas. Reg. § 1.1402(a)-4(b)(2) (1963).

145. The regulation states that one is doing agricultural labor if the work involves "(i) Cultivating the soil; (ii) Raising, shearing, feeding, caring for, training or managing livestock, bees, poultry, fur-bearing animals or wildlife; or (iii) Raising or harvesting any other agricultural or horticultural commodity." 20 C.F.R. § 404.1057 (1980).

146. *See, e.g.*, Celebrezze v. Miller, 333 F.2d 29 (5th Cir. 1964) (farm/owner/landlord who agreed to pay a third of the cost of fertilizer, poisons, and all labor hired, and to absorb one-third of any loss materially participated under the lease to qualify for social security benefits); Bryant v. Celebrezze, 229 F. Supp. 329 (E.D.S.C. 1964) (the landowner did not materially participate; she did not supervise the operation, nor possess the requisite management skills, and did not pay for any of the labor, equipment, machinery, or insecticides); Vance v. Ribicoff, 202 F. Supp. 790 (E.D. Tenn. 1961) (farm owner who supplied all tobacco plants, fertilizer, spray, and barns to dry the tobacco, and who furnished one-half of the seed and fertilizer for hay, and one-third for wheat and corn materially participated under the Social Security Act).

147. *See, e.g.*, Celebrezze v. Maxwell, 315 F.2d 727 (5th Cir. 1963) (farm owner did not qualify for social security benefits because when compared with the expenditures of his tenants, the owner's financial contributions were proportionately small); Bridie v. Ribicoff, 194 F. Supp. 809 (N.D. Iowa 1961) (Congress included the concept of "material participation" in recognition of the fact that many farms are leased in which the landlord makes substantial personal contributions to the farm operation).

148. 283 F.2d 882 (5th Cir. 1960). In this case a 91-year-old invalid widow had an arrangement with her tenants in which she was required to plant the crop. Although the court held that the physical labor could be accomplished through an agent or employee, her son, in this case there was not enough physical work to be considered "material." The arrangement also required the owner to bear the expenses of seed, one-half of the insecticide, fuel, and machinery depreciation. In deciding that there had been material participation, the court emphasized the risks the owner had taken. "One is hardly a mere landlord in the traditional sense if he must risk considerable funds in addition to the land in the success of the venture." *Id.* at 888.

> It takes more than land and a willing hand. It takes working capital, frequently in considerable amounts. An owner of land who is required to (and does) furnish substantial amounts of cash, credit, or supplies toward this mutual undertaking which are reasonably needed in the production of the agricultural commodity and from the success of which we must look for actual recoupment likewise makes a "material participaton."[149]

The regulations give considerable weight to such factors as whether the owner advised, consulted, and inspected in determining the existence of material participation.[150] Case law, however, has generally focused on the aspect of *who* made the final decision, and that advice, consultation, and inspections are only factors in making the final decision.[151]

c. *§ 2032A Regulations*

The regulations accompanying § 2032A provide a two-prong test for material participation to cover different farming operations.[152] If the decedent or a member of the decedent's family is employed as a full-time[153] farmer, there

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149. *Id.*

150. Treas. Reg. § 1.1402(a)-4(b)(3)(iii) (1963) and 20 C.F.R. § 404.1057 (1980) provide that inspections, advice, and consultation are especially important in the making of management decisions.

> Thus, if under the arrangement it is understood that the owner or tenant is to advise or consult periodically with the other person as to the production of the commodities required to be produced by such person under the arrangement and to inspect periodically the production activities on the land, a strong inference will be drawn that the arrangement contemplates participation by the owner or tenant in the management of the production of such commodities. The mere undertaking to select the crops or livestock to be produced or the type of machinery and implements to be furnished or to make decisions as to the rotation of crops generally is not, in and of itself, sufficient. Such factors may be significant, however, in making the overall determination of whether the arrangement contemplates that the owner or tenant is to materially participate in the management of the production of the commodities.

Treas. Reg. § 1.1402(a)-4(b)(3)(iii) (1963). *See* Treas. Reg. § 20.2032A-3(e)(2) (1983).

> As a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and/or family members must participate in making a substantial number of those decisions. Additionally, production activities on the land should be inspected regularly by the family participant, and funds should be advanced and financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm . . . .

Id.

See also Celebrezze v. Benson, 314 F.2d 219 (8th Cir. 1963) (landowner materially participated because she had advised and consulted with her tenant twice a month about the crops, fertilization, spraying, rotation of crops, planting and harvesting, and thus was entitled to social security benefits based on self-employment income derived from that farm); Harper v. Flemming, 288 F.2d 61 (4th Cir. 1961) (the court held that the activities of the bank, as agent for the owner in supervising and advising and consulting the sharecroppers constituted material participation).

151. *E.g.*, McCormick v. Richardson, 460 F.2d 783 (10th Cir. 1972) (farm owner materially participated by making substantial contributions to the management of production which greatly increased the amount of crops produced); Hoffman v. Gardner, 369 F.2d 837 (8th Cir. 1966) (the owner made the decisions concerning the production of crops and finances); Foster v. Celebrezze, 313 F.2d 604 (8th Cir. 1963) (under the lease the landlord had broad management powers); Colegate v. Gardner, 265 F. Supp. 987 (S.D. Ohio 1967) (The Court found that "an elderly maiden lady" materially participated even though consultations and inspections were short because she made the basic farm decisions.). For a discussion of these cases see Begleiter, *supra* note 4, at 46-50.

152. I.R.C. § 20.2032A-3(e) (1981).

153. Full-time is defined as 35 hours a week or more. *Id.*

is material participation.[154] Employment that is less than full-time but is sufficient to fully manage the farm also constitutes material participation.[155] If the farm is not fully operated by the participant as in the case of leased property or property operated by an entity, there must be an arrangement providing for actual participation in the production or management of production in order to meet the material participation requirement.[156]

In order to establish material participation under a lease agreement, the lease should require the landowner to be involved in managerial decisions.[157] It is generally suggested that the landowner be involved in such decisions as what crops to plant, type and levels of fertilizer, insect and weed control, participation in government programs, soil conservation, and tillage practices.[158] If the farm is owned by an entity, such as a corporation, partnership, or trust, an arrangement between the entity and the individual is necessary for the executor to establish material participation by the decedent.[159] The mere fact that an individual serves as an officer or director of the corporation does not establish material participation.[160] "[T]he presence of material participation is

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154. If two or more family members are involved with the operation of the farm, the work of at least one alone must be material; the efforts of the parties cannot be combined to determine if there has been sufficient material participation. *Id.*

155. *Id.* The regulations recognize that some farming operations involve only seasonal activity. In that case, material participation occurs as long as the participant fully performs the necessary functions in the producing season.

156. *See* Treas. Reg. § 20.2032A-3(e)(1),(f)(1) (1983). While the arrangement may be oral, it is wise to formalize the provisions in a written document in order to have proof of the material participation contemplated. Activities that are not dealt with in the agreement cannot later constitute material participation. *Id.*

157. *See supra* notes 150 & 151. For examples of material participation and lease agreements see Treas. Reg. § 20.2032A-3(g) (1980).

158. *See* ALI-ABA, TAX PLANNING FOR AGRICULTURE 667 (1981); N. HARL, FARM ESTATE AND BUSINESS PLANNING 4-17 (1981). These are suggestions only, each lease should be tailored to fit the particular situation at hand.

For a detailed discussion of arrangements involving land leased to and by entities, see 5 N. HARL, *supra* note 53, at 50-100 to 50-109.

159. *See* Treas. Reg. § 20.2032A-3(f)(1) (1983). For a detailed discussion of use valuation by entities, see 5 N. HARL, *supra* note 53, at § 50.06.

The regulations give an example of a person who did not hold a formal position in the corporation, but did own 90% of the stock and spent several hours each day in the corporate office making routine decisions. This was not material participation because his activities were not pursuant to an agreement. Treas. Reg. § 20.2032A-3(g) example 5.

The requisite arrangement may be in any form to show that the decedent materially participated. Examples include an employment or management contract, an agreement to act as trustee, or the control retained by the settlor of a trust. In Private Letter Rul. 8149002 (July 22, 1981), the I.R.S. held that a family member who managed property for an incompetent owner had materially participated even though the family member was not compensated or acting pursuant to a power of attorney, conservatorship, or guardianship, because he was acting under color of authority.

160. *See* Treas. Reg. § 20.2032A-3(f)(2) (1981). This may be so even though the individual paid self-employment taxes income taxes on corporate or partnership earnings. However, whether the individual held a position is one factor to consider in determining material participation. *Id.*

The regulations in this area are not well-defined, and the potential for many problems exists. For example, the regulations do not deal with the situation in which only one of several co-equal partners meets the material participation test.

> It is not clear whether the presence of one co-equal decision maker as a qualified material participator would be sufficient for qualified real property status for all land attributed to the decedent, whether the presence of one or more nonacceptable managers (for material participation purposes) would preclude eligibility for use valuation, or whether the land would become qualified real property on a percentage basis governed by the proportion of all co-equal decision makers who were qualified material participators.

5 N. HARL, *supra* note 53, at 43-216.

determined by looking at the activities of the participant with regard to the property in whatever capacity rendered."[161] If the land to be valued is owned by a trust, there are four situations in which an arrangement for material participation will generally be found.[162]

The regulations state that the following factors will be considered to determine whether material participation exists: physical work, participation in management decisions, advice and consultation, inspection of activities, substantial financial contribution, and living on the farm.[163] It must be remembered that several individuals cannot aggregate their activities,[164] and a person must be a family member at the time the activities are carried out.[165] In addition, material participation in the diversion and conservation uses required under the PIK program will be treated as material participation in the operation of the land.[166]

3. *Changes by ERTA*

Several important amendments were made to the material participation requirement by ERTA to enable more estates to qualify. First, material participation may be by the decedent *or* by a member of the decedent's family.[167] Secondly, the decedent qualifies if the material participation was for five or more of the eight years prior to death, disability, or retirement.[168] Retired or disabled[169] persons who rent land to non-family members no longer must choose between qualifying for special use or receiving social security benefits.[170]

ERTA made another important change by creating a subclass of qualified heirs known as "eligible qualified heirs."[171] These persons meet the material participation test if they are engaged in "active management" of the farm.[172] Eligible qualified heirs include the decedent's surviving spouse[173] or a quali-

161. Treas. Reg. § 202032A-3(f)(2) (1980).

162. The four arrangements are: the decedent was appointed trustee, the trust employed the decedent, the decedent managed the farmland under a contract, or the trust agreement granted the decedent management rights. Treas. Reg. § 20.2032A-3(f)(1) (1980). *See* Comment, *supra* note 30, at 169 (these provisions are evidence that the I.R.S. allows flexibility in estate planning). Once an arrangement is found to exist the executor must then show how the decedent materially participated.

163. *See* Treas. Reg. § 20.2032A-3(e)(1) (1980). Treas. Reg. § 20.2032A-3(g) (1980) provides eight examples of situations to determine whether material participation exists.

164. *See supra* note 50.

165. *See* Treas. Reg. § 20.2032A-3(e)(1) (1981).

166. *See* Pub. L. No. 98-4, § 3(a)(2), 97 Stat. 7 (1983); 129 CONG. REC. 22 (1983).

167. I.R.C. § 2032A(b)(1)(C)(ii) (1954). Thus an elderly farmer may retire and receive social security and still qualify for special use valuation if a family member materially participates in the operation of the farm.

168. *See* I.R.C. § 2032A(b)(4)(A) (1954).

169. A person is 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." I.R.C. § 2032A(b)(4)(B) (1954).

170. *See* H. DUBROFF & D. KAHN, FEDERAL TAXATION OF ESTATES, GIFTS, AND TRUSTS 29 (J. Silverman Supp. 1982).

171. I.R.C. § 2032A(c)(7)(B), (C) (1954).

172. I.R.C. § 2032A(c)(7)(B) (1954).

173. The spouse must be *surviving*; activities by a spouse which occur before the death of the deceased do not count as active management by the spouse to be considered as material participation. *See* Comment, *supra* note 44, at 746.

fied heir who is under the age of 21,[174] a full-time student,[175] or disabled.[176]

"Active management" is defined by statute as "making of the management decisions of a business (other than the daily operating decisions)."[177] Farming activities that may constitute active management including inspecting crops, reviewing and approving annual crop plans, making a substantial number of the management decisions, and approving major expenditures.[178] Management decisions include "what crops to plant or how many cattle to raise, what fields to leave fallow, where and when to market crops and other business products, how to finance business operations and what capital expenditures the trade or business should make."[179] Even though active management was designed to be an easier test to meet,[180] the activities listed in the Committee Report are similar to the factors listed in the regulations as indicia of material participation.[181] However, there are two important differences between active management and material participation. Active management is not dependent upon the surviving spouse's payment of self-employment

174. Active management by a fiduciary is allowed if the qualified heir is under the age of 21 or is disabled. *See* I.R.C. § 2032A(c)(7)(B)(ii) (1954).

175. A qualified heir is treated as a student if he is a full-time student at an organization defined in I.R.C. § 170(b)(1)(A)(ii) (1954) for five months during the calendar year. *See* I.R.C. §§ 151(c)(4), 2032A(c)(7))D) (1954).

176. *See supra* note 169. If the eligible qualified heir is under 21 or disabled, active management may be by a fiduciary. The fiduciary can be a guardian or trustee, but not an agent. Uchtmann & Fischer, *supra* note 53, at 432.

177. I.R.C. § 2032A(e)(12) (1954). Prior to 1983, a problem arose if the surviving spouse died within eight years of the predeceased spouse. For example, *H* retires in 1981 after farming for 40 years. He leases the farm to an unrelated person under a lease in which he does not materially participate. *H* does in 1990, leaving the farm to *W* who engages in active management until her death in 1992. The farm would not qualify for special use valuation because there was no material participation or active management by *W* for at least five of the eight years preceeding *W*'s death. *See* 5 N. HARL, *supra* note 53, at 43-192.

The Technical Corrections Act of 1982, § 104(b)(1), 96 Stat. 2365, 2381 (1982) amended § 2032A by adding subsection (b)(5)(C). If spouses die within eight years of each other, the years of active management by the surviving spouse may be tacked onto the number of years of material participation by the predeceased spouse. The following example illustrates the situation Congress was addressing:

> Assume that B dies two years after A (B's spouse) in whose estate Whiteacre was eligible for current use valuation. B engaged in the active management of Whiteacre during the two years following A's death. A was retired for the five years immediately before A's death, but had materially participated in Whiteacre's operation for eight years before his retirement. The six most recent of the eight years before A's retirement will be considered with B's two years of active management for purposes of satisfying the five years of an eight-year period pre-death material participation requirement for B's estate.

H.R. REP. No. 201, 97th Cong., 1st Sess. 170 (1981). *See* J. CLARK, *supra* note 37, at 12A-8,-9.

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

179. *Id.* It must be remembered that only for a surviving spouse, and not by a member of the surviving spouse's family, will active management constitute material participation. *See* 4 E. FIORE, M. FRIEDLICH, T. MCINERNEY & A. CHEVAT, MODERN ESTATE PLANNING 22-16 to 22-18 (1981).

180. Active management was Congress's response to criticism that oftentimes a surviving spouse, especially an elderly widow, was unable to elect § 2032A to save the family farm because of physical inability to materially participate. *See* M. WEINBERGER, *supra* note 44, at 63. *Cf.* Cornelius, *An Analysis of Federal Incentives to Assure Economic Independence for Farm Women*, 7 OHIO N.U.L. REV. 20 (1980) (examining the application of federal statutes and regulations to farm credit and taxes concerning farm women).

181. *See supra* text accompanying notes 163, 178, & 179. *See also* Osach, *supra* note 44, at 91-92 (it will take future rulings and court decisions to distinguish active management and material participation).

tax,[182] and a written agreement is not mandated in a lease situation.[183]

F. *Present Interest Requirement*

Prior to amendment, regulations required that a person must receive a "present interest" in real property to be a qualified heir.[184] As such, discretionary life estates established in trusts that give trustees discretion to distribute were considered future interests, and hence the life tenant was not considered to be a qualified heir for § 2032A purposes.[185] As amended by ERTA in 1981, the Code now provides that "an interest in a discretionary trust all the beneficiaries of which are qualified heirs shall be treated as a present interest"[186] to allow that property to qualify for § 2032A election. In addition, trusts established for minors pursuant to I.R.C. § 2503(c) are considered present interests.[187]

If the decedent creates successive interests, such as life estates and remainders, all persons receiving an interest must be qualified heirs in order for the property to be eligible for special use valuation.[188] Thus, the property in a standard trust will in which the spouse is given a life estate with remainder to the children will qualify for special valuation.[189] Remainder interests created by the decedent can be received by qualified heirs if the interest is not contin-

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182. H.R. REP. No. 201, 97th Cong., 1st Sess. 170 (1981). *See supra* note 129 and accompanying text.

183. In a rental situation there must be a lease agreement contemplating material participation by the land owner. *See supra* notes 157 & 158 and accompanying text; *see also* Uchtmann & Fischer, *supra* note 53, at 428.

184. *See* Treas. Reg. § 20.2032A-3(b) (1983) (prior to amendment by ERTA).

185. For example, in Private Letter Rul. 8020011 (Feb. 7, 1980) the I.R.S. held that decedent's grandchildren did not receive a present interest in a discretionary trust. In order for the property to qualify for § 2032A election, income from the trust must be distributed annually.

186. I.R.C. § 2032A(g) (1954). This change is retroactive to decedents dying after 1976. Neither the Code nor the regulations made a specific reference to "present interest." Thus it is unclear as to what extent a present interest is required in interests in trusts or direct interests in property. *See* Bellatti, *supra* note 22, at 48. For detailed legislative history of the present interest requirement, see R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 30 at 4-54-5 n.78; *Recommendations for Regulations and Legislative Changes Regarding I.R.C. § 2032A*, 17 REAL PROP., PROB. & TR. J. 321, 323 (1982) [hereinafter cited as *Recommendations for Regulations*].

187. The trust must provide that the property and income may be expended before the age of majority, and that the trust res will pass to the donee upon reaching 21 years of age. I.R.C. § 2503(c) (1954).

188. *See* Treas. Reg. § 20.2032A-8(2) (1983). This regulation does not include a present interest requirement, but states that only qualified heirs can receive successive interests if the property is to remain eligible for § 2032A. If, for example, the surviving spouse's brother receives a remainder interest, the property would not qualify, as the remainder person is not a qualified heir of the decedent. *Id*. *See supra* note 59 and accompanying text.

In Private Letter Rul. 8044018 (July 30, 1980) the transfer was held not to qualify because a remainder interest passed to a stepchild. After the 1981 amendments, this transaction would not qualify. *See supra* text accompanying note 53. In Private Letter Rul. 8203011 (Sept. 30, 1982) (handed down after ERTA became effective) the Service held that the property qualified because grandchildren are qualified heirs.

One must also be careful in creating powers of appointment. Granting a qualified heir a life estate with a power of appointment permitting appointment to non-family members would render the property ineligible for the special use election. However, in Rev. Rul. 140, 1982-2 C.B. 208 such a transfer qualified because the heir made a qualified disclaimer of the special power of appointment which causes the remainder interest to vest in another qualified heir.

189. It now appears that there are no problems of interests in trust meeting the present interest requirement so long as all of the interests to be specially valued are transferred to qualified heirs. *See Recommendations for Regulations*, *supra* note 186, at 323. However, one author points out that I.R.C. § 20.2032A-8(a)(2) does not specifically refer to interests in trusts, and it can only be

gent upon surviving a non-family member or is not subject to divestment in favor of a non-family member.[190] It has been held that charitable remainders disqualify the property because qualified heirs do not receive the total property interest.[191] This ruling may require certain trust arrangements to be redrafted.[192]

G. *Election and Agreement*

1. *Election Procedure*

Once the above requirements are met, the executor of the estate may elect § 2032A special use valuation for the qualified real property included in the estate.[193] The election is made by attaching a notice of election[194] and the

presumed that this amended regulation applies to successive interests in trust so as to meet the present interest requirement. *See* Bellatti, *supra* note 22, at 49.

190. *See* Treas. Reg. § 20.2032A-8(a)(2). However, the I.R.S. in Private Letter Rul. 8223004 (Feb. 10, 1982) ruled that a vested remainder is not a present interest. Therefore, § 2032A may not be used to value a vested remainder interest held by the decedent. In the above example, if a child died holding a vested remainder, that property could not be valued according to § 2032A. It has been suggested that the regulations be amended to allow a remainder interest that is owned by the decedent and which passes to a qualified heir to qualify for special use valuation. *See* Bellatti, *supra* note 22, at 51.

191. *See* Rev. Rul. 220, 1981-2 C.B. 175. If tax considerations are the primary concern, testators must decide whether the deduction allowed for charitable remainder interests outweighs the tax savings of special use valuation if the remainder was granted to a qualified heir instead of the charity. *See Special-Use Valuation Lost by Charitable Remainder*, 9 EST. PLAN. 167 (1982).

In Private Letter Rul. 8407006 (Nov. 9, 1983) the decedent's will established a trust for the farmland whereby the decedent's husband and daughter were to receive a life estate and upon their death the land was to go to charities. The beneficiaries and the executor entered into a post-death agreement. The daughter received the property in fee and the charities received cash. The I.R.S. held that the land was ineligible for special use valuation because it did not meet the § 2032A(e)(9) "acquired from or passed from" requirements. *See supra* notes 36-45 and accompanying text.

192. For instance, many trust instruments alternatively provide that in case of death of the remainderpersons, the corpus is to be distributed to a charity or to persons who are not qualified heirs. It has not been decided whether the ultimate takers in this situation are to be considered "beneficiaries" of the trust so as to prevent the transfer from meeting the present interest requirement. *See* Bellatti, *supra* note 22, at 48-49.

193. A decedent may elect *both* alternate valuation under § 2032 and special use valuation under § 2032A. *See* Rev. Rul. 31, I.R.B. 1983-8, at 8. I.R.C. § 2032 (1954) provides that the executor may elect to have the property in the estate valued six months after the decedent's death or date of distribution, sale, exchange, or other disposition.

In addition, a § 2032A election does not preclude an election under § 6166. I.R.C. § 6166 (1954) provides that if an interest in a closely held business or farm comprises more than 35% of the adjusted gross estate, the estate tax may be deferred for five years and then paid in ten installments. In order to elect § 2132A and § 6166, the percentage requirements for both must be met. *See* Comment, *supra* note 44, at 752-55 (discussing the requirements for § 6166).

194. The notice of election must contain the following information: (1) the decedent's name and taxpayer identification number; (2) the use to which the property is put; (3) the real property to be specially valued; (4) the fair market value of the property to be specially valued; (5) the use value of the specially valued property; (6) the adjusted value of all real property "used in a qualified use" that passes from the decedent to qualified heirs and the adjusted value of all specially valued real property; (7) personal property that is used in the qualified use; (8) the adjusted value of the gross estate; (9) the valuation method used; (10) copies of written appraisals; (11) a statement that all the property being specially valued has been owned and used in a qualified use for five of the eight years preceeding the death and that there was material participation in its operation for a like period; (12) the name, address, and social security number of each qualified heir; (13) affidavits attesting to material participation and naming the material participant; and (14) a legal description of the specially valued property. Treas. Reg. § 20.2032A-8(A)(3) (1981).

For examples of election forms see Kelley, *Valuation of Farm and Ranchland after the Tax Reform Act*, 1979 AGRIC. L.J. 75, 109 (form for application of § 2032A); Thomas, *supra* note 30, at 88, 89, 93 (notice of election form and affidavit of activities for material participation form); *see*

consent agreement[195] to the decedent's federal estate tax return. Election may be made on a late return, provided that it is the first estate tax return filed by that estate.[196] Once this election is made, it is irrevocable.[197] If the executor is unsure whether the election could or should be made, a protective election may be filed.[198] Attachment of an abbreviated notice of election to the estate tax return preserves the estate's right to elect § 2032A should the estate qualify.[199] A finalized election must then be filed within sixty days after final determination of values.[200] This second notice of election and the consent agreement must be attached to an amended federal estate tax return.[201] When the election is made a lien for the amount of estate tax saved by special use valuation is imposed on the specially valued property.[202] As noted earlier,[203] an election can be made for less than all of the qualified real property.[204]

2. *Consent Agreement*

A consent agreement[205] signed by all parties having an interest[206] in the

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also 2 ALI-ABA, TAX PLANNING FOR AGRICULTURE 453, 456 (1983) (example of a completed election, and affidavit of activities for material participation form); 2 ALI-ABA, BASIC ESTATE AND GIFT TAXATION 531-76 (1983) (detailed example of a completed tax return form 706 electing special use valuation, and supporting schedules).

195. *See infra* notes 205-11 and accompanying text.

196. Prior to amendment by ERTA in 1981, election had to have been timely made, nine months after the decedent's date of death, or within 15 months if an extension of time to file the estate tax return was properly granted. I.R.C. § 2032A(d)(1) (1954) (prior to 1981). *See* Osach, *supra* note 44, at 92.

An estate is not required to document a higher use than farming before a valid election can be made.

197. I.R.C. § 2032A(d)(1) (1954).

198. Treas. Reg. § 20.2032A-8(b) (1981). *See* 2 J. JUERGENSMEYER & J. WADLEY, *supra* note 6, at 488 (protective election gives you time to decide without losing the opportunity); M. WEINBERGER, *supra* note 44, at 62 (protective election provides an "out" for the executor who has not compiled all the data or obtained consents by the time the estate tax return is filed). The I.R.S. in Private Letter Rul. 8407005 (Nov. 8, 1983) held that a protective election may be filed even though the percentage tests are initially met and the estate qualifies upon returned values.

199. This notice must include such information as (1) the decedent's name and taxpayer identification number; (2) the relevant qualified use; and (3) the real and personal property shown on the estate tax return that is used in a qualified use and passes to qualified heirs. Treas. Reg. § 20.2032A-8(b) (1981). *See* Thomas, *supra* note 30, at 71-72 (checklist for protective elections).

200. Treas. Reg. § 20.2032A-8(b) (1981). *See* Private Letter Rul. 8223017 (Mar. 3, 1982) (the additional notice of election must be filed when values are finally agreed to in a closing agreement between the taxpayer and the I.R.S.).

It must be remembered that a protective election does not extend the time for payment of the estate tax. In addition, § 2032A election can *not* be retroactively elected once an estate tax return has been filed. *See* Rev. Rul. 62, 1982-1 C.B. 130.

201. Rev. Rul. 62, 1982-1 C.B. 130. The final notice of election must contain the information listed in *supra* note 184.

202. *See infra* note 258 and accompanying text.

203. *See supra* note 95.

204. In addition, a partial election may be made in the case of interests held as joint tenants or tenants in common. In this manner, inclusion of the interest of one heir for special use valuation does not mandate that the interest of the other heir be included, so long as the percentage tests are met. *See* 3 RESEARCH INSTITUTE OF AMERICA, ESTATE PLANNING AND TAXATION COORDINATOR 44,222D-E (1983).

205. Rev. Proc. 14, 1981-1 C.B. 669 provides an example of the form of the agreement. *See* Kelley, *Valuation of Farm and Ranch Land after the Tax Reform Act*, 1979 AGRIC. L.J. 75, 110 (consent agreement form); Thomas, *supra* note 30, at 93-95 (consent agreement form for qualified heirs, and agreement form for other than qualified heirs).

206. "Interest" in property includes present, future, vested, and contingent interests. Those who must enter into the agreement include fee owners; owners of remainder and executory interests; holders of general or special powers of appointment; beneficiaries of a gift over in default of

specially valued property must be filed with the estate tax return.[207] Qualified heirs who sign the agreement consent to personal liability for the payment of the estate tax in the event of recapture.[208] Fulfillment of this requirement is critical; an election may be disqualified if all the interested parties do not consent.[209] If the parties are infants or incompetent, a representative under local law is appointed to sign for them.[210] The agreement must designate an agent with power of attorney to act on behalf of all persons to the agreement in all matters regarding § 2032A.[211]

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exercise of a general or special power of appointment; co-tenants, joint tenants, and holders of other undivided interests; trustees of trusts holding an interest in use valuation property. *See* Treas. Reg. § 20.2032A-8(c)(2) (1981).

Creditors are not considered to be persons with an interest in the property. *Id.* Also, persons under local law who have the power to challenge a will are not persons with an interest. *Id.*

207. *See* I.R.C. § 2032A(d)(2) (1954). In Private Letter Rul. 8042009 (June 30, 1980) a co-tenant was permitted to sign the consent agreement late to perfect the estate's election because he had believed in good faith that his signature was not needed. This situation is unusual in that the I.R.S. usually does not allow any latitude in obtaining the consent from all the parties within the time allowed. *See infra* note 209 and accompanying text.

208. *See infra* notes 235-52 and accompanying text. I.R.C. § 2032A(c)(6) (1954) provides that the qualified heirs are liable for the recaptured estate tax. Once made, consent to liability is irrevocable. *But see* Private Letter Rul. 8041016 (date unavailable) (a parcel of land which had already been sold was allowed to withdraw from consent and election).

Consent of parties in interest other than qualified heirs is also required. I.R.C. § 2032A(d)(2) (1954); Treas. Reg. § 20.2032A-8(c) (1981). These other parties are not liable for the tax, but they must consent because their interest in the specially valued property is subordinated to that of the United States government.

209. *See* I.R.C. §§ 2032A(a)(1)(B), 2032A(d)(2) (1954); Treas. Reg. § 20.2032A-8(c) (1981). As made clear in Private Letter Rul. 8145028 (Aug. 7, 1981) a special use valuation election that fails to include the consent of co-tenants cannot be cured by a post-mortem partition agreement and an amended election. *See* Private Letter Rul. 8102009 (Oct. 28, 1980) (each co-tenant must sign the agreement even if the executor excludes the interest of some co-tenants from special use valuation). *See also* Private Letter Rul. 8048012 (Aug. 20, 1980) (the property could not be specially valued because the remaindermen, under rules preceeding the regulations to § 2032A, validly withdrew their consent).

In some situations there may be problems of obtaining the consent of a necessary party. For example, the decedent is survived by a second wife and a son from a prior marriage and the son will take over the farm operation. If a pecuniary formula marital clause is involved, the wife may not want to consent to § 2032A election since this would reduce the amount of the gross estate, and hence she would have a smaller marital share. One author suggests two ways in which the wife's signature can be obtained:

> First, the planner can advise the client to persuade his wife and son to sign the agreement during his lifetime . . . . Second, the planner could insert a provision in the client's will in the nature of an in terrorem clause which would reduce the share of the wife (perhaps in an amount equal to the tax cost to the estate of her refusal to sign) if she failed to execute the agreement upon a demand by the executor.

Kinley, *Some Thoughts on Section 2032A*, 1978 U. ILL. L.F. 409, 413.

210. Treas. Reg. § 20.2032A-8(c)(3) (1981).

Several recommendations have been made to make the obtaining of consent a less burdensome task. One suggestion is that the regulations should adopt a "reasonable efforts" standard for obtaining signatures. This would be especially helpful where persons cannot be located. Another suggestion is that a legal proceeding should not be necessary in order to bind unknown heirs. Consent could be obtained through legal proceeding publication or by the doctrine of virtual representation. Or a statute could be enacted to allow a testator to include a clause such as, "my executor may execute the consent agreement so as to bind all of my heirs." *See Report of Committee on Tax Litigation and Regulations: Special Rules for Valuation and Deferred Payment of Taxes*, 15 REAL PROP., PROB. & TR. J. 707, 710 (1980).

It has also been suggested that a parent or natural guardian be allowed to consent for a minor or disabled qualified heir instead of going through a court proceeding to have a guardian appointed under local law. *See* Bellatti, *supra* note 22, at 51. However, such a proposal by the House Ways and Means Committee was not adopted. H.R. REP. NO. 201, 97th Cong., 1st Sess. 17 (1981).

211. *See* Treas. Reg. § 20.2032A-8(c)(1) (1981). The agent has the specific duty of notifying

IV. VALUATION AND RECAPTURE

A. *Valuation Methods*

1. *Formula Method*

The formula method determines valuation by capitalizing the rental income of comparable property by a return based on the interest rate charged for new Federal Land Bank loans.[212] Specifically, value equals the average annual gross cash rental,[213] reduced by the average property taxes,[214] for comparable farmland[215] that is located in the same locality as the farm to be valued divided by the average annual effective interest rate for all new Federal Land Bank loans.[216] For example, assume a Kansas farmer owned 1500 acres with a fair market value of $850 an acre. The average cash rental value for comparable property is $40 an acre. State and local taxes are approximately $5 an acre, and the Federal Land Bank interest rate for the Wichita district for decedents dying in 1983 is 11.65 percent. Using the above formula, the estate value of the land is reduced from $1,275,000 (fair market value) to $450,643 (use value). However, by statute the estate is limited to a reduction of $750,000.[217] In this example the special use value of the estate is $525,000 for a savings of $294,000 in estate taxes.[218]

"Average annual gross cash rental" is defined as the total amount of cash

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the I.R.S. of the name of the material participant and of any disposition of cessation of qualified use during the recapture period. Treas. Reg. § 20.2032A-8(c)(4) (1981). This way the I.R.S. can check the income tax returns of the named participant to see if the farm income is being reported.

212. I.R.C. § 2032A(e)(7) (1954). The formula method cannot be used if there is no comparable farmland in the locality from which the average annual gross cash rental or net share rental may be determined, or the executor elects to value the property by the factor method. I.R.C. § 2032A(e)(7)(C) (1954). This rent-income capitalization approach is not a new concept. It has long been used by real estate appraisers, and was applied by the Tax Court in Estate of Chloe A. Nail, 59 T.C. 187 (1972) and Estate of Ethel C. Dooley, 31 T.C.M. (CCH) 814 (1972). *See supra* note 18. *See also* 5 N. HARL, *supra* note 53, at 43-132.

213. *See infra* note 219 and accompanying text.

214. Treas. Reg. § 20.2032A-4(c) (1980) provides as follows: "[S]tate and local taxes are taxes which are assessed by a state or local government and which are allowable deductions under section 164. However, only those taxes on the comparable real property from which cash rentals are determined may be used in the formula valuation." *Id.*

215. *See infra* notes 226-30 and accompanying text.

216. Each year the I.R.S. issues a revenue ruling stating the effective interest rate for each of the 12 Federal Land Bank Districts. *E.g.*, Rev. Rul. 71, 1983-1 C.B. 227; Rev. Rul. 104, 1982-1 C.B. 129; Rev. Rul. 170, 1981-1 C.B. 454; Rev. Rul. 199, 1980-2 C.B. 253; Rev. Rul. 189, 1979-1 C.B. 293; Rev. Rul. 363, 1978-2 C.B. 232.

The average annual interest rate effective for decedents dying in 1983 in the Wichita district (which includes Colorado, Kansas, New Mexico, and Oklahoma) is 11.65%. Rev. Rul. 71, 1983-1 C.B. 227.

The formula may be written in mathematical form as follows:

$$\text{Value} = \frac{\text{Average annual gross cach rental for comparable land in the locality used for farming} - \text{Annual annual real estate taxes in the locality for the comparable land}}{\text{Average annual effective interest rate for all new federal land bank loans.}}$$

See Kelley, *Valuation of Farm and Ranch Land after the Tax Reform Act*, 1979 AGRIC. L.J. 75, 82.

As can be seen by the equation, the higher the interest rate, the lower the value of the property for estate tax purposes.

217. The limit on estate tax savings is $600,000 for decedents dying in 1981, $700,000 for decedents dying in 1982, and $750,000 for decedents dying in 1983 or thereafter. *See* I.R.C. § 2032A(a)(2) (1954).

218. Using the estate tax rate schedule in I.R.C. § 2001(c) (1954), the estate tax that would be

received in a calendar year for rents undiminished by expenses.[219] These rents cannot be contingent in any way and must result from an arms-length transaction.[220] The average is based on the five "most recent calendar years ending before the date of the decedent's death."[221] However, most farmland is rented according to some sort of crop-share agreement.[222] The formula method was amended to provide that the dollar value of the average annual net share rental may be substituted in the formula for the average annual gross cash rental.[223] "Net share rental" is the value of the crop received by the lessor, less the cash operating expenses other than real property taxes paid by the lessor under the lease.[224] If rent is paid by a share of the proceeds from the sale of the crop rather than an actual share of the crop, the lease is treated as a net share rental.[225]

The executor must identify to the I.R.S. the land that is being used as the comparable property to determine the average gross cash or net share rentals.[226] The comparable property must be located in the same locality as the decedent's farmland.[227] Comparability is a factual determination that can be

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due on the fair market value of $1,250,000 is $459,050. The estate tax that must be paid after electing § 2032A is $165,050, for a tax savings of $294,000.

219. *See* Treas. Reg. § 20.2032A-4(b) (1980).

220. Under the gross cash rental any rents contingent upon production do not qualify. Leases between family members are scrutinized to determine if they are bona fide arms-length transactions. In addition, cash rents from lands leased from the federal or state governments do not meet the arms-length transaction requirement until it is demonstrated that the rents received are as high as those charged by private individuals. If the transaction is not at arms-length, a weighted average price for the crop is applied instead of the gross selling price. *See* Treas. Reg. § 20.2032A-4(b)(2)(ii) (1980); Hartley, *Section 2032A Regs. Detail Special Use Valuation Methods, How to Make the Election*, 53 J. TAX'N, 364 (1980).

If personal property, such as farm machinery, is included in the lease, no adjustment to the rents need be made unless the lease specifies the amount of rent that is attributable to the personal property. *See* Treas. Reg. § 20.2032A-4(b)(2)(v) (1980).

221. I.R.C. § 2032A(e)(7) (1954). However, each annual average for the five years need not be derived from the same tract of comparable farmland. *See* Treas. Reg. § 20.2032A-4(b)(2)(iv) (1980).

222. *See* 2 J. JUERGENSMEYER & J. WADLEY, *supra* note 6, at 403-04 (it is estimated that in Kansas 90 percent of the farm leases involve cropsharing). In theory, the use of cash rentals rather than net share rentals will yield a more favorable use valuation. Because of the element of risk that is involved in corp-share agreements, a landlord will generally receive a greater return on crop-share leases than cash-rental leases. Since the rate of return is lower, the use of cash rentals will yield a lower use valuation amount. In practice, however, cash-rentals are generally higher in areas where there is little farmland to rent. In that case, lower crop-share rentals will yield a more favorable use valuation amount. *See* Uchtmann & Fischer, *supra* note 53, at 425.

223. In order to use crop-share rentals, a showing must be made that there are no comparable cash rents. *See* I.R.C. § 2032A(e)(7)(B) (1954).

224. I.R.C. § 2032A(e)(7)(B)(ii) (1954). As pointed out by one author, there are practical problems in the use of the net share rentals. Since comparable lands must be used, this may involve invading a neighbor's records "to provide the executor and the I.R.S. with complete records of all farm income and farm expenses for the five years prior to decedent's death." Bellatti, *supra* note 22, at 47.

225. H.R. REP. No. 201, 97th Cong., 1st Sess. 172 n.18 (1981). If the produce is not sold in an arms-length transaction, price is determined as a weighted average for produce sold on that date in the closest national or regional commodities market. *Id.*

226. Treas. Reg. § 20.2032A-4(b)(2) (1980). Farms are comparable "if they could be rented for comparable sums in light of their income producing potential." Meth, *Guidelines for Sustaining the Special Use Valuation of Property*, 8 EST. PLAN. 30, 31 (1981). The rentals must be based on an arms-length transaction. Lands leased from the federal government or from family members are suspect. *See* Treas. Reg. § 20.2032A-4(b) (1980).

227. *See* Treas. Reg. § 20.2032A-4(d) (1980). Locality is not defined by mileage or political divisions, but "is to be judged according to generally accepted real property valuation rules." *Id.*

based on narrowly interpreted factors listed in the regulations.[228] If the specially valued property is used for various purposes, each different portion must be matched to its own comparable property.[229] This requirement is probably the most difficult of all of the § 2032A requirements as it is often very difficult to locate comparable leased property.[230]

2. *Multiple Factor Method*

The multiple factor method[231] of valuation is used either where comparable farmland cannot be found or where the executor has affirmatively elected this method.[232] The statute provides that five factors are to be considered in valuing the land: the capitalized value of reasonable anticipated earnings, the capitalized value of the fair rental value based on the farming use, the assessed land value in a state that has a differential or use value assessment law for qualifying property, the value of comparable sales of land in the geographical area, and any other factor that tends to establish a value based on actual use of property.[233] It appears that the weight given to each factor depends on the circumstances of each case.[234]

The comparable property must actually be rented, appraisals and averages cannot be used. *See* Treas. Reg. § 20.2032A-4(d)(iii) (1980).

228. The ten factors that may be considered in determining what constitutes comparable land are listed as follows:

1. Similarity of soil as determined by any objective means, including an official soil survey in a soil productivity index.
2. Whether the crops' growth would deplete the soil in a similar manner.
3. The soil conservation techniques practiced on the two properties.
4. Whether the two properties are subject to flooding.
5. The slope of the land.
6. In the case of livestock operations, the carrying capacity of the land.
7. Whether the land is timbered.
8. Whether the property as a whole is unified or segmented, and where segmented, the availability of the means necessary for movement among the different segments.
9. The number, types and conditions of all buildings and other fixed improvements located on the properties and their location as it affects efficient management and use of the property and value per se.
10. Availability and type of transportation facilities in terms of costs and of proximity of the properties to local markets.

Treas. Reg. § 20.2032A-4(d) (1980). This list is not exclusive. Any factor generally used to value land may be used. *Id.*

229. *Id.* In addition, if the land to be valued contains any improvements, the comparable property must have similar buildings and improvements. *Id.*

230. The search for comparable leased farmland is often difficult and time-consuming. As a pre-mortem planning matter, it is wise for an individual who contemplates § 2032A election at death to begin the search in advance to avoid the estate being tied up. *See* Meth, *supra* note 226, at 31.

231. I.R.C. § 2032A(e)(8). It has been recommended that the multiple factor method be eliminated. A convenient and easy alternative to either method would be to simply allow a percentage reduction of the farmland fair market value. *See Recommendations for Regulations*, *supra* note 186, at 330.

232. I.R.C. § 2032A(e)(7)(C) (1954). The formula method of valuation may be used *only* to value farms. I.R.C. § 2032A(e)(7)(A) (1954). That method is also frequently called the "farm method." The multiple factor method may be used to value farms or closely held businesses.

233. I.R.C. § 2032A(e)(8)(A)-(E) (1954).

234. *See* R. STEPHENS, G. MAXFIELD, & S. LIND, *supra* note 30, at 4-69.

It has been contended that a farm estate will not receive substantial savings under the multiple factor method because this method does not eliminate the speculative value in the sale of comparable land. *See* Comment, *supra* note 53, at 871. On the other hand, farm estate planning

B. *Causes of Recapture*

It was the intent of Congress in enacting § 2032A to reduce the estate tax burden on those family farms in which the property would continue to be used for farming.[235] In order to carry out this objective, an additional estate tax[236] is imposed when there is a disqualifying disposition or cessation of qualified use during the post-death period.[237]

1. *Disposition*

Disposition of any interest in specially valued property during the ten year recapture period[238] to someone other than a member of the qualified heir's family[239] will result in the recapture tax.[240] Disqualifying dispositions include gifts, sales, exchanges, sale-leasebacks, partitions, and severance of timber on qualified woodland.[241] After 1981, recapture does not occur in tax-free exchange circumstances in which the qualified real property is exchanged solely for qualified exchange property[242] or if qualified replacement property

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expert Donald Kelley states that the multiple factor method is useful only where comparative sales reflect urban speculation. *See* Kelley, *supra* note 52, at 829.

235. *See supra* note 24 and accompanying text.

236. *See infra* notes 255-64 and accompanying text.

237. I.R.C. § 2032A(c) (1954).

238. *See infra* notes 254-58 and accompanying text.

239. *See supra* notes 46-66 and accompanying text. *See, e.g.*, Private Letter Rul. 8223017 (Mar. 3, 1982) (if a corporation holds the qualifying property, a redemption of stock is a sale pro rata to the other shareholders; if they are qualified persons, no recapture results); Private Letter Rul. 8140008 (June 24, 1981) (The executor sold the property to one child and distributed the proceeds to the other three children who inherited the property. The I.R.S. ruled this was not a disqualifying disposition.); Private Letter Rul. 8133012 (Apr. 16, 1981) (a disqualifying disposition where the spouse who received the property sold it to the deceased spouse's brothers; brothers are not family members of the surviving spouse); Private Letter Rul. 8115085 (Jan. 16, 1981) (the I.R.S. held that a sale of qualifying farm property from a qualified heir to a member of the family of the qualified heir is not a disposition that triggers the recapture tax).

If the transfer is made to the qualified heir's family member, the transferee is responsible for the recapture tax if the transferee disposes or ceases use of the property to disqualify during the remaining recapture period. *See* J. KASNER, *supra* note 19, at 6-72.

240. I.R.C. § 2032A(c)(1)(A) (1954).

241. *See, e.g.*, I.R.C. § 2032A (c) (2) (E) (1954) (The severance of timber on qualified woodland is treated as a disqualifying disposition.); Private Letter Rul. 8306049 (Nov. 10, 1982) (building a house on the qualified land would not be a disposition since the heir would live there and continue to farm); Private Letter Rul. 8120127 (Feb. 23, 1981) (voluntary partition of specially valued property to non-family members would be a disqualifying disposition); Private Letter Rul. 7934009 (Apr. 30, 1979) (sale-leaseback arrangement was a disposition because there was no certainty that the property would be leased back).

Transfer of the qualified property to a trust is not a disposition if the qualified heir has a present interest and the grantor retains the beneficial interest. *See* Kelley, *Valuation of Farm and Ranch Land after the Tax Reform Act*, 1979 AGRIC. L.J. 75, 88. The regulations do not indicate whether mortgaging the qualified real property would be considered a disqualifying disposition. *See* [1983] SECTION 2032A—SPECIAL USE VALUATION—TAX PORTFOLIO (BNA) No. 445, at A-19.

242. The tax-free exchange must be pursuant to I.R.C. § 1031. *See* I.R.C. § 2032A(i)(1)(A) (1954). If other property is received, the recapture tax imposed is reduced by an amount which "bears the same ratio to such tax, as the fair market value of the qualified exchange property bears to the fair market value of the qualified real property exchanged." I.R.C. § 2032A(i)(1)(B) (1954). *See* 34A AM. JUR. 2D *Federal Taxation* § 44,279 (1984) (step by step method to calculate the partial tax).

To determine whether the time periods for qualified use and material participation are met, replacement property is considered to be owned from the date it is actually acquired. *See* Treas.

is acquired in involuntary conversion situations.[243] A recent private letter ruling indicates that a partial disposition of the qualified use property may result in the recapture of all the tax savings.[244] A mere change in the form of business ownership (such as the formation of a partnership or corporation) will not cause the benefits to be recaptured.[245]

2. *Cessation of Qualified Use*

The recapture tax is also imposed if, within the recapture period, the specially valued property ceases its qualified use.[246] The qualified heir is not required to continue the qualifying use immediately upon the decedent's death; a two-year grace period is allowed during which the recapture tax will not be triggered.[247] Cessation of use may occur several ways. If the farmland is converted to a non-farming purpose, recapture occurs.[248] There is also ces-

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Reg. § 20.2032A-3(d) (1980); Private Letter Rul. 8006013 (Nov. 5, 1979); Shaffer, *Section 2032A: Use Value Election for Qualified Real Property*, 10 COLO. LAW. 285, 287 (1981).

When the qualifying properties are exchanged, the recapture lien must be transferred to the replacement property. I.R.C. § 6324B(c)(2) (1954).

243. There is no tax if the value of the replacement property equals or exceeds the amount realized on the involuntary conversion, pursuant to I.R.C. § 1033. I.R.C. § 2032A(h) (1954). If the value of the qualified replacement property is less than the conversion proceeds, the recapture tax imposed is reduced by an amount which "bears the same ratio to such tax, as the cost of the qualified replacement property bears to the amount realized on the conversion." I.R.C. § 2032A(h)(1)(B) (1954).

The recapture period is not affected if the involuntarily converted property is replaced within two years. If the replacement period exceeds two years, the recapture period is extended by the excess over two years. *See* I.R.C. § 2032A(h)(2)(A) (1954).

In Rev. Rul. 285, 1981-2 C.B. 173, the decedent's farm was made up of several tracts of land acquired in different years. When the decedent acquired a single tract of land as replacement property as a result of a involuntary conversion, the I.R.S. ruled that "the duration of the decedent's ownership of the original tracts will be attributed to the replacement property on a proportionate basis . . . ." *Id.*

In 1981 I.R.C. § 2032A(e)(14) was added to permit the time periods accrued for the ownership, qualified use, and material participation requirements to be tacked on to the replacement property acquired as a result of like-kind exchanges and involuntary conversions. *Id.* For estates of decedents dying before 1982, the time periods are calculated from when the replacement property was received. *See* E. FIORE, M. FRIEDLICH, T. MCINERNEY & A. CHEVAT, *supra* note 179, at 22-25.

244. *See* Private Letter Rul. 8308004 (Oct. 19, 1983). In this situation the son inherited two tracts of land from the decedent and disposed of one tract prior to the expiration of the recapture period. The question presented to the I.R.S. was how much tax was due. The Service held that there is not a pro rata disposition, that all of the estate tax savings may be recaptured. The amount of additional tax would be less only where the selling price less the special use valuation would be a lesser amount. *Id.*

245. *See* H.R. REP. NO. 1380, 94th Cong., 2d Sess. 25 n.3, *reprinted in* 1976-3 C.B. 759; Private Letter Rul. 8217017 (Jan. 27, 1982). To be a qualifying transfer, three conditions must be met: (1) the qualified heir retains the same interest in the property after it has been transferred; (2) the partnership or corporation qualifies as a "closely held business" as defined in I.R.C. § 6166(b); and (3) the corporation or partnership must consent to liability for payment of any recaptured taxes. *See* R. STEPHENS, G. MAXFIELD & S. LIND, *supra* note 30, at 4-77.

After the corporation or partnership has acquired the qualified use property, the entity must meet all the requirements imposed upon the qualified heir. *Id.* at 4-78. *See supra* notes 239-44 and accompanying text.

246. I.R.C. § 2032A(c)(6) (1954).

247. *See supra* note 113 and accompanying text. Cessation of use during the time replacement property is obtained in a § 1033 involuntary conversion situation will not lead to the imposition of the tax. *See* I.R.C. § 2032A(h)(2)(C)(i) (1954).

It must be remembered that the grace period does not suspend the rule that there cannot be three or more years of non-material participation in any eight-year period. *See infra* note 249.

248. *See* I.R.C. § 2032A(c)(6)(A) (1954). *See also supra* note 95.

sation of use if there was no material participation by the decedent or a member of the decedent's family in the pre-death period, or by the qualified heir or members of the qualified heir's family in the post-death period for periods aggregating more than three years for *any* eight-year period ending after the date of the decedent's death.[249]

A very important pre-mortem planning consideration is whether special use valuation should be elected if there is a reasonable chance that the qualified heirs will not be able to meet the post-death requirements to prevent recapture. This decision turns on whether it is more advantageous to minimize the decedent's estate tax liability or that of the family as a whole. On the one hand, special use valuation could have the effect of an interest-free loan.[250] On the other hand, it could lead to substantial income taxes to the heir who takes a low basis in the property.[251] However, for land specially valued after 1981, an election may be filed to increase the basis.[252]

C. *Recapture Lien and Taxes*

"What Congress giveth, Congress may taketh away."[253] As a penalty for not complying with the requirements of the statute, a tax is imposed upon the

249. This floating "5 of 8" period can be illustrated as follows: The decedent is a life-long farmer, and had been farming for fifty years. Two years prior to his death he suffers a stroke and leases the land to a non-family member. The qualified heir, his son, leases the land for two more years after his father's death to a non-family member before farming it himself. In this example the pre-death requirement is met as the decedent was materially involved for five of the eight years preceeding his disability. However, the post-death material participation is not met. Contrary to the belief held by many practitioners, the heir does *not* have eight years after death to achieve five years of material involvement. This is a floating period. There must not be more than three years of aggregate non-participation in *any* eight year period that *ends* after the decedent's death. In the above example there was a four year period of non-material participation, two years prior to death and two years after decedent's death. The two-year grace period does not extend the period. The heir must begin farming at least one year after his father's death. *Cf.* [1983] SECTION 2032A-SPECIAL USE VALUATION—TAX PORTFOLIO (BNA) No. 445, at A-20.

250. For example, if the estate saved $100,000 in taxes by special use election, this savings compounded at an eight percent rate of return would equal $215,894 in ten years. Especially if recapture is not foreseen until the latter part of the recapture period, it would be economically wise to elect § 2032A, invest the savings, and pay the $100,000 later. *See* 5 N. HARL, *supra* note 53, at 43-243.

251. If § 2032A is elected, the qualified heir takes a basis in the property equal to the land's use value. If the heir disposes of the property, the taxes resulting from the low basis could more than offset the gain realized from investment of the initial savings. If special use valuation was not elected, the heir would take a stepped up basis based on the fair market value of the decedent's land. *See* Comment, *supra* note 44, at 751. However, since farmland values have recently started to decline, the basis problem may not be as acute as it was when farmland was appreciating rapidly. *See* Hawver, *Land Valuation Drop May Purge Speculators*, Topeka Daily Capital, Jan. 13, 1984, at 10, col. 1.

252. If recapture is triggered on realty that was specially valued after 1981, the qualified heir may file a § 1016(c) election to have the basis increased from the use value amount to its fair market value as of the decedent's death or the alternative valuation date. I.R.C. § 1014(a) (1954). If there is a partial disposition, the basis is of the heir's entire interest is increased by the proportionate amount of the difference between the fair market value and the special use value of the entire interest equal to the proportionate part of the total potential recapture tax. I.R.C. § 1016(c)(2) (1954).

If such election is made, interest must be paid on the recapture tax at the prime interest rate for the period ending nine months after decedent's death to the date payment is made. I.R.C. § 1014(a)(5)(B) (1954). *See* I.R.C. § 6601 (1954). This election is made by filing a statement form 706A (additional estate tax return).

253. Old saying by George W. Simpson, associate professor of political science, emeritus, Washburn University of Topeka.

qualified heir[254] to recapture the savings the estate realized through use valuation.[255] The length of time that the heir must meet the qualified use and material participation tests, known as the recapture period, is ten years for decedents dying after 1981 and fifteen years for decedents dying before 1982.[256] Death of the qualified heir before the recapture period has expired does not trigger the tax.[257] In order to insure repayment, a lien by the federal government arises with respect to the specially valued property at the time the election is filed.[258] To alleviate the fears of inability to obtain farm financing, the I.R.S. announced that the lien is not valid against agreements securing loans needed to operate the farm.[259] In addition, the Secretary of the Treasury has authority to subordinate the lien so that the farmer may obtain a Federal Land Bank loan.[260]

The amount of the recapture tax is the lesser of the adjusted tax difference[261] or the excess of the amount realized (or the fair market value of the

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254. The qualified heir, not the estate, is liable for payment of the recapture tax. This is the primary reason why all persons having an interest in the specially valued property must sign the consent agreement. *See supra* note 206 and accompanying text. However, a member of the family of a qualified heir who acquires the property is liable for the recapture tax even though this person was not required to sign the agreement. *See supra* text accompanying note 126.

I.R.C. § 2032A(c)(5) and (11) provide that the qualified heir may be relieved of personal liability for the recapture tax by furnishing a bond. The amount of the bond would at least equal the amount of tax that could be recaptured.

255. I.R.S. § 2032A(c) (1954).

256. I.R.C. § 2032A(c)(1) (1954). When this section was changed in 1981 to provide for a ten year recapture period, it was not made to apply retroactively to those decedents dying after 1976. This adds to the complexity of applying the statute, and has been criticized. *See* Bellatti, *supra* note 22, at 44 (all amendments pertaining to recapture should have been made to apply retroactively). *See also* Allen, *Washington Saves The Farm? The Peculiar Remedy of IRC Section 2032A*, 56 TAXES 205, 211 (1978) (the recapture period should be only three years because adverse income tax consequences is a sufficient deterrent to premature disposition).

257. I.R.C. § 2032A(c)(1) imposes the recapture tax "[i]f, within 10 years after the decedent's death and before the death of the qualified heir . . . ." *Id.* With this factor in mind, a decedent may want to transfer to a qualified heir who is not expected to outlive the decedent by very long so that the property could be put to non-qualified uses without a penalty.

258. I.R.C. § 6324B (1954). This lien must be filed to have priority over purchasers, holders of security interests, lien holders, or creditors, but the recapture lien is subordinate to property tax liens, mechanics liens, and construction or improvement liens on the specially valued property. The lien remains in effect until contingent liability for the recapture tax is removed either by payment of the tax, lapse of the recapture period, or death of the potentially liable qualified heirs. *See* I.R.C. § 6324B(b) (1954). The statute also provides that the I.R.S. may accept substitute security for the specially valued property. *See* I.R.C. § 6324B(d) (1954).

259. The recapture lien is not valid "against financing agreements securing loans for construction or improvements of real property, raising or harvesting of farm crops, or raising livestock or other animals." I.R.S. News Release 1823 (June 2, 1977), 3 FED. EST. & GIFT TAX. REP. (CCH) ¶ 12,029.

260. *See* I.R.C. § 6325(d)(3) (1954). "[I]n the case of any lien imposed by section 6324B, [the Secretary may subordinate the lien] if the Secretary determines that the United States will be adequately secured after such subordination." *Id. See also* Polisher, Kapustin, & Schwartz, *Federal Estate and Gift Tax Provisions of the Revenue Act of 1978 and Implications for Estate Planning*, 84 DICK. L. REV. 1, 22 (1979).

261. The "adjusted tax difference" is basically the amount of estate tax saved by electing special use valuation. *See* I.R.C. § 2032A(c)(2)(B) (1954).

If only part of the property is disqualified, then only that part of the estate tax savings allocable to the property is recaptured. To calculate the amount recaptured on partial disposition:

> [multiply] the excess of what would have been the estate tax had special use valuation not been elected over the actual estate tax by a fraction, (a) whose numerator is the excess of the estate tax value of the interest determined without regard to special use valuation over the special use value of the interest, and (b) whose denominator is the

property if not at arms length) at sale[262] over the special use valuation.[263] No interest is due if the tax is paid within six months after the recapture event.[264]

V. CONCLUSION

Section 2032A special use valuation was enacted to attack the problem of forced farm sales due to high estate taxes. In spite of the numerous qualification requirements and procedures that must be met, a § 2032A election should never be overlooked in planning and handling a farmer's estate. As has been shown, the application of use value can result in substantial estate tax savings. Though the requirements for this section were eased in 1981 to allow more estates to qualify, the main feature of § 2032A remains unnecessarily complicated. The formula method of valuation is cumbersome and time-consuming as it is very difficult to locate qualified comparable farmland that is actually being rented. One way to avoid this complexity is to simply allow an across the board percentage reduction in th value of qualified family farm estates.[265] Perhaps this will not totally eliminate the speculative value from farmland located near rapidly developing areas, but these are also the situations in which it is the most difficult to locate comparable property. The purpose of the statute, to preserve more family farms, would be enhanced by this measure.

In discussing the qualification requirements for § 2032A, this Note has dealt with only one aspect of estate planning for farmers. Special use valuation must be evaluated alongside other estate planning tools, such as the use of gifts, trusts, the unlimited marital deduction, and the unified credit, before special use valuation is elected. While effective estate tax planning is especially essential for farmers, it is remedial in nature. The heavy burden of the estate tax is another example of the problems faced by farmers and the need

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excess of the estate tax value of *all* qualified real property determined without regard to special use valuation over the special use value of *all* qualified real property.

34A AM. JUR. 2D *Federal Taxation* § 44,275 (1984). This calculation can be better understood when written as follows:

$$\frac{\text{Fair Market Value of heirs interest, less its § 2032A value}}{\text{Fair market value of all qualified property less its § 2032A value}} \times \text{Estate tax calculated with fair market values, less allowable credits; minus the estate tax calculated using § 2032A values less allowable credits} = \text{Adjusted tax difference attributable to an heir's interest}$$

See 5 N. HARL, *supra* note 53, at 43-128.

262. This must be the fair market value of the property at the time the property was disposed. *See* § 2032A(c)(2)(A)(ii) (1954).

263. *See* I.R.C. § 2032A(c)(2)(A) (1954). In the case of decedents dying before 1982, the recapture tax is reduced if the recapture occurs after the tenth year. The amount of reduction is calculated by multiplying the full amount of the tax by one-sixtieth for each full month past the tenth year. *See* Goggans & Keller, *Current Use Valuation: Opportunities and Restrictions for Estate Planning*, 119 TRUSTS & EST., Nov. 1980, at 41, 43.

264. *See* I.R.C. § 2032A(c)(4) (1954); Rev. Rul. 308, 1981-2 C.B. 176. The I.R.S. has three years from the date of notification of the disqualifying event to assess the recapture tax before the statute of limitations has run. *See* I.R.C. § 2032A(f) (1954).

265. *See supra* note 231 and text accompanying notes 226-30.

for a comprehensive national agricultural policy to ensure that our next generation may realize their dreams of owning and operating the family farm.

Rita Noll