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An Agricultural Law Research Article

Saving the Family Farm Through Federal Tax Policy: Easier Said than Done

by

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I. Introduction

The economic importance of the family farm, as well as its place in the rhetoric of political leaders, has changed dramatically since the birth of the United States. Thomas Jefferson advocated an agrarian economy where the ideal citizen was an independent yeoman farmer.¹ In the post-Civil War era, the promise of "forty acres and a mule" meant freedom and opportunity for former slaves.² During the Great Depression, Congress and President Franklin Roosevelt coordinated their efforts to ensure the survival of small farmers through such legislative efforts as the Agricultural Adjustment Acts of 1933³ and 1938,⁴ the Soil Conservation and Domestic Allotment Act of 1936,⁵ and the Agricultural Marketing Act of 1937.⁶

In the twenty-first century, Jefferson's agrarian ideal has given way to the reality of the modern industrial economy where the small family farm has lost its predominance as an economic player.⁷ For most people, the American dream is no longer forty acres and a mule, but a comfortable home in the

1. See Philip M. Raup, *Societal Goals in Farm Size*, in *SIZE, STRUCTURE, AND FUTURE OF FARMS* 3, 4–5 (A. Gordon Ball & Earl O. Heady eds., 1972) (discussing Jefferson's ideal of a nation made up of small independent farmers).

2. See Emma Coleman Jordan, *A History Lesson: Reparations for What?*, 58 N.Y.U. ANN. SURV. AM. L. 557, 602–03 (2003) (describing Union General William T. Sherman's famous field order and the subsequent failure of the federal government to fulfill its promise of land for freed slaves).

3. See Agricultural Adjustment Act of 1933, 7 U.S.C. § 6012 et seq. (2000) (attempting to raise and to stabilize farm prices and income).

4. See Agricultural Adjustment Act of 1938, 7 U.S.C. § 1281 et seq. (2000) (enacting mandatory price supports for corn, cotton, and wheat, and imposing marketing quotas to keep supply in line with market demand).

5. See Soil Conservation and Domestic Allotment Act, 16 U.S.C. § 590a (2000) (supporting farm income by making soil-conservation and soil-building payments to participating farmers).

6. See Agricultural Marketing Agreement Act of 1937, ch. 296, 50 Stat. 246 (1937) (authorizing the USDA to issue marketing agreements, which are legal instruments designed to stabilize market conditions for certain agricultural commodities by regulating the handling of those commodities in interstate or foreign commerce).

7. See STEVEN C. BLANK, *THE END OF AGRICULTURE IN THE AMERICAN PORTFOLIO* 17–18 (1998) (discussing an "economic food chain" whereby countries develop from food producers and exploiters of natural and human resources to manufacturers and information producers, and arguing that the American economy has moved up the chain away from food production and towards information production); Harold F. Breimyer & A.L. Frederick, *Does the Family Farm Really Matter?*, at <http://muextension.missouri.edu/explore/agguides/agecon/g00820.htm> (last visited Nov. 16, 2004) (stating that according to the U.S. Census, 50% of all farms market only 3% of all farm products, while the largest farms, making up only about 3% of the nation's farms, market 40% of farm products) (on file with the Washington and Lee Law Review).

suburbs and a well-paying job.⁸ The modernization of agriculture substantially transformed the family farm itself with the result that any large-scale legislative efforts in the agricultural arena directly benefit a much smaller percentage of the American population than in Roosevelt's era.⁹

One byproduct of the changes in agriculture and the national economy has been the gradual extinction of America's small family farms.¹⁰ Without serious government intervention, these farms will continue to die off.¹¹ But there is much more at stake than the loss of the farms themselves. The survival of small family farms is vital to the national economy because such farms remain important sources of food production and crop diversity and because they help to counteract the market dominance of agribusiness.¹² Additionally, the American public benefits from the existence of small farmers because they support rural communities, preserve open spaces and the environment, and serve as a source of values and tradition.¹³ By dispersing food production,

8. Cf. BRUCE L. GARDNER, *AMERICAN AGRICULTURE IN THE TWENTIETH CENTURY: HOW IT FLOURISHED AND WHAT IT COST* 2 (2002) ("Since 1920 the United States has lost two-thirds of its farms and, in the course of that decline, helped to populate many urban neighborhoods with its refugees.").

9. See *infra* notes 24–32 and accompanying text (discussing the decline in the number of U.S. citizens living and working on farms during the twentieth century, and noting changes in the size and structure of family farms); cf. Christopher K. Leman & Robert L. Paarlberg, *The Continued Political Power of Agricultural Interests, in AGRICULTURE AND RURAL AREAS APPROACHING THE TWENTY-FIRST CENTURY* 32, 34–35 (R.J. Hildreth et al. eds., 1988) (arguing that although the U.S. farm population dropped dramatically in the twentieth century, the farmers that remain still enjoy considerable political clout and have received substantial federal aid).

10. See *infra* Part II.A (discussing the problems faced by the modern family farmer).

11. See BLANK, *supra* note 7, at 8–21 (arguing that America's transition out of agriculture is inevitable economically and that most countries attempt to resist the necessity of leaving agriculture).

12. See, e.g., NAT'L COMM'N ON SMALL FARMS, U.S. DEP'T OF AGRIC., *A TIME TO ACT* 13 (1998) [hereinafter *A TIME TO ACT*] (noting that small farms provide diversity of farm ownership and cropping systems); *id.* (stating that the dominance of a small number of large agricultural producers leads to a loss of market competition); Stephanie A. Weber, *Re-Thinking the Estate Tax: Should Farmers Bear the Burden of a Wealth Tax?*, 9 ELDER L.J. 109, 130 (2001) (arguing that the dangers of market concentration may be countered by helping to keep small farmers competitive).

13. See *A TIME TO ACT*, *supra* note 12, at 13 (stating that small farms help to prevent environmental destruction, provide opportunities in small communities, and serve as a source of values for children); STEVEN GORELICK, *THE FARM CRISIS, HOW WE ARE KILLING THE SMALL FARMER* 2 (2000) (arguing that farmers are "the economic linchpins of their communities" and that the decline of small farms can lead to environmental destruction from pesticide use and air pollution); INGOLF VOGELER, *THE MYTH OF THE FAMILY FARM: AGRIBUSINESS DOMINANCE OF U.S. AGRICULTURE* 251–64 (1981) (explaining how the loss of small farms leads to the decline of small towns).

family farmers also help to keep the nation's food supply safe from contamination and bioterrorism.¹⁴ For these reasons, it is in the federal government's best interest to take action to ensure the survival of small family farms.

Questions remain, however, about the appropriate and necessary means of preserving family farms. One approach is federal tax reform. Over time, Congress has enacted and amended a number of provisions of the Internal Revenue Code (Code) designed to benefit family farmers either directly or indirectly.¹⁵ Recently, the family farm again rose to the forefront of American politics when Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA),¹⁶ which significantly alters the current estate and income tax regimes. Notably, one of the main policy goals of the Act, according to its supporters, was to save the family farm.¹⁷ This claim has

14. See 147 CONG. REC. S10,412-13 (2001) (statement of Sen. Dorgan) (arguing that the concentration of agricultural production adds to the threat of bioterrorism); GORELICK, *supra* note 13, at 5 (stating that monocultural production by large farms leaves America's food supply vulnerable to destruction by pests and diseases).

15. See generally RON DURST & JAMES MONKE, ECON. RESEARCH SERV., U.S. DEP'T OF AGRIC., EFFECTS OF FEDERAL TAX POLICY ON AGRICULTURE (2001).

16. See Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, 115 Stat. 38 (2001) (codified in scattered sections of 26 U.S.C.). In part, this piece of legislation raises the estate tax wealth exemption while lowering the tax rate gradually between 2001 and 2010. The Act replaces the combination of estate tax and a stepped-up basis with a modified carryover basis system in 2010 and requires a return of the estate tax in 2011 if Congress does not address the issue by that time. See *infra* Part IV (discussing EGTRRA and its provisions).

17. See, e.g., *President's Tax Relief Proposals that Affect Individuals: Hearing Before the House Comm. on Ways and Means*, <http://waysandmeans.house.gov/legacy/fullcomm/107cong/3-21-01/107-6final.htm> (last visited Nov. 28, 2004) [hereinafter *Hearing on President's Tax Relief Proposals*] (statement of Bob Stallman, President, American Farm Bureau Federation) ("Eliminating death taxes is the top priority of the American Farm Bureau Federation. Families own 99 percent of our Nation's farms and ranches, and unless death taxes are repealed, many of these family farms are at risk."); H.R. REP. NO. 107-37, at 25 (2001) (stating the opinion of the House Ways and Means Committee that the estate, gift, and generation-skipping taxes unfairly burden taxpayers, particularly families owning businesses and farms); 147 CONG. REC. E238 (daily ed. Feb. 28, 2001) (statement of Rep. Mink) (arguing that the existing inheritance taxes disproportionately affect family farmers and that the current exemptions from the estate tax and planned increases in the exemptions are not large enough to protect such farmers); see also Tye J. Klooster, Note, *Repeal of the Death Tax? Shoving Aside the Rhetoric To Determine the Consequences of the Economic Growth and Tax Relief Reconciliation Act of 2001*, 51 DRAKE L. REV. 633, 635 (2003) (citing justifications for EGTRRA by the Bush Administration and Republicans); cf. 148 CONG. REC. H3075-76 (daily ed. June 4, 2002) (statement of Rep. Pitts) (arguing in favor of permanent repeal of the estate tax because it forces small businesses and family farms to spend large percentages of their value to cover tax liability).

generated extensive scholarly debate over the effect EGTRRA will have on family farms and whether it will actually benefit family farmers.¹⁸

This Note asks a different question: If Congress really intends to modify the Code to save the family farm, what alternatives would advance or hinder this objective? The analysis rests on two basic ideas. First, a successful Code provision will effectively address the problems that are driving family farmers from the industry without jeopardizing efficient food production. If a remedy fails in this regard, family farmers will continue to lose ground while the government wastes tax resources. Second, to actually benefit the family farmers that need help, Congress must draft a Code provision that effectively targets that group.¹⁹ Applying this framework to several current Code sections, EGTRRA, and some proposed alternatives, this Note attempts to identify the tax legislation that best advances the goal of saving the family farm.

Part II of the Note lays the groundwork for the two-pronged analysis of the effectiveness and targeting of various pieces of tax legislation that affect family farms. Part II first discusses the specific problems faced by family farmers and then explores the issues involved in defining the family farm. Using the two-prong effectiveness/targeting analysis, Part III evaluates several current Code sections that either directly or indirectly benefit family farmers. These sections include provisions that provide (1) valuation discounts for family farmers and thereby lighten their estate tax burden, (2) an ethanol credit that helps to ensure a local market for corn producers, and (3) special tax deductions for farmers' cooperatives. Part IV discusses EGTRRA and its potential for benefiting small family farms. Part V proposes several changes to the Code for the purpose of saving family farms. Part VI ultimately concludes that Congress can save many small family farms through its tax policy and discusses the best alternatives for tax reform.

II. Defining the Modern Family Farm and the Problems That It Faces

At a recent cooperative meeting, a middle-aged farmer exclaimed, "in my particular neighborhood, I can tell you, the smaller farms are gone."²⁰ If one

18. Compare Dennis J. Ventry, Jr., *Straight Talk About The Estate and Gift Tax: Politics, Economics, and Morality*, 89 TAX NOTES TODAY 1159, 1160 (2000) (arguing that Congress should not repeal the estate tax because such a move would not really protect small farms and businesses) with Weber, *supra* note 12, at 127–28 (arguing that the estate tax creates a heavy burden that drives many small farmers out of business).

19. Otherwise, the benefits will either fail to reach the farmers most in need or will further the interests of rival entities.

20. See Ted Czech, *County Farmers Call for Action to Better Their Future*, YORK

knows where to look, the crisis in family farming is easy to see; it plays itself out each time residential development covers a prime piece of farmland, a Wal-Mart drives a farmers' market out of business, or a small dairy sells off its cows. Finding appropriate solutions to the crisis is much more challenging, especially in the arena of tax policy. Any tax provision designed to reverse the crisis in family farming must effectively address the problems that lie at the root of the crisis while targeting benefits to the farmers most in need of aid. Otherwise, the farmers' predicament will only get worse. The next two subparts lay the groundwork for analysis of specific Code sections by describing the problems faced by family farmers and by discussing the definition of the family farm.

A. *Why Is the Family Farm in Danger?*

A century of fundamental change in American agriculture dramatically improved the economic efficiency of farming.²¹ With this change, however, came a serious crisis in family farming.²² Though efficiency in agriculture has certain advantages for consumers, the destruction of family farms is too high of a price to pay in terms of the loss of benefits to the general public.²³ If Congress intends to save family farmers through tax policy, the relevant Code sections must counter the forces that created the crisis without depriving consumers of the efficiency gains in agriculture. Evaluating tax legislation thus requires an understanding of the transformation of American agriculture and its results, both positive and negative.

The shape of farming changed dramatically in the last one hundred years, with large farms taking over a greater share of the nation's farmland and production. In 1900, there were nearly six million farms in the United States, and the average farm size was 147 acres.²⁴ By 1997, the number of farms

DISPATCH, Feb. 2, 2004 (quoting Steve Gross, Jr., Pennsylvania livestock farmer).

21. See, e.g., Harold F. Reetz, *Why North America Imports Few Food or Fiber Staples*, 87 BETTER CROPS 6, 6 (2003) (stating that modern, efficient agriculture has the ability to produce a stable domestic food supply and to help sustain the international market, requiring only a small portion of America's overall workforce).

22. See generally A TIME TO ACT, *supra* note 12; Wendell Berry, *Faith in Industrial Agriculture Getting Harder to Maintain Because of its Increasingly "Manifest Failures"*, AGRIBUSINESS EXAMINER, Apr. 19, 2002; Nicholas D. Kristof, *As Life for Family Farmers Worsens, the Toughest Wither*, N.Y. TIMES, Apr. 2, 2000.

23. See *supra* notes 10–14 and accompanying text (discussing why the extinction of America's family farms will have a significant negative impact on the nation).

24. NAT'L AGRIC. STATISTICS SERV., U.S. DEP'T OF AGRIC., TRENDS IN U.S. AGRICULTURE: FARM NUMBERS AND LAND IN FARMS, at <http://www.usda.gov/nass/pubs/trends/farmnumbers>.

dropped to less than two million, but the average farm size increased to 487 acres.²⁵ In aggregate terms, the number of acres devoted to farmland rose from nearly 840 million in 1900 to roughly 930 million in 1997.²⁶ In the past fifty years, however, the amount of land in farms has decreased by approximately 25% from its peak total.²⁷ Besides the loss in farmland, the numbers show that the ownership of remaining farmland has become increasingly concentrated. Today, 5% of landowners own 50% of all farmland.²⁸ Stated another way, since the 1960s, the number of small family farmers has declined by 75%.²⁹

Meanwhile, the farm population has dwindled from 42% of the overall U.S. population in 1900 to only 1.5% at the close of the twentieth century.³⁰ During the same period, the percentage of the U.S. workforce employed as farmers or farm laborers dropped from approximately 40% to just 2%.³¹ The farmers that remain have become highly specialized, tending to concentrate on a particular crop or type of livestock rather than producing a diverse basket of goods.³² In sum, compared to his twentieth century counterpart, the twenty-first century family farmer is more likely to have a larger land holding, to comprise a smaller percentage of the general population, and to operate a more specialized farm.

htm (last visited Nov. 16, 2004) (on file with the Washington and Lee Law Review).

25. *Id.*

26. *Id.*

27. See GARDNER, *supra* note 8, at 53 ("Land in farms has declined by almost 25 percent from its peak of over 1.2 billion acres in 1950.").

28. Tim Weiner, *It's Raining Farm Subsidies*, N.Y. TIMES, Aug. 8, 1999, § 4, at 16.

29. *Id.* This number assumes that small family farms are those with gross sales below \$250,000. See ECON. RESEARCH SERV., THE ERS FARM TYPOLOGY—IMPLICATIONS FOR SMALL FARMS 2 (2000) [hereinafter THE ERS FARM TYPOLOGY] (defining small farms as those with yearly gross incomes of below \$250,000). Farm income is typically used to distinguish large from small family farms. See *infra* notes 78–81 and accompanying text (discussing how gross income is one means of defining small family farms). Comparing the physical sizes of farms in acres is not a good method for distinguishing large from small farms, despite some correlation between size and income, because farm acreage also varies by type of production.

30. Kristof, *supra* note 22.

31. NAT'L AGRIC. STATISTICS SERV., U.S. DEP'T AGRIC., TRENDS IN U.S. AGRICULTURE: FARM POPULATION AND LABOR, at <http://www.usda.gov/nass/pubs/trends/farmpopulation.htm> (last visited Nov. 16, 2004) (on file with the Washington and Lee Law Review).

32. See NAT'L AGRIC. STATISTICS SERV., U.S. DEP'T AGRIC., TRENDS IN U.S. AGRICULTURE: MARKET BASKET, at <http://www.usda.gov/nass/pubs/trends/marketbasket.htm> (last visited Nov. 16, 2004) (discussing specialization in agriculture) (on file with the Washington and Lee Law Review); Jim Hoyer, *Thank Politicians for Some Farm Problems*, COURIER J. (Jan. 1, 2000), at <http://www.citact.org/farmprob.html> (describing how it is no longer economical for farmers to raise both crops and livestock, leading to specialization in farming) (on file with the Washington and Lee Law Review).

Changes in the size and makeup of family farms in the United States are the result of the transformation of agriculture as an industry. Technological advances have made American farming more productive over time.³³ Consequently, farms with the same number of acres can typically produce more food,³⁴ and a farmer can now perform a greater portion of his work with machinery.³⁵ Fewer farmers are needed to produce the same amount of food, resulting in the substantial population shift away from farms.³⁶ Additionally, the ability of farmers to produce more with the same amount of land has created an oversupply of crops such as corn, wheat, rice, and cotton.³⁷ This oversupply ensures that such crops are available at low prices as inputs in food production.³⁸

Besides increased productivity, the modern family farmer is more likely to sell his crops into the global food market instead of traditional local markets. This development has been a major part of the transformation of American agriculture. The globalization of food production and distribution is a result of modern trade policy and a revolution in transportation.³⁹ Global marketing forces different regions of the world to specialize in whatever commodities

33. See NAT'L AGRIC. STATISTICS SERV., U.S. DEP'T AGRIC., TRENDS IN U.S. AGRICULTURE: PRODUCTIVITY, at <http://www.usda.gov/nass/pubs/trends/productivity.htm> (last visited Nov. 16, 2004) (stating that over the past fifty years, agricultural output has increased substantially while inputs have been steady or declining, meaning that farming has become much more productive during that span) (on file with the Washington and Lee Law Review); NAT'L AGRIC. STATISTICS SERV., U.S. DEP'T AGRIC., TRENDS IN U.S. AGRICULTURE: MECHANIZATION, at <http://www.usda.gov/nass/pubs/trends/mechanization.htm> (last visited Nov. 16, 2004) (discussing advances in technology in farm machinery during the first half of the twentieth century and a subsequent shift in emphasis to biological and chemical technology as well as improved business practices in farming) (on file with the Washington and Lee Law Review); Kristof, *supra* note 22 ("This surge in output is the main force driving the restructuring of agriculture.").

34. See Ronald A. Wirtz, *Saving the Family Farm, But From What?*, FEDGAZETTE (Oct. 1999), <http://minneapolisfed.org/pubs/fedgaz/99-10/familyfarm.cfm> (last visited Nov. 16, 2004) (describing the impact of technological advancements in agriculture on individual farmers).

35. See GARDNER, *supra* note 8, at 14 (stating that one of the most substantial effects of mechanization is the replacement of human labor in a variety of farm chores).

36. See Kristof, *supra* note 22 (discussing how the increase in the productivity of agriculture creates an abundant supply of products and a marked drop in the percentage of the U.S. population living on farms).

37. See Al Krebs, *U.S.'s Cheap Food No Bargain for Farmers*, AGRIBUSINESS EXAMINER, Nov. 6, 2003, <http://www.organicconsumers.org/corp/cheap110803.cfm> (last visited Nov. 17, 2004) (discussing the oversupply of four major U.S. crops).

38. See *id.* (arguing that oversupply of crops has led to a decrease in the sale price of such crops).

39. See GORELICK, *supra* note 13, at 4 ("The precise aim of agricultural policy almost everywhere is to pull farmers into an export-led global economy.").

their farmers can produce most efficiently.⁴⁰ Regional producers are then able to sell their product into the global market while importing most locally consumed food items from other regions.⁴¹ The global food system favors farms that are large, mechanized, and specialized because such farms can produce single crops more efficiently than smaller farms,⁴² contributing to the fundamental changes in U.S. agriculture.

A third and related cause of the transformation of U.S. agriculture has been the rise of agribusiness.⁴³ Over the last several decades, giant corporations have gained increasing dominance over agricultural inputs and outputs.⁴⁴ For example, one corporation, Cargill, controls 80% of the world's grain distribution through its ownership of the grain elevators, railroads, and ships needed to transport grain around the globe.⁴⁵ Such market power forces individual farmers to buy inputs and sell crops on the corporations' terms.⁴⁶ Because corporations control the market for farm products and have a growing demand for low-cost crops, farmers must grow their crops as efficiently as possible.⁴⁷ As farmers strive for efficiency in this environment, the result has been the growing trend toward farm specialization as well as an increase in the average size of the U.S. farm.

U.S. government policy has also contributed to the transformation of American agriculture and the loss of small family farms. Since the 1950s, the U.S. Department of Agriculture (USDA) has encouraged farmers to "get big or get out."⁴⁸ This policy signifies the government's commitment to the theory

40. *Id.*

41. *See id.* (describing the effects of a global food economy on farming).

42. *See id.* at 5 ("The highly specialised farms this system favours are most 'efficient' when they are large, monocultural, and employ heavy machinery.")

43. *See id.* at 7 (stating that the globalization of agriculture has led to the accumulation of immense power by large farming corporations).

44. *See id.* at 8 (describing how several huge agribusiness firms control the market for a number of key agricultural inputs and how vertically integrated corporations, such as Cargill, have near monopolies in food distribution); A TIME TO ACT, *supra* note 12, at 16–17 (stating that in 1980, four firms controlled 36% of the beef slaughter in the United States, but by 1998, four firms controlled 80% of the beef slaughter).

45. *See GORELICK, supra* note 13, at 8 (discussing Cargill's monopoly on grain distribution).

46. *See GARDNER, supra* note 8, at 128 (stating that farmers are at a disadvantage in market power compared to the agribusinesses from which they buy inputs and to which they sell their output).

47. *See GORELICK, supra* note 13, at 6 (stating that the global agricultural economy forces farmers to be as efficient as possible).

48. *See* Howard Silverman, *What's the Big Idea? Return from the Twilight Zone of Food*, SECTION Z, 2002, at 2, at http://www.sectionz.info/ISSUE_3/1Big_idea.html (last visited Nov. 14, 2004) (describing the statements and policy of the U.S. Secretaries of Agriculture from the

that the small producer of diverse crops is doomed to extinction, to be supplanted by the highly specialized megafarms of the future.⁴⁹ The government has carried out its policy by maintaining tax and subsidy systems that favor large farms.⁵⁰ Federal subsidies have been immense both in terms of their benefits to large farms and their cost to taxpayers.⁵¹ The Freedom to Farm Act of 1996 pledged to phase out this broad subsidy system,⁵² and there have been recent efforts to study and improve the position of the small farmer.⁵³ However, the government continues to subsidize the status quo of ever-larger specialized grain farms.⁵⁴ The same policymakers have been slow to encourage prosecution of giant agribusinesses for antitrust violations, allowing these entities to increase their hold on agricultural markets.⁵⁵

On the one hand, American agriculture has become the model of industrial efficiency. The factors contributing to the transformation of farming—technological advances, globalization, the rise of agribusiness, and government policy—ensure a steady food supply at a low cost for U.S. consumers. On the other hand, the same factors have doomed the small family farm. Technological advancements in the industry mean that farmers require ever-increasing capital investments to stay competitive: the family farmer must "get big" to spread these capital costs across more acreage or "get out" of the business entirely.⁵⁶ Farmers that survive must rent or buy additional land at the

1950s through the 1970s) (on file with the Washington and Lee Law Review).

49. See *id.* (discussing the federal government's bias towards large farms).

50. See, e.g., A TIME TO ACT, *supra* note 12, at 22–23 (discussing how "[f]arm payments have been calculated on the basis of volume of production, thus giving a greater share of payments to large farms, enabling them to further capitalize and expand their operations"); *id.* at 17 (stating that "recent changes in Federal tax policy provide disproportionate benefits to large farms through tax incentive for capital purchases to expand operation").

51. See GARDNER, *supra* note 8, at 187–88 (discussing the cost of federal assistance to farmers and the bias of federal programs towards large farms).

52. See H.R. REP. NO. 104-462, pt. 1, at 2 (1996) (stating that one of the purposes of the Freedom to Farm Act was to terminate price support programs for farmers created by a previous act).

53. See, e.g., A TIME TO ACT, *supra* note 12, at 14 (stating that in 1997, the Secretary of Agriculture appointed the thirty-member National Commission on Small Farms for the purposes of examining the problems of small farmers and determining ways to respond to their particular needs).

54. See Tim Weiner, *Congress Agrees to \$7.1 Billion in Farm Aid*, N.Y. TIMES, Apr. 14, 2000, at A20 (noting that despite statements in the legislative history of the Freedom to Farm Act claiming otherwise, Congress has continued to approve subsidies that benefit large farmers and thereby drive smaller farms out of business).

55. See Weber, *supra* note 12, at 130 (arguing that Congress needs to constrain the growth in market concentration of agribusiness through antitrust law).

56. See BLANK, *supra* note 7, at 25 ("Technological advances first encourage, then force

same time that affordable land is becoming harder to find. Land prices have risen steadily, and farmland is disappearing, especially in areas of substantial suburban development.⁵⁷ Increased investment in modern farm machinery means more debt for farmers, while falling commodity prices make debt service more difficult.⁵⁸ Likewise, the increase in productivity per acre, the resulting oversupply, and the fall in crop prices have meant that per-acre earnings have not risen substantially.⁵⁹

In the modern American economy, family farmers' crops tend to reach consumers through the global food market rather than traditional local markets.⁶⁰ As farmers respond by specializing, their market position becomes increasingly precarious. Lack of diversification can expose farmers to major price drops in bumper years,⁶¹ and sudden shifts in consumer preferences can quickly turn a profitable year into a disaster.⁶² To illustrate, the collapse of the Asian economy in the late 1990s eliminated the demand for half of the U.S. grain harvest, meaning farmers received substantially lower prices for their crops.⁶³ Similarly, the recent "mad cow" scare in Washington state caused a dramatic fall in the price of beef, which negatively affected ranchers and corn producers.⁶⁴

farmers to adopt ever more expensive production methods to compete.").

57. See NAT'L AGRIC. STATISTICS SERV., U.S. DEP'T OF AGRIC., TRENDS IN U.S. AGRICULTURE: LAND VALUES, at <http://www.usda.gov/nass/pubs/trends/landvalue.htm> (last visited Jan. 10, 2004) (describing the rise in the price of farmland through most of the twentieth century) (on file with the Washington and Lee Law Review); GARDNER, *supra* note 8, at 83 ("Now that the boom and bust of the 1972–1985 period is behind us, it is clear that U.S. farmland is still on an upward price trend, albeit at a slower pace than from 1940 to 1970."); *id.* at 53 (stating that the loss of farmland has raised substantial alarm, but arguing that such loss is not a serious threat to agriculture).

58. See GARDNER, *supra* note 8, at 196–201 (discussing farmers' need for credit to finance capital acquisition and the problems farmers have in handling debt because of economic problems in the industry).

59. See Weiner, *supra* note 28 (stating, for example, "Midwestern corn farmers' gross earnings per acre are about the same as they were in 1950, though their yields have doubled").

60. See *supra* notes 39–42 and accompanying text (noting that the trend towards a global food distribution system forces farmers to specialize in single crops rather than producing a diverse basket of goods).

61. Cf. GARDNER, *supra* note 8, at 135 (describing the drop in wheat prices resulting from changes in U.S. government price support programs that led to increased wheat production).

62. See *id.* at 143 (discussing the impact of "food scares" on producers of particular food commodities).

63. See GORELICK, *supra* note 13, at 7 (reporting that "in the United States, nearly one billion bushels of grain—half the nation's harvest—found no market in 1999, largely because the Asian economic slowdown reduced the demand for US farm exports").

64. See Cathy Booth Thomas, *How Now, Mad Cow?*, TIME, Jan. 12, 2004, at 46, 47 (discussing the impact of the mad cow scare on U.S. agriculture).

As large corporations gain control of the markets for inputs and the distribution of farm products, farmers get a smaller piece of the pie. With their market power, huge agribusiness corporations are able to drive up the price of inputs such as seed and fertilizer.⁶⁵ Farmers must strive to increase the size and efficiency of their farms to spread the cost of these higher priced inputs. At the same time, agribusiness corporations control the processing, marketing, and distribution of farm products, enabling them to take a larger cut of the profits from food sales.⁶⁶ In 1980, for every consumer dollar spent on food in the United States, thirty-seven cents went to the farmer.⁶⁷ By 1998, that number had fallen to twenty-three cents.⁶⁸

The subsidies that were supposed to be phased out under the Freedom to Farm Act remain substantially in effect. Small farmers have difficulty competing with the larger and wealthier farms that benefit disproportionately from the system.⁶⁹ In 1999, 94% of the nation's farms were small farms, yet they received only 41% of farm receipts.⁷⁰

With the current state of affairs, family farmers are leaving the business never to return, and the average age of the American farmer has crept gradually higher.⁷¹ Many small farmers now depend on income from other occupations for their survival.⁷² For some small farmers, "getting out" does not always mean entering a different line of business. Suicide is the leading cause of death of farmers, and the suicide rate among farmers is three times that of the general population.⁷³

65. See VOGELER, *supra* note 13, at 107–10 (arguing that large corporations have oligopolies in input markets, thus allowing them to drive up the input prices charged to farmers).

66. See *id.* at 118–19 (describing how a few large agricultural corporations dominate the processing and marketing of farm goods, enabling them to control the prices farmers receive for their products).

67. A TIME TO ACT, *supra* note 12, at 17.

68. *Id.*

69. See *supra* notes 48–55 and accompanying text (describing how the agricultural policy of the U.S. government favors large farms).

70. A TIME TO ACT, *supra* note 12, at 8.

71. See ECON. RESEARCH SERV., U.S. DEP'T OF AGRIC., FARM STRUCTURE: QUESTIONS AND ANSWERS, at <http://www.ers.usda.gov/Briefing/FarmStructure/Questions/aging.htm> (last visited Nov. 16, 2004) (noting that the average age of U.S. farmers was 54.3 years in 1997 and that the percentage of farmers age 55 and older rose from 37% in 1954 to 61% in 1997) (on file with the Washington and Lee Law Review); *id.* (stating that fewer younger farmers are replacing the older generations).

72. See A TIME TO ACT, *supra* note 12, at 18 (stating that for some small farmers, "off-farm jobs are not a choice, but a necessity due to the inability to obtain an adequate return from farming").

73. GORELICK, *supra* note 13, at 2.

Policymakers striving to save the family farm through the Code cannot hope to succeed if they fail to address the substantial and complex problems of the modern family farmer. Saving the family farm is vitally important because such farms bring major benefits to the general public.⁷⁴ When allocating resources, however, policymakers must remember that small farmers now make up only a minute fraction of the American workforce and that the changes in agriculture have also brought certain benefits to consumers. Policy decisions therefore entail a delicate balancing act; solving the problems of small farmers is a justifiable policy goal, but any solution must not cost consumers the benefits of efficient agriculture. Solutions must also be comprehensive, or they will not succeed. Both short- and long-term remedies are necessary because farmers are currently in crisis and because the agricultural economy as it stands is not conducive to the survival of small family farms. In the short run, prices must be stabilized and existing operations must be kept intact. In the long run, policymakers must form a niche in the agricultural economy for the small family farm without disrupting low-cost food production. Policymakers must also recognize the ramifications of any attempted changes. In modern agriculture, the size of an operation is vital economically, as small farms have suffered disproportionately from the crisis. Any action that benefits large farms at the expense of small farms may add to efficiency, but it will result in the loss of family farms that are also valuable to society. These considerations reveal the incredible challenge involved in saving the family farm, but they also provide a basis for measuring any actual or proposed solutions.

B. What Is a Family Farm?

The Code provisions that benefit family farms work by directly providing special advantages to family farmers or by supporting other businesses that help family farms.⁷⁵ An effective Code provision targets its benefits to the family farms most in need. The provision will not exclude farms that deserve tax benefits, nor will it advance the interests of rival entities. To achieve proper targeting, policymakers must proceed in drafting the Code with an appropriate

74. See *supra* notes 10–14 and accompanying text (describing how the United States benefits from the existence of small family farms).

75. Tax provisions may act as substitutes for direct government spending. See Roberta Mann, *Tax Incentives for Historic Preservation: An Antidote To Sprawl?*, 8 WIDENER L. SYMP. J. 207, 220 (2002) (defining tax expenditure as "a special income tax provision that acts like a direct spending program").

definition of the family farm in mind.⁷⁶ This requires an understanding of the characteristics, sizes, and types of family farms.

Certain characteristics distinguish the family farm among agricultural entities. Any farm structure has four characteristics: land, labor, capital, and management.⁷⁷ A family farm exists where the family unit primarily owns the land, performs the labor, controls the capital, and manages the operation.⁷⁸ Congress may grant tax benefits to a broader or narrower group of family farmers by altering these basic characteristics within a statutory provision. For example, by requiring land ownership for qualification as a family farm, Section 2032A excludes tenant farmers, who may need the tax benefits of the section just as much as a landowner.⁷⁹ Congress may also vary the management component so that a family farm will continue to receive tax benefits if an employee rather than a family member manages the farm. Such adjustments may be necessary to account for modern developments in family

76. Arriving at such a definition has been difficult. *See, e.g.*, VOGELER, *supra* note 13, at 11–34 (1981) (describing the complexity of defining the family farm); Ryan D. Downs, *A Proposal to Amend Section 2032A to Reduce Restrictions on Cash Leasing of Farm Property*, 73 NEB. L. REV. 342, 377 (1994) (discussing Congress's definition of the family farm in the context of Section 2032A of the Internal Revenue Code); Radoje Nikolitch, *The Individual Family Farm, in SIZE, STRUCTURE, AND FUTURE OF FARMS* 248, 248–49 (A. Gordon Ball & Earl O. Heady eds., 1972) (stating that flexibility in the various components of the family farm make defining the entity difficult).

77. VOGELER, *supra* note 13, at 11; *see also* Nikolitch, *supra* note 76, at 248 (defining the family farm "as one for which the operator is a risk taking manager, who with his family does most of the farm work and performs most of the managerial activities," and discussing ownership as a related component of the definition).

78. Nikolitch, *supra* note 76, at 248; *see also* Downs, *supra* note 76, at 377 (quoting Rita Noll, Note, *Taxation: Valuation of Farmland for Estate Tax Purposes, Qualifying for I.R.C. § 2032A Special-use Valuation*, 23 WASHBURN L.J. 638, 643 (1984)) (stating that under the Jeffersonian ideal of family farming, the farmer was a subsistence operator who did his own work, owned his own land, and made his own managerial decisions). Other definitions of family farms use essentially the same distinguishing characteristics, though highlighting the importance of certain criteria over others. For example, under the USDA definition, ownership is not crucial. Instead, the operator must bear the risk of the operation regardless of ownership, and the operator's family must perform the majority of the farm work. *See* Downs, *supra* note 76, at 377–78 (discussing the USDA definition of the family farm). Economist Radoje Nikolitch argues that ownership is not a distinguishing criterion in defining the family farm. Nikolitch focuses on the labor component, highlighting the ratio of hired laborers to family members to distinguish family from nonfamily farms. *See* Nikolitch, *supra* note 76, at 249–51 (distinguishing family from nonfamily farms based on the supply of hired labor used by the average family farm, which was one-and-a-half man-years in 1972); *see also* VOGELER, *supra* note 13, at 23 (discussing alternative definitions of the family farm).

79. *See* Downs, *supra* note 76, at 378 (arguing that Congress should adopt the USDA definition of the family farm because, by doing so, additional tenant family farmers would become eligible for Section 2032A special-use valuation).

farming but should not be made so flexible that tax benefits will spill over to farming entities that are not family-owned and operated businesses.

Second, family farms come in a variety of shapes and sizes, but in the current agricultural economy, small family farms are disproportionately in danger of failure.⁸⁰ An appropriate statutory definition of the family farm, therefore, enables tax benefits to be targeted to smaller entities.⁸¹ Through a statutory size component, Congress may restrict the benefits of a Code provision by exempting larger farms or by reducing their tax advantages. Congress may also tailor size restrictions to create incentives for family farms to reach an optimal acreage or production level. One measure of farm size is gross income. Congress should define small family farms as those earning gross receipts below an appropriate level and structure tax benefits to favor this group.⁸² Another size measure is the value of farm property. Congress may characterize family farm estates on the basis of their total value,⁸³ but it should develop an understanding of the correlation between gross income and estate value.

Third, families do not own farms solely as sources of income.⁸⁴ Some family farms are "hobby farms," meaning that their owners do not report farming as their major source of income.⁸⁵ Other farms are retirement investments, owned by families primarily for enjoyment.⁸⁶ Though many traditional family farmers seek off-farm income out of necessity,⁸⁷ Congress should attempt to exclude hobby and retirement farms from tax benefits

80. See *supra* notes 56–73 (discussing the economic disadvantages of small family farms).

81. The failure to target federal subsidies to smaller farms means that larger farms will benefit disproportionately. See, e.g., Hoyer, *supra* note 32 (describing how the Rulon family farm, a 5000-acre operation, has benefited from agricultural policy favoring large farms).

82. See A TIME TO ACT, *supra* note 12, at 28 (defining small farms as "farms with less than \$250,000 gross receipts annually on which day-to-day labor and management are provided by the farmer and/or the farm family that owns the production or owns, or leases, the productive assets"); ERS FARM TYPOLOGY, *supra* note 29, at 2 (discussing the cutoff in annual gross income between large and small farms).

83. See CENSUS BUREAU, LARGE FARMS ARE THRIVING IN THE UNITED STATES 2 (1996) (stating that the average value of large farm assets is five times greater than that of smaller farms); see, e.g., I.R.C. § 2032A(a)(2) (2000) (setting a cap on the value that a farm owner may exclude from his gross estate under the section).

84. See ERS FARM TYPOLOGY, *supra* note 29, at 11 (listing several types of small family farms).

85. See *id.* (defining residential/lifestyle farms as operations where owners reported a major occupation other than farming); *id.* at 8 (stating that residential/lifestyle farms are one of three types of farms where average income exceeds the national average).

86. See *id.* at 11 (defining retirement farms).

87. See *supra* note 72 and accompanying text (stating that many family farmers need to seek off-farm occupations to supplement their income).

designed to help family farms. Owners of these farms do not depend on farm income for their survival and therefore do not deserve the same tax benefits as farms that substantially sustain the families that operate them.

In sum, besides their effectiveness, tax provisions designed to protect family farmers may be evaluated by how well they target benefits to the family farms most in need of federal aid. Congress should attempt to limit tax benefits to farms where the family owns the land, performs the labor, controls the capital, and manages the operation.⁸⁸ Congress should also define small farms as those that have gross receipts below an appropriate level and target tax benefits to this group.⁸⁹ Finally, Congress should target tax benefits to family farms that depend on farming for their survival by excluding hobby and retirement farms. A properly targeted Code provision will account for all of these factors when allocating tax benefits.

III. Current Tax Benefits for the Family Farm

Currently, the federal Code contains a number of provisions that benefit family farmers.⁹⁰ This Note will focus on four of these provisions: the Section 2031(c) qualified conservation easement deduction,⁹¹ the Section 2032A special-use valuation option,⁹² the Section 40 small ethanol producer credit,⁹³ and the Section 521 special income tax deductions for farmers' cooperatives.⁹⁴ The first two Sections, 2031(c) and 2032A, create estate tax incentives for families to continue the operation of their farms after the death of the older generation of owners. The second two Sections, 40 and 521, provide income tax advantages for agricultural businesses that benefit family farmers economically. The following subparts analyze each of these four Sections by evaluating first whether they provide effective relief to the fundamental

88. On the other hand, Congress must provide some flexibility in recognizing modern developments in family farming.

89. Congress may also determine tax benefits based on the value of a farm estate, but it should look for a correlation between estate value and gross receipts.

90. See generally DURST & MONKE, *supra* note 15 (discussing the federal taxation of family farms and individual Code provisions that benefit family farmers).

91. See I.R.C. § 2031(c) (2000) (allowing deductions from a decedent's gross estate for the donation of a qualified conservation easement).

92. See *id.* § 2032A (providing special-use valuation for qualified real farm property).

93. See *id.* § 40(b)(4) (granting a tax credit to small ethanol producers).

94. See *id.* § 521 (allowing qualified farmers' cooperatives to receive special income tax deductions). Note that Section 521 does not include the special deductions for farmers' cooperatives, but it contains the requirements for such deductions.

problems in family farming,⁹⁵ and second, whether their benefits target the family farms most in need of federal aid.⁹⁶ This analysis provides a snapshot of the positives and negatives of current Code sections intended to benefit small family farmers.

A. Valuation Discounts

The federal estate tax is one of several means of raising revenue by taxing the transfer of wealth.⁹⁷ Much of the wealth of a family farm is often tied up in land,⁹⁸ and land values throughout the nation have appreciated substantially, especially in areas of heavy suburban development.⁹⁹ At the death of a family farmer, this combination of factors commonly causes the farmer's estate to be comprised primarily of illiquid real property, even though it may be large in nominal terms.¹⁰⁰ Family members that hope to continue farming require land, but they may face an estate tax bill that forces them to sell the family farm.¹⁰¹ The Code provides several means of protecting family farmers from the "liquidation problem," including estate tax deductions for the donation of a qualified

95. See *supra* Part II.A (discussing the crisis in family farming and the need to balance the policy goals of protecting family farmers and sustaining efficiency in agriculture).

96. See *supra* Part II.B (arguing that the family farms most in need of protection are family-owned and managed, small in terms of annual gross receipts, and operated primarily for income rather than enjoyment).

97. See Stephen C. Gara & Craig J. Langstraat, *Property Valuation for Transfer Taxes: Art, Science, or Arbitrary Decision?*, 12 AKRON TAX J. 125, 126 (1996) (discussing the general operation of the federal transfer tax system, which includes the estate, gift, and generation-skipping transfer taxes).

98. See TAX PLANNING FOR AGRICULTURE 7 (Alfred J. Olson & Thomas L. Schoaf eds., 2d ed. 1977) ("A severe lack of liquidity is found in the farm or ranch enterprise. The farm family's wealth almost entirely resides in production assets, with liquid assets typically controlling less than 5% of total worth.").

99. See *supra* note 57 and accompanying text (discussing the rise in land prices throughout the United States).

100. RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION § 2.01(1)(a) (8th ed. 2002) (discussing computation of the estate tax). Stephens states that in computing a decedent's estate tax liability, the first step is calculating a "tentative tax on the aggregate amount of the decedent's 'taxable estate' and 'adjusted taxable gifts.'" *Id.* The taxable estate is the decedent's gross estate minus any allowable deductions. *Id.* The property included in the gross estate is valued according to either Section 2031 or Section 2032A. *Id.*

101. See Downs, *supra* note 76, at 345 (noting that absent additional protection, the valuation of farmland based on its fair market value may force heirs to sell all or part of the farm property to satisfy estate tax obligations); Stephen J. Small, *Understanding the Conservation Easement Estate Tax Provisions*, TAX NOTES, Apr. 17, 2000, at 435 (stating that land transfers between generations of property owners frequently result in heavy estate taxes, often forcing the heirs to sell inherited land to pay the tax).

conservation easement¹⁰² and special-use valuation for property used in family farming.¹⁰³

1. *Qualified Conservation Easements*

Stated simply, a conservation easement is a device whereby the owner of real property donates an easement to a public body or private charitable organization with a set of restrictions preventing any future changes to the land except as stated in the granting document.¹⁰⁴ The tax benefits derived from the donation of a conservation easement provide one solution to the liquidation problem that can endanger family farms.¹⁰⁵ Additionally, such easements do not threaten efficient food production, but rather benefit the general public in a number of ways.¹⁰⁶ Thus, tax incentives for the donation of conservation easements¹⁰⁷ represent effective use of the Code to benefit small family farmers without harming consumers.¹⁰⁸

Section 2055(f) allows a tax deduction from a decedent's gross estate for the testamentary donation of a qualified conservation easement.¹⁰⁹ Congress

102. See I.R.C. § 2031(c) (2000) (providing for a reduction of a decedent's gross estate upon donation of a qualified conservation easement); *id.* § 2055(f) (allowing an estate tax charitable deduction for qualified conservation easements).

103. See *id.* § 2032A (providing for the special-use valuation of property used for agricultural purposes).

104. See JESSE DUKEMINIER & JAMES E. KRIER, PROPERTY 858 (5th ed. 2002) (defining conservation easements).

105. See *supra* notes 97–103 and accompanying text (describing how the heirs of a family farm may be forced to sell the farmland because of the estate tax, and defining this phenomenon as the "liquidation problem").

106. See *infra* notes 115–17 and accompanying text (discussing the public benefits of conservation easements).

107. The Code provides tax incentives for the lifetime and posthumous donation of qualified conservation easements. See I.R.C. § 170(h) (2000) (providing an income tax deduction for the donation of a conservation easement); *id.* § 2031(c) (allowing a reduction in a decedent's gross estate for the donation of a qualified conservation easement); *id.* § 2055(f) (permitting an estate tax charitable deduction for the posthumous donation of a qualified conservation easement). Although several Code sections address conservation easements, Sections 2055(f) and 2031(c), which provide potential estate tax relief, go the furthest toward protecting small family farms from the liquidation problem.

108. See *supra* Part II.A (arguing that an effective Code solution to the problems of family farmers must address the fundamental problems in agriculture without depriving the public of the benefits of efficient food production).

109. I.R.C. § 2055(f) (2000); see also *id.* § 170(h) (defining a qualified conservation contribution as a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes); DONALD H. KELLEY ET AL., ESTATE PLANNING FOR FARMERS AND RANCHERS § 6.70 (2003) (discussing the requirements for qualification under the

allows executors to deduct the entire value of the easement from the estate, providing the potential for a substantial reduction in estate tax liability.¹¹⁰ This deduction may be enough to protect a family farm from the liquidation problem.¹¹¹

By enacting Section 2031(c), Congress greatly expanded the tax benefits for donation of a conservation easement and provided family farmers with additional protection from the liquidation problem.¹¹² While leaving Section 2055(f) intact, this new provision adds an additional exclusion from a decedent's gross estate, allowing a deduction of up to 40% of the value of land subject to a qualified conservation easement.¹¹³ Sections 2031(c) and 2055(f) work in tandem to lessen the potential estate tax burden on a farm family.¹¹⁴

section).

110. See I.R.C. § 2055(d) (2000) ("The amount of the deduction under this section for any transfer shall not exceed the value of the transferred property required to be included in the gross estate.").

111. See, e.g., Small, *supra* note 101 (illustrating the effect of Section 2055(f)). As a hypothetical example, assume a decedent dies with land valued at \$1.5 million and donates a qualified conservation easement worth \$500,000 under her will. Decedent's taxable estate would be \$1.5 million. Section 2055(f) allows the executor of Decedent's estate to exclude the full \$500,000 easement value from Decedent's taxable estate, meaning her taxable estate will only be \$1 million because of the donation.

112. See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 508, 111 Stat. 788, 857 (codified at 26 U.S.C. § 2031(c) (2000)) (enacting Section 2031(c)); see also S. REP. NO. 105-33, at 31 (1997) (discussing reasons for enacting Section 2031(c) and stating that "[t]he Committee believes that a reduction in estate taxes for land subject to a qualified conservation easement will ease existing pressures to develop or sell off open spaces in order to raise funds to pay estate taxes, and will thereby help to preserve environmentally significant land").

113. See I.R.C. §§ 2031(c)(1)-(2) (2000) (allowing a deduction of up to 40% of the value of land subject to a qualified conservation easement, but reducing the deduction's cap linearly if the easement is less than 30% of the land). The maximum amount that may be excluded under Section 2031(c) was \$100,000 in 1998 but is currently set at \$500,000. See *id.* § 2031(c)(3) (listing the yearly exclusion limitation and stating that this limitation is set at \$500,000 in 2002 and thereafter).

114. See *id.* § 2031(c)(1)(A) (stating that the value of land to which the exclusion percentage is applied is reduced by any Section 2055(f) deduction). Note that Section 2031(c) is not a strict double benefit on top of the Section 2055(f) exclusion. Section 2055(f) reduces the value of the estate by the amount of the conservation easement, and Section 2031(c) applies the applicable percentage to this reduced value to obtain the total deduction. See also KELLEY ET AL., *supra* note 109 (discussing the Section 2055(f) and Section 2031(c) deductions working together and concluding that "[t]he total of the two deductions is \$440,000, which is obviously better than either alone and \$40,000 better than the exclusion alone"). In an example based on Kelley's analysis, assume a piece of land is valued at \$1 million and an easement is worth \$200,000. Applying the Section 2055(f) exclusion, decedent's executor may reduce the taxable estate by the \$200,000 easement value. Assuming a simultaneous election of Section 2031(c), the 40% deduction is applied to the property value with the easement, allowing a deduction of 40% of \$800,000, or \$320,000. If the Section 2031(c) election is made alone, the deduction is

By encouraging the donation of qualified conservation easements, Section 2031(c) provides tangible benefits to the general public without jeopardizing efficient food production. Sections 2055(f) and 2031(c) create indirect long term benefits for farming communities. If a farmer places a conservation easement on his land, state law ensures that the farm will never be developed, meaning it will remain available for use in future agricultural production.¹¹⁵ At the same time, conservation easements help to prevent the urban sprawl that greatly increases the price of property.¹¹⁶ Sections 2055(f) and 2031(c) also permanently preserve open spaces for the benefit of the general public.¹¹⁷ These benefits cost consumers nothing in terms of lost efficiency because the donation of conservation easements does not interfere with agricultural markets.

Congress did not explicitly target the benefits of Sections 2055(f) and 2031(c) to small family farmers, but it made the Sections attractive to such farmers in several important situations. If a farmer wants to preserve his land and ensure that his family will not have to liquidate to pay the estate tax, he may grant a conservation easement through his will, and his executor may exclude the easement amount under Section 2055(f).¹¹⁸ Alternatively, a farmer may grant his property to a family member. If the family member hopes to continue farming but faces the liquidation problem, Section 2031(c) permits her to make the easement donation and to elect the estate tax deduction.¹¹⁹ Finally,

equal to 40% of \$1 million, or \$400,000. If the two provisions are elected together, the total reduction would be \$320,000 plus \$200,000, but due to the exclusion limitation, this amount would be capped at \$500,000 in 2004.

115. See *DUKEMINIER & KRIER*, *supra* note 104, at 858 (stating that almost all fifty states have enacted statutes authorizing conservation easements, thereby resolving questions as to their validity, transferability, and perpetual duration).

116. See *Mann*, *supra* note 75, at 208–09 (discussing urban sprawl and its consequences on communities).

117. See, e.g., S. REP. NO. 105-33, at 31 (1997) (stating that the reason for changing Section 2031(c) was to prevent the loss of environmentally significant land).

118. See I.R.C. § 2031(c)(8)(C)(i) (2000) (allowing a decedent to donate a qualified conservation easement); *id.* § 2055(f) (allowing a decedent who transfers a qualified conservation easement through a will to obtain an estate tax deduction); see also *STEPHENS ET AL.*, *supra* note 100, ¶ 4.02(7)(b) (discussing options for election of the Section 2031(c) deduction).

119. See I.R.C. § 2031(c)(8)(C)(ii) (2000) (allowing a member of the decedent's family to donate a qualified conservation easement); *id.* § 2032A(e)(2) (defining members of the decedent's family to include the decedent's ancestors, spouses, lineal descendants and their spouses, the decedent's spouse's lineal descendants and spouses, and the decedent's parents' lineal descendants and their spouses). *But cf.* *Small*, *supra* note 101 (counseling families against using postmortem provisions involving conservation easements to address estate tax problems, partially because of the hurdle of obtaining the agreement of all the estate's heirs.

the executor of the decedent's estate¹²⁰ may make the Section 2031(c) election if it is in the best interest of the heirs.¹²¹ By providing these alternatives, Congress recognizes the particular needs of the small family farmer.

Several of the statutory restrictions on qualification for Sections 2031(c) and 2055(f) indicate that Congress intended small family farms to benefit from the Sections. Only easements for conservation purposes receive tax benefits under Section 2031(c).¹²² The list of conservation purposes that qualify includes preserving open space and specifically mentions farmland.¹²³ Additionally, the maximum 40% exclusion available under the Section is reduced by the value of any development rights retained by the easement donor.¹²⁴ However, development rights do not include commercial uses related to farming.¹²⁵ Congress also targeted the provision to smaller estates by

which is required to donate such an easement).

120. Similar logic applies in cases where the decedent places the farm property into a trust. See I.R.C. § 2031(c)(8)(C)(iv) (2000) (stating that the trustee of a corpus, including land to be placed in a conservation easement, may donate such an easement).

121. See *id.* § 2031(c)(8)(C)(iii) (allowing the executor of the decedent's estate to donate a qualified conservation easement). The executor may have difficulty donating a conservation easement under Section 2031(c) because of his fiduciary obligations. See Robert H. Levin, *You're Not Too Late: Post-Mortem Donations of Conservation Easements*, TAX NOTES, Oct. 30, 2000, at 661 (discussing the fiduciary duty of estate executors, whereby fiduciaries are "required to act solely in the best interest of their beneficiaries"); *id.* (discussing situations where title to property devised by a will does not vest immediately in the devisees, but rather the executor or personal representative takes either temporary legal title or personal control of the property). Levin argues that in such situations, executors' fiduciary duties may present obstacles to the donation of conservation easements, but that these obstacles are not insurmountable. *Id.* at 435. Although donation of a conservation easement may help with the liquidation problem, such an easement eliminates the development potential of farm property, which may be extremely valuable. An executor may therefore breach his fiduciary duty if the loss of such development potential is not in the heirs' best interest. See Small, *supra* note 101 (arguing that absent court approval or explicit authorization from the will, an executor may have difficulty making a charitable contribution from the estate's assets, but noting that Colorado and Virginia have enacted legislation allowing executors and trustees to donate conservation easements in certain situations).

122. See I.R.C. § 2031(c)(8)(B) (2000) (stating that qualified conservation easements are defined by Section 170(h), which requires that the easement be granted for conservation purposes).

123. See *id.* § 170(h)(4)(A)(iii) (stating that the preservation of open space is a conservation purpose when such preservation is either for the scenic enjoyment of the public or where it furthers a stated governmental conservation policy that yields a significant public benefit).

124. See *id.* § 2031(c)(5)(A) (stating that the estate tax exclusion does not apply to the value of development rights retained by the donor of the easement).

125. See *id.* § 2031(c)(5)(D) (stating that "development right" means any right to use the land subject to the qualified conservation easement in which such right is retained for any commercial purpose that is not subordinate to and directly supportive of the use of such land as

capping the maximum estate tax deduction allowable under Section 2031(c).¹²⁶

In sum, Sections 2055(f) and 2031(c) enable family farms to substantially lower their estate tax liability by donating conservation easements. These Sections may thereby prevent the forced liquidation of farm property that can occur upon the death of a farm owner and instead allow the owner's family to continue operation of the farm. Sections 2055(f) and 2031(c) are also effective as tax expenditures. By encouraging the donation of conservation easements, they benefit the general public without hindering efficient food production. Though the tax advantages of the provisions are not explicitly targeted to small family farmers, Congress clearly drafted the Sections with this group in mind. Thus by providing tax incentives for the donation of qualified conservation easements, Congress has taken positive, though limited, steps toward the goal of saving the family farm.

2. Section 2032A: Special-Use Valuation

Because the estate tax is based on the value of the transferred property, issues related to valuation are extremely important when determining tax liability.¹²⁷ In general, for estate tax purposes, real property is valued at its fair market value, determined according to its "highest and best use."¹²⁸ Valuation based on highest and best use means the hypothetical price obtained if the land was sold in the open market for its most economic use—the use that would bring the highest price.¹²⁹

a farm for farming purposes (within the meaning of Section 2032A(e)(5)); see also *id.* § 2032A(e)(5) (defining farm purposes broadly to include cultivating land to produce crops, handling and processing farm commodities provided the farm produces more than half of such commodities, and growing and harvesting trees for sale).

126. See *id.* § 2031(c)(3) (setting the exclusions limitation for Section 2031).

127. See Gara & Langstraat, *supra* note 97, at 126 (1996) ("Valuation issues, as a result, have a significant impact in the transfer tax system. Valuation is the very essence of these taxes.").

128. See I.R.C. § 2031 (2000) (defining decedent's gross estate); *Estate of Juden v. Comm'r*, 865 F.2d 960, 963 (8th Cir. 1989) ("The fair market value of real property must reflect the highest and best use of that property on the relevant valuation day."); *Treas. Reg. § 20.2031-1(b)* (1965) (stating the default rule that the value of all property included in a decedent's gross estate is its fair market value on the date of death, and defining fair market value for purposes of the section); see also Dennis R. Delaney, *How Small Businesses Really Fared Under the Estate Tax Provisions of the Taxpayer Relief Act of 1997*, 17 VA. TAX REV. 245, 257 (1997) ("Generally, the Code values property at its fair market value for purposes of the estate tax."); Gara & Langstraat, *supra* note 97, at 142 (discussing the standard valuation of real property for purposes of the estate tax).

129. See *Estate of Pattison v. Comm'r*, 60 T.C.M. (CCH) 471, 1990 Tax Ct. Memo LEXIS 445, at *6-7 (1990) (citing the definition of "highest and best use" used by the American

Valuation based on highest and best use creates obvious problems for family farmers that face the estate tax. Farmland typically comprises the bulk of the value of a family farm estate,¹³⁰ and highest and best use valuation may make such estates very large in nominal terms. Particularly in locales where extensive development has led to rapidly appreciating land values,¹³¹ the value of a large tract of property when put to its prior agricultural use is commonly much lower than its highest and best value, which is often the price the land would bring if sold for development.¹³² For example, in York County, Pennsylvania, residential development has led to a substantial rise in the value of farm property.¹³³ For a particular 200-acre York County farm, the difference between the development and agricultural values is \$830,000.¹³⁴ Thus the valuation system may create substantial additional estate tax liability, and family members that inherit farmland may be forced to liquidate the property to pay the tax.¹³⁵

The Section 2032A special-use valuation provides an effective though narrowly targeted solution to the liquidation problem by allowing the heirs of farmland to value such property based on its agricultural value rather than its highest and best use.¹³⁶ If the property meets the detailed requirements of the

Institute of Real Estate Appraisers in reference to the valuation of two properties under I.R.C. § 2031). The highest and best use of a property is the "most economic use which is reasonably probable." *Id.*; see also Gara & Langstraat, *supra* note 97, at 142 (explaining that the highest and best use of a property is the use that results in the property's highest value).

130. See *supra* notes 98–100 and accompanying text (describing the typical family farm estate).

131. See *supra* note 57 and accompanying text (discussing land appreciation in areas of substantial development).

132. See Downs, *supra* note 76, at 344 (stating that a property's agricultural value is less than its fair market value because assets invested in agriculture typically have a low rate of return).

133. York County is located between Harrisburg, Pennsylvania, and Baltimore, Maryland. Heavy suburban development in the county has led to substantial appreciation in land value.

134. These values are based on data from the Farm and Natural Lands Trust of York County.

135. See *supra* note 101 and accompanying text (discussing the "liquidation problem" faced by family members that inherit farmland).

136. See I.R.C. § 2032A(a) (2000) (providing for special-use valuation of certain farm property); see also Delaney, *supra* note 128, at 257 ("Congress enacted this section in an attempt to allow heirs who intended to continue the operation of a farm to avoid the necessity of selling part or all of the real property in order to pay the federal estate tax."). But see Treas. Reg. § 20.2032A-3 (as amended in 1981) (stating that when the taxpayer elects and qualifies for the special-use valuation, the property in question will be valued according to its agricultural value rather than fair market value, even if its highest and best use is its agricultural use).

Section, which essentially ensure that the entity is a small family farm,¹³⁷ the executor of the estate may elect the special-use valuation option.¹³⁸ Such an option effectively lowers the value of the decedent's gross estate, meaning in turn that the family's estate tax liability will be less, and hence reduces the chance that the family will have to liquidate the farm property.¹³⁹ The extent of the reduction in estate tax liability depends on the spread between the special-use valuation and the highest and best use valuation—the greater the spread, the greater the tax benefits.¹⁴⁰

Notably, special-use valuation has little impact on American consumers. The benefits of the Section target the liquidation problem faced by family farmers and thereby helps to keep such farms in business. On the other hand, the efficient food production that benefits consumers derives from the functioning of agricultural markets.¹⁴¹ The protection of small family farmers through special-use valuation therefore comes at a low cost to consumers.

Congress set strict qualifications for special-use valuation, effectively targeting the Section so that it benefits small family farmers.¹⁴² The upside to such targeting is that the benefits of Section 2032A reach the farmers most in need of federal aid: small family-owned and operated farms that depend on agriculture for their livelihood.¹⁴³ The downside is that Congress has erected a number of complex requirements that make qualification difficult.¹⁴⁴

137. See *infra* notes 142–158 and accompanying text (describing how the restrictions on Section 2032A ensure that the provision only applies to small family farms).

138. See I.R.C. § 2032A(a)(1)(B) (2000) (stating that if the subject property qualifies under the Section, the estate executor may elect special-use valuation).

139. See Downs, *supra* note 76, at 345 ("By valuing farm property on the basis of its actual use for agricultural purposes rather than on its higher fair market value, section 2032A reduces the size of the gross estate from which estate taxes are calculated and, therefore, reduces the estate tax liability at the decedent's death.").

140. Thus in theory, the Section provides relatively smaller benefits to farmers in largely rural areas, where the highest and best use of land is likely to be farmland rather than development.

141. See *supra* Part II.A (discussing the transformation of U.S. agriculture that has led to efficient food production).

142. See I.R.C. § 2032A(a)–(b) (2000) (listing requirements for special-use valuation); see also Downs, *supra* note 76, at 345 (stating that Congress made it difficult to qualify for special-use valuation). *But see* I.R.C. § 2032A(b)(2)(B) (2000) (stating that the benefits of the Section are not restricted to farming, as other trades and businesses that satisfy the requirements of the Section may qualify). Discussion of such additional trades and businesses is beyond the scope of this Note.

143. See *supra* Part II.B (concluding that when allocating tax benefits, Congress should define the family farm as an entity that is small, family-owned and operated, and dependent on agriculture for income).

144. See STEPHENS ET AL., *supra* note 100, ¶ 4.04(1) ("Thus, Congress, while lamenting the

Congress effectively targeted the benefits of Section 2032A to farms that are family-owned and operated, satisfying the first element of the definition of family farms. To qualify for special-use valuation, the decedent must transfer the property to another family member,¹⁴⁵ ensuring continuation of the operation.¹⁴⁶ The family must also have used the property as a farm¹⁴⁷ for a specified period of time both before and after the decedent's death.¹⁴⁸ Finally, the family must have participated in the farm's operation and shared in its business risks during the relevant statutory periods.¹⁴⁹ Ownership of a farm by

impact of the estate tax on small business, has itself contributed to the problem for small businesses by enacting relief provisions that are exceedingly complex, not properly coordinated, and in an attempt to be targeted at only specific situations, probably too restrictive.").

145. The decedent must pass the property to an individual falling within a restricted subset of the decedent's immediate family, whom the Code refers to as "qualified heirs." See I.R.C. § 2032A(b)(1) (2000) (requiring that the subject property pass to a qualified heir); *id.* §§ 2032A(e)(1)–(2) (stating that a qualified heir is a recipient of property from the decedent who is one of the decedent's family members); *id.* § 2032A(e)(2) (defining family members eligible to receive the subject property under the Section). The statutory definition of family member includes ancestors, spouses, and lineal descendants of the decedent, his spouse, or his parents. See STEPHENS ET AL., *supra* note 100, ¶ 4.04(3)(b)(vii) (discussing the statutory definition of "member of the family"). Note that the definition is flexible because it recognizes that many generational transfers of farm property involve not only family members related by blood, but also their spouses. See I.R.C. § 2032A(e)(2)(D) (2000) (defining members of the decedent's family to include the spouses of decedent, decedent's parents, and decedent's lineal descendants); see also *id.* § 2032A(e)(2) (treating an adopted child as a blood relative).

146. See STEPHENS ET AL., *supra* note 100, ¶ 4.04(7) ("Section 2032A was enacted to encourage the continued use of real property in family farms and other small business operations.").

147. See I.R.C. § 2032A(b)(1) (2000) (defining qualified real property as that which "on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family"); *id.* § 2032A(b)(2)(A) (stating that qualified use equates to use as "a farm for farming purposes"); *id.* § 2032A(e)(4) (defining a farm as "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"); *id.* § 2032A(e)(5) (defining farming purposes as the cultivation or production of an agricultural commodity on a farm, the storing or processing of such a commodity if more than half of the commodity was produced on the farm, or the cutting or cultivating of trees).

148. The decedent must have used the real property passing to his qualified heirs as a farm for an aggregate of five years during an eight-year period prior to that decedent's death, and the decedent must have owned the farm and "materially participated" in its operation during that period. I.R.C. § 2032A(b)(1)(C) (2000). If the family ceases to operate the farm within ten years of the decedent's death, Congress imposes a recapture tax, effectively revoking the benefits of the Section. See *id.* §§ 2032A(c)(1)–(2) (imposing a recapture tax in the event that a qualified heir ceases to use the property as a farm within ten years of the decedent's death). Note, however, that the heir has two years after the death of the decedent to begin the qualified use, tolling the start of the ten-year period until such use commences. *Id.* § 2032A(c)(7).

149. Congress included a material participation requirement in the Section, which

a corporation or partnership does not necessarily preclude special-use valuation, importing valuable flexibility into the Section for family farmers.¹⁵⁰

Congress also attempted to limit the benefits of Section 2032A to small estates and therefore to small farms.¹⁵¹ This attempt addresses the size component in the definition of the family farm.¹⁵² Congress set caps on the allowable reduction in estate value that can be obtained from special-use

distinguishes passive investment in the farm from active involvement and risk. *See id.* § 2032A(b)(1)(C)(ii) (requiring material participation by decedent or a member of his family during the allotted holding period prior to disposition); *id.* § 2032A(c)(6)(B)(i) (stating that if the qualified heir fails to materially participate in the operation of the farm for certain periods of time following decedent's death, the special-use valuation will be lost); *see also* Delaney, *supra* note 128, at 259 (highlighting the importance of the "material participation" requirement as a screening mechanism, and discussing the types of activity that qualify as material participation). The Treasury regulations accompanying Section 2032A provide for a fact specific determination of material participation, but they clearly state that the key criteria are the level and type of participation and the amount of risk involved. No single factor is determinative of the presence of material participation, but physical work and participation in management decisions are the principal factors to be considered. *See* Treas. Reg. § 20.2032A-3(a) (as amended in 1981) (discussing the method for determining whether participation in a farm business qualifies as "material participation"); *id.* § 20.2032A-3(e) (listing activities that may qualify as material participation and factors to be considered in making the determination); Cynthia A. Miller, *Reasonable Options for Those Who Do Not Want To Sell the Farm: Farm Leases and Farm Management Companies*, 5 DRAKE J. AGRIC. L. 251, 262 (2000) ("Residing on the farm, physically inspecting crop operation on a continual or regular basis and directly participating with the tenant in management decisions . . . might mean the difference between the farm estate qualifying for special-use valuation or that farm being taxed at its highest and best use."); *see also* STEPHENS ET AL., *supra* note 100, ¶ 4.04 (describing the qualifications an estate must meet to acquire special-use valuation, including the material participation requirement).

150. *See* I.R.C. § 2032A(g) (2000) (discussing the election of special-use valuation for partnerships, corporations, and trusts).

151. Note that the traditional means of distinguishing between large and small farms is based on gross receipts. *See supra* notes 80–83 and accompanying text (discussing the means of distinguishing between large and small farms). Estate size may also be used to define differences in farm size, though it may be difficult to find the correlation between gross receipts and estate value. However, there is likely to be some correlation between the two measures. For example, a large farm will likely have high gross receipts but also own valuable assets. *See* CENSUS BUREAU, *supra* note 83, at 2 (stating that large farms, those with annual sales exceeding \$100,000, on average own machinery and equipment valued at \$150,852 and land and buildings valued at \$1,059,510). The Census Bureau estimates that the average value of assets owned by large farms exceeds that of small farms by a factor of five. *Id.*

152. *See supra* notes 80–83 and accompanying text (discussing the size component in the definition of the family farm).

valuation,¹⁵³ fixing the cap at \$840,000 in 2003.¹⁵⁴ Relatively speaking, these caps make the provision less valuable to larger farm estates.¹⁵⁵

Finally, Congress attempted to limit the availability of Section 2032A to family farms owned primarily for business rather than pleasure.¹⁵⁶ The Section applies only to estates where farm assets make up a substantial portion of both real and personal property.¹⁵⁷ Congress could have excluded more hobby and retirement farms from the benefits of the Section by directly requiring that the owner depend on farm income for sustenance. The present statutory requirements, however, represent at least some effort at preventing hobby and retirement farms from qualifying.¹⁵⁸

Special-use valuation under Section 2032A may provide an effective remedy to the liquidation problem, but there is room for improvement in the provision. Section 2032A contains detailed requirements for special-use valuation. Although these requirements effectively target the provision to small family-owned and operated farms, their complexity makes the Section difficult to apply and adds to the costs of estate planning.¹⁵⁹ A

153. See I.R.C. § 2032A(a)(2) (2000) (capping the aggregate discount allowed under the Section, and providing an annual inflation adjustment for the cap).

154. *Id.* § 2032(A)(2).

155. *Cf. Delaney, supra* note 128, at 258 (describing the cap on the allowable special-use discount as "substantial").

156. *Cf. id.* at 258–59 (stating that the 50% and 25% requirements effectively limit the Section 2032A special-use valuation to small estates by requiring farm property to make up a substantial portion of the decedent's estate).

157. Section 2032A applies only where actual farm property comprises a substantial portion of a decedent's estate. See I.R.C. § 2032A(b)(1)(A) (2000) (requiring that at least 50% of the real *and* personal property in decedent's gross estate have been used for farming purposes); *id.* § 2032(A)(b)(2)(A) (defining qualified use as a use of a farm for farming purposes); *id.* § 2032A(b)(1)(B) (requiring that farmland comprise at least 25% of the decedent's gross estate).

158. A hobby farm may be a family-operated entity, but is such that the owner derives most of his income from sources other than the farm. See THE ERS FARM TYPOLOGY, *supra* note 29, at 11 (discussing residential/lifestyle farms whose owners report a major occupation other than farming). On such farms, a decedent's estate is more likely to contain a large percentage of nonfarm property and therefore fail to qualify under the Section.

159. See *Hearing on President's Tax Relief Proposals, supra* note 17 ("Attempts to target death tax relief make the law even more complex and necessitate even more extensive and expensive death tax planning. Even with the best advice, estates may fail to meet eligibility criteria at death, making a bad situation even worse.") (on file with the Washington and Lee Law Review); see also PATRICIA A. WOLFF, STATEMENT OF THE AM. FARM BUREAU FED. TO THE U.S. DEP'T OF THE TREAS. ROUNDTABLE ON JOBS, GROWTH AND THE ABOLITION OF THE DEATH TAX 2 (2003) (stating that special estate tax relief provisions applicable only to farms may reduce the number of farm estates paying taxes, but such relief costs a considerable amount of time and money in the form of estate planning and administration).

simpler set of requirements, however, could increase the spillover of tax benefits to farm entities that do not need protection.

In sum, Section 2032A, like Sections 2055(f) and 2031(c), provides a remedy to the liquidation problem and thereby helps to preserve family farms. The Section may provide substantial estate tax relief in situations where the highest and best use valuation of a property is much greater than its agricultural value. Additionally, by its nature, such estate tax relief does not jeopardize the benefits of efficient food production. Congress effectively targeted the provision to small family-owned and operated farms and made some attempt to exclude hobby and retirement farms. The same specific targeting and detailed requirements, however, make qualification for special-use valuation difficult. Thus, special-use valuation provides an important benefit, but it does not amount to a final solution to the problems of America's small family farmers.

B. Current Income Tax Benefits

Like other taxpayers, family farmers are subject to the federal income tax. The Code contains a number of income tax provisions that benefit family farmers by simplifying their recordkeeping and accounting procedures, granting special deductions and credits, and subsidizing farm-related businesses.¹⁶⁰ Two provisions of special note are the Section 40 small ethanol producer credit¹⁶¹ and the special advantages for agricultural cooperatives under Section 521.¹⁶² These provisions illustrate the effective utilization of income tax benefits for farm-related businesses to combat some of the fundamental problems in small family farming without jeopardizing modern efficient agriculture.¹⁶³

160. See DURST & MONKE, *supra* note 15, at 5–25 (discussing the federal income taxation of farms).

161. See I.R.C. § 40(a)(3) (2000) (providing a small ethanol producer credit).

162. See *id.* § 521 (setting the qualifications for special farmers' cooperative deductions). Although Section 521 contains only the qualifications for the special deductions, cooperatives that qualify for the deductions are known as Section 521 cooperatives. See RURAL BUS. COOPERATIVE SERV., U.S. DEP'T OF AGRIC., INCOME TAX TREATMENT OF COOPERATIVES: INTERNAL REVENUE CODE SECTION 521, 1 (1996) [hereinafter INTERNAL REVENUE CODE SECTION 521] (describing farmers' cooperatives and their treatment by the Code).

163. See *supra* Part II.A (concluding that solutions to the problems of family farmers must not cost consumers the gains derived from modern efficient food production).

1. Small Ethanol Producer Tax Credit

Small family farmers have suffered from the loss of local markets for their products and from a gradual decline in crop prices.¹⁶⁴ Policymakers seeking to remedy these losses have found a solution in ethanol.¹⁶⁵ Accordingly, Congress created the small ethanol producer credit (the Credit) to encourage and support the production of ethanol by small plants, many of which are owned by farmers.¹⁶⁶ The Credit is a successful tax solution to the crisis in family farming because it simultaneously benefits family farmers and the general public.¹⁶⁷

Ethanol, alcohol distilled from corn, is used as a gasoline additive to reduce emissions.¹⁶⁸ In 1990, Congress amended the Clean Air Act to require the sale of cleaner burning fuels in areas of high carbon monoxide, which increased the demand for ethanol dramatically.¹⁶⁹ Concerns over dependence

164. See *supra* notes 56–73 and accompanying text (discussing the problems faced by the modern small family farmer).

165. See Dave Mowitz, *Figuring Out the Actual Cost of Ethanol and Big Oil*, SUCCESSFUL FARMING, Jan. 2002, http://www.findarticles.com/p/articles/mi_m1204/is_1_100/ai_82512760 (last visited Nov. 17, 2004) (noting that the ethanol industry increased farm income by \$4.5 million in 2000 by consuming corn and supporting prices) (on file with the Washington and Lee Law Review); cf. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 1508, 101 Stat. 1330, 29 (codified at 42 U.S.C. § 7545 (2000)) (stating Congress's finding that ethanol usage could reduce grain surpluses and farmers' dependence on federal subsidies). But see Stu Ellis, *Farmer Mentality*, at <http://www.urbanext.uiuc.edu/macon/agcolumn/030528.html> (May 28, 2003) (arguing that overproduction of ethanol will lead to a drop in corn prices) (on file with the Washington and Lee Law Review).

166. See Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11502, 104 Stat. 1388, 11502 (creating the small ethanol producer tax credit); see also Mary Thompson & Kevin McNew, *New Tool Helps Producers Assess Ethanol Plant Impact*, FARM FOUNDATION PRESS RELEASE, Sept. 17, 2003 (stating that currently more than seventy ethanol plants operate in the United States with additional plants under construction and that many of the plants are owned by farmers).

167. See *supra* Part II.A (concluding that solutions to the problems of family farmers must not cost consumers the gains derived from modern efficient food production); *Hearing on Energy Security and Agricultural Issues Before the S. Comm. on Agric., Nutrition, and Forestry*, <http://waysandmeans.house.gov/legacy/fullcomm/107cong/3-21-01/107-6final.htm> (last visited Nov. 28, 2004) (prepared statement of Roger K. Conway, Dir., Office of Energy and New Uses, Economic Research Service, U.S. Dep't of Agric.) ("Farm products as a source of energy are promising because they have the potential to provide benefits in energy security and environmental quality while raising farm income.") (on file with the Washington and Lee Law Review).

168. See ALTERNATIVE FUELS DATA CTR., U.S. DEP'T OF ENERGY, WHAT IS ETHANOL? (2003), at http://www.eere.energy.gov/afdc/altfuel/whatis_eth.html (last modified Oct. 13, 2004) (describing ethanol and its uses) (on file with the Washington and Lee Law Review).

169. See HOSEIN SHAPOURI ET AL., U.S. DEP'T OF AGRIC., THE ENERGY BALANCE OF CORN ETHANOL: AN UPDATE I (2002) (discussing the factors that led to increases in ethanol demand

on foreign oil also drove this spike in demand.¹⁷⁰ Ethanol production, therefore, benefits consumers both because of its environmental advantages and because of its potential as an energy source. Family farms have also profited from the surge in demand for ethanol because it has increased and stabilized the price of corn.¹⁷¹ Likewise, small farmer-owned ethanol processing plants have begun to appear throughout the United States.¹⁷² Such plants create local markets for farmers' corn and provide much needed revenue for the farmers who invest in them.

In 1990, Congress instituted the small ethanol producer tax credit to promote ethanol production.¹⁷³ The Credit amounts to ten cents per gallon on ethanol production of up to fifteen million gallons per year.¹⁷⁴ It is available to ethanol plants owned by individuals, corporations, partnerships, and cooperatives.¹⁷⁵ Congress also limited the Credit to smaller plants.¹⁷⁶

The Credit benefits family farmers both directly and indirectly. The Credit is one component of the General Business Credit (GBC), which reduces an individual's income tax liability dollar for dollar.¹⁷⁷ Because many small ethanol plants are owned directly by farmers,¹⁷⁸ such farmers receive a share of

and production).

170. *See id.* ("The oil embargo of 1973 and the Iranian revolution of 1978 caused oil prices to increase rapidly, creating much concern over the security of national energy supplies.").

171. *See id.* (noting that added production of ethanol increases the demand for corn and raises the average corn price).

172. *See* DOWNSTREAM ALTERNATIVES INC., THE CURRENT FUEL ETHANOL INDUSTRY TRANSPORTATION, MARKETING, DISTRIBUTION, AND TECHNICAL CONSIDERATIONS 2-10 (2000) (stating that in 2000, there were fifty ethanol plants operating in twenty states, though the plants were heavily concentrated in the Midwest); *id.* at tbl.2-1 (listing operating ethanol plants in the United States).

173. *See* Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11502, 104 Stat. 1388, 11502 (creating the small ethanol producer tax credit).

174. I.R.C. § 40(b)(4) (2000); *see* CCH INC., 2004 MASTER TAX GUIDE 429 (describing the small ethanol producer credit).

175. *See* I.R.C. § 40(g) (2000) (defining eligibility for the small ethanol producer credit and limiting such eligibility to plants owned by individuals, partnerships, corporations, and cooperatives).

176. *See id.* § 40(g)(1) (stating that eligible small ethanol producers are those with productive capacities of up to thirty million gallons per year).

177. *See id.* § 38(b)(3) (stating that the GBC is the sum of individual credits, including the alcohol fuels credit of Section 40(a)); *see also* CCH INC., *supra* note 174, at 427 (describing the GBC).

178. *See, e.g.,* David Morris, *A Bottom Up Energy Policy*, TWIN CITIES STAR TRIB., May 16, 2001, <http://www.newrules.org/electricity/stlbushcolumn.html> (last visited Nov. 16, 2004) (noting that two thirds of Minnesota's ethanol plants are farmer-owned and that 15% of grain farmers are shareholders in an ethanol plant) (on file with the Washington and Lee Law Review); Mary Thompson & Kevin McNew, *So You Want to Build an Ethanol Plant?*, MONT.

the tax credit based on their ownership.¹⁷⁹ Farmers also benefit indirectly because the Credit acts as an incentive for the construction of ethanol plants. When finished, such plants create the localized corn markets and higher corn prices that may help to sustain many small family farmers.¹⁸⁰

Although family farmers derive substantial benefits from Section 40, Congress did not target the provision directly to that group, as the statute does not limit the Credit to farmer-owned plants.¹⁸¹ This means that the large agribusiness companies and megafarms that increasingly dominate small family farms may invest in ethanol plants and reap the rewards of the Credit with little, if any, added benefit to consumers.¹⁸² Until recently, the provision excluded farmers' cooperatives from the Credit despite the fact that such entities own a number of ethanol plants.¹⁸³ Recognizing that cooperatives provide a means for small farmers to pool resources and improve their collective market position,¹⁸⁴ Congress amended the Section to allow cooperatives to pass the Credit on to

UNIV. NEWS, Sept. 15, 2003, <http://www.montana.edu/commserv/csnews/nwview.php?article=1250> (last visited Nov. 17, 2004) (stating that many of the ethanol plants operating in the United States in 2003 were owned by farmers and that nine out of sixteen plants in Iowa were farmer-owned).

179. See I.R.C. § 40(g)(4) (2000) (stating that in situations where more than one person has an interest in an ethanol facility, the capacity of the plant will be allocated according to the Treasury Secretary's instructions).

180. See *supra* notes 168–72 and accompanying text (discussing the indirect benefits of the small ethanol producer credit).

181. See I.R.C. § 40(g) (2000) (stating the eligibility requirements for the small ethanol producer credit).

182. See *supra* notes 65–68 and accompanying text (arguing that one of the main factors contributing to the decline of small family farms is the increasing dominance of agribusiness). Consumers benefit from ethanol because it helps to reduce pollution and dependence on foreign oil. So long as ethanol plants provide a stable supply of their product, the ownership of such plants has no impact on such benefits.

183. See Pub. L. No. 108-357, § 313, 118 Stat. 1418, 1467–68 (2004) (modifying the credit to make cooperatives eligible); RENEWABLE FUELS ASS'N, MODIFICATIONS ARE NEEDED TO MAKE THE SMALL ETHANOL PRODUCER CREDIT WORKABLE FOR FARMERS (2004), <http://www.ethanolrfa.org> (last visited Nov. 17, 2004) ("Due to their structure, farmer cooperatives are not eligible for this credit.") (on file with the Washington and Lee Law Review); see, e.g., Robert Pore, *Ethanol Industry More Diversified*, PLAINSMAN, Feb. 18, 2002 (stating that, for example, three out of four ethanol plants currently in operation in South Dakota are cooperatives, four other plants under construction are cooperatives, and several proposed plants would be cooperatives).

184. See, e.g., 149 CONG. REC. S1,745 (daily ed. Jan. 29, 2003) (statement of Sen. Fitzgerald) (discussing the positive impact of cooperative organization on family farmers, and advocating the extension of the ethanol credit to cooperatives); see also *infra* notes 204–13 and accompanying text (discussing the benefits small family farmers receive by joining cooperatives and the trend toward small farmer participation in such cooperatives).

their patrons.¹⁸⁵ Due to a lack of specific targeting, however, this move merely put farmer-owned cooperative ethanol plants on the same footing as facilities operated by large agribusiness corporations.

In conclusion, the small ethanol producer credit is a successful Code remedy to some of the problems faced by the modern family farmer. Ethanol production benefits the general public by providing cleaner burning gasoline and by reducing dependence on foreign oil. At the same time, ethanol production helps family farmers by stabilizing corn prices and creating local markets for corn. The Credit increases these benefits by generating incentives for investment in ethanol plants. Likewise, the Credit directly benefits farmers who invest in eligible ethanol plants by reducing their income tax burden. By failing to target Section 40 exclusively to small farmers, however, Congress allows agribusiness to claim the Credit. Thanks to this failure, farmers may suffer additional loss of market power to agribusiness with little or no gain to the public.

2. *Income Tax Deductions for Agricultural Cooperatives*

Agricultural cooperatives offer economic benefits for small family farmers by enabling them collectively to market their produce, purchase inputs, and gain better access to necessary services.¹⁸⁶ Thus cooperatives offer small family farmers the ability to act as a unit, countering the market dominance of large farms and agribusiness. Such collective action also encourages efficiency and thereby benefits the general public. Through its tax policy, Congress has not only recognized the unique nature of cooperatives as a form of business organization, but it has also provided special benefits to agricultural cooperatives that qualify under Section 521 of the Code.¹⁸⁷ By supporting agricultural cooperatives through the Code, Congress also benefits the small family farmers that depend on such entities for their survival.

Cooperatives are business organizations owned and controlled by the individuals who use their services, and cooperative benefits are distributed on

185. See Pub. L. No. 108-357, § 313, 118 Stat. 1418, 1467–68 (2004) (modifying Section 40 to allow qualified cooperatives to pass the ethanol credit on to their members).

186. U.S. DEP'T OF AGRIC., CO-OPS 101: AN INTRODUCTION TO COOPERATIVES 26–28 (1997) [hereinafter CO-OPS 101] (discussing marketing, purchasing, and service cooperatives).

187. See I.R.C. §§ 1381–1388 (2000) (governing the federal income taxation of cooperatives); *id.* § 521 (granting tax-exempt status for qualified farmers' cooperatives); see also RURAL BUS. COOPERATIVE SERV., U.S. DEP'T OF AGRIC., INCOME TAX TREATMENT OF COOPERATIVES: BACKGROUND 14–16 (1996) [hereinafter BACKGROUND] (describing the income taxation of cooperatives).

the basis of use.¹⁸⁸ Members of a cooperative benefit from participation in two ways: members receive the use of their cooperative's services¹⁸⁹ and members' use of such services entitles them to a share of the cooperative's earnings.¹⁹⁰ While members invest in cooperatives in the same way that people invest in corporations, the two entities differ by how they distribute earnings.¹⁹¹ When a corporation earns a profit, the corporation distributes its earnings through dividends to investors based on the amount of their investment.¹⁹² On the other hand, the primary purpose of a cooperative is to provide services to investors that they would not otherwise have.¹⁹³ The cooperative therefore distributes earnings to its members according to the amount of business they do with the cooperative.¹⁹⁴ The members' return is based on use rather than investment.¹⁹⁵

Through its income tax policy, Congress has recognized the fundamental difference between corporations and cooperatives and has taken measures to increase the desirability of the cooperative as a form of organization. The Code treats corporations as taxable entities in their own right, imposing an income tax on corporate earnings.¹⁹⁶ Additionally, when such earnings are passed on to the investor in the form of a dividend, the Code requires the investor to include the dividend in his gross income, subjecting it to the personal income tax.¹⁹⁷ Cooperatives, on the other hand, may qualify for pass-through taxation so that their earnings are taxed only at the individual level.¹⁹⁸ By allowing single

188. See CO-OPS 101, *supra* note 186, at 6 (stating the general definition of cooperatives).

189. RURAL BUS. COOPERATIVE SERV., U.S. DEP'T OF AGRIC., AGRICULTURAL COOPERATIVES IN THE 21ST CENTURY 2 (2002) ("Benefits available to cooperative members include both the right to receive services and to share in the earnings.").

190. *Id.*

191. BACKGROUND, *supra* note 187, at 15.

192. See *id.* (discussing earnings distribution by noncooperative entities).

193. CO-OPS 101, *supra* note 186, at 10.

194. See BACKGROUND, *supra* note 187, at 15 (describing patronage refunds by cooperatives). As an example, assume a cooperative has a net margin of \$5000 in a particular year. The net margin is the net income a cooperative earns from business conducted on a cooperative basis. *Id.* at 13. If the cooperative member accounts for 5% of the business conducted by the cooperative during the year, the member receives a patronage refund of \$5000 times 5%, or \$250. *Id.* at 15.

195. See CO-OPS 101, *supra* note 186, at 11 (stating that cooperative earnings are returned to patrons based on how much business the patron did with the cooperative during the year).

196. See I.R.C. § 11 (2000) (stating that the income of a corporation is subject to the federal income tax); BACKGROUND, *supra* note 187, at 19–21 (discussing the taxation of corporations).

197. See *id.* § 61(a)(7) (requiring taxpayers to include dividends from corporate stock holdings in gross income); BACKGROUND, *supra* note 187, at 19–21 (discussing the taxation of corporations).

198. See *id.* § 1382(b) (stating that certain payments by cooperatives to their patrons are

taxation of cooperative earnings, Congress concedes that cooperatives serve as a conduit for members' money.¹⁹⁹ When the members put resources into the cooperative, they are entrusting the cooperative to use their money to provide a service, not for the purpose of investment.²⁰⁰ Because the patron funds never belong to the cooperative, Congress does not tax earnings at the cooperative level.²⁰¹

Another justification for single taxation is that the patronage refund is a price adjustment.²⁰² When patrons provide products to the cooperative, the cooperative initially pays the patron for the product. After the cooperative sells the product, any premium on the sale must be returned to the patron as a price adjustment in the form of a patronage refund.²⁰³ Single taxation of cooperatives, therefore, represents congressional recognition of the basic function of the entity.

Agricultural cooperatives serve several important purposes in the farming community. For one, family farmers may form cooperatives to market their goods.²⁰⁴ In the modern farm economy, vertically integrated food retailers increasingly monopolize food production from start to finish.²⁰⁵ The marketing of farm products through cooperatives increases farmers' collective bargaining strength and influence over large retailers, counteracting their market domination and providing a means for farmers to sell their products at a stable price.²⁰⁶ Farmers' cooperatives also serve as purchasers, increasing the market

not taxable at the cooperative level); *id.* § 1385(a)(1) (requiring cooperative patrons to include patronage dividends in their gross income for income tax purposes); BACKGROUND, *supra* note 187, at 22 (discussing the general single tax principles of cooperative taxation).

199. See BACKGROUND, *supra* note 187, at 69–70 (discussing the conduit or agent characterization of cooperative taxation).

200. See *id.* at 69 (arguing that the cooperative serves as the patrons' agent when receiving the patrons' money).

201. See *id.* ("As the funds never belonged to the cooperative, the patrons, not the cooperative, recognize the income for tax purposes.").

202. See *id.* at 68 (discussing the price adjustment characterization of patronage refunds).

203. See *id.* (stating that "a cooperative may receive the product and make an advance payment," and "following sale of the product, the cooperative pays an additional amount to the patron as a patronage refund").

204. See Shannon L. Ferrell, Note, *New Generation Cooperatives and the Capper-Volstead Act: Playing a New Game by the Old Rules*, 27 OKLA. CITY U. L. REV. 737, 739 (2002) (stating that one of the functions agricultural cooperatives may serve is the marketing of patrons' goods).

205. See *supra* notes 43–47 and accompanying text (discussing market domination by huge food retailers).

206. See GARDNER, *supra* note 8, at 169 (stating that farmer-owned marketing cooperatives

power of the individual farmer.²⁰⁷ Purchasing cooperatives aid farmers by giving them access to bulk discounts on inputs and by assuring the quality of such inputs.²⁰⁸ Thus, purchasing cooperatives grant their small farmer members many of the advantages that would otherwise be limited to larger farms. Farmers may also organize cooperatives to provide services to their members.²⁰⁹ Through their cooperatives, small farmers may gain affordable access to services including crop harvesting, credit, and artificial insemination.²¹⁰ Notably, cooperatives that process raw inputs allow small family farmers to avoid market domination by agribusiness middlemen.²¹¹ Modern agricultural cooperatives serve more than one basic function.²¹² Many so-called "new wave" cooperatives seek to fully integrate food production from the farm to the store, effectively placing food distribution in the hands of their small farmer members.²¹³

have been established to counter the market power of corporate buyers); CO-OPS 101, *supra* note 186, at 12 ("Marketing on a cooperative basis, like purchasing supplies and services, permits members to combine their strength. . . . They can lower distribution costs, conduct joint product promotion, and develop the ability to deliver their products in the amounts and types that will attract better offers from purchasers."); David P. Claiborne, Comment, *The Perils of the Capper-Volstead Act and Its Judicial Treatment: Agricultural Cooperatives and Integrated Farming Operations*, 38 WILLAMETTE L. REV. 263, 266 (2002) (stating that cooperatives act as agents for their members, bargaining for the sale of the covered commodity, and possibly setting the price all members will charge in such sales). *But see* RURAL BUS. COOPERATIVE SERV., *supra* note 189, at 10 (arguing that even the largest cooperatives cannot establish market influence and bargaining power over the increasingly consolidated food industry).

207. *See* Ferrell, *supra* note 204, at 739 (stating that purchasing cooperatives are those that are "used to accumulate and focus the buying power of the members, thus enabling them to acquire inputs at lower costs").

208. *See* CO-OPS 101, *supra* note 186, at 22 (stating that farmers began organizing purchasing cooperatives as a means of obtaining affordable production supplies of high quality).

209. *See* Ferrell, *supra* note 204, at 739 (stating that service cooperatives are formed to provide a specific service to producers).

210. *See* CO-OPS 101, *supra* note 186, at 23 (discussing farm specific service cooperatives that provide services such as fertilizer, lime, and pesticide application, feed processing, and crop harvesting, and general service cooperatives that provide, for example, electricity, credit, and telephone service).

211. *See* Claiborne, *supra* note 206, at 264 ("Middlemen add processing and/or marketing costs to products, increasing the price and decreasing the farmers' share of the consumer dollar.").

212. *See* BACKGROUND, *supra* note 187, at 16 ("Many cooperatives engage in two or three types of activities, although they are classified under only one primary function."); CO-OPS 101, *supra* note 186, at 21 (stating that cooperatives can serve one or more of three primary purposes: marketing products, purchasing supplies, and providing services).

213. *See* Ferrell, *supra* note 204, at 739–40 (discussing vertical integration by new-generation cooperatives and the ability of such cooperatives to recapture from corporate middlemen larger portions of the price paid by consumers for final products). Such

Congress grants special tax treatment to qualifying agricultural cooperatives under Section 521 of the Code.²¹⁴ If an agricultural cooperative satisfies the statutory qualifications, which impose strict requirements to ensure that the entity is a true farmers' cooperative,²¹⁵ it will be entitled to additional deductions beyond those accorded to other cooperatives.²¹⁶ Notably, by limiting both the types of farmers' cooperatives that may qualify and the services that they may provide, Congress has effectively targeted the benefits of Section 521 to cooperatives organized by small family farmers.²¹⁷

cooperatives have been called "value-added cooperatives" because they channel consumer funds to their patrons that would otherwise go to separate transporters, processors, and marketers. *Id.*

214. See I.R.C. § 521(a) (2000) (providing income tax exemption for qualified farmers' cooperatives). Note that the term exemption is misleading because qualification as a farmers' cooperative only entitles the entity to special deductions, not total exemption. See BACKGROUND, *supra* note 187, at 16 ("The term 'exempt' is misleading as these cooperatives are not truly exempt from all taxation, but only entitled to additional deductions for dividends on capital stock and patronage-based distributions of nonpatronage income."); I.R.C. § 1382(c) (2000) (providing additional deductions for qualified farm cooperatives).

215. See *id.* § 521(b) (stating the requirements for qualification as a farmers' cooperative under the section). Only farmers, fruit growers, and like associations will qualify, and such associations must be organized to market members' goods or purchase their supplies. *Id.*; see also Treas. Reg. § 1.521-1(a)(1) (1960) (discussing the requirements for exemption under Section 521); INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 4.44.1 (2003) (citing case law that defines various components of the Section 521 requirements); Michael Cook et al., *How Agricultural Cooperatives are Taxed*, Univ. of Mo. Extension (1999), at <http://muextension.missouri.edu/explore/agguides/agecon/g00903.htm> (last visited Nov. 17, 2004) (listing the requirements for qualification as a farmers' cooperative) (on file with the Washington and Lee Law Review). Note that although Section 521 contains a number of detailed requirements for qualification, the traditional agricultural cooperative owned by farmers and organized for marketing, purchasing, or providing services will likely qualify due to its structure.

216. A Section 521 cooperative may deduct from its income amounts paid during the year as dividends on its capital stock and amounts paid to patrons from earnings derived from nonpatron business such as rent and interest. See I.R.C. § 1382(c) (2000) (allowing special deductions for Section 521 cooperatives); Treas. Reg. § 1.1382-3 (1963) (describing the special deductions for exempt farmers' cooperatives); Cook et al., *supra* note 215 (explaining the taxation of Section 521 cooperatives). Both of these items are taxable income at the cooperative level for non-521 cooperatives. See INTERNAL REVENUE CODE SECTION 521, *supra* note 162, at 82 (stating that the primary tax advantage for cooperatives qualifying under Section 521 is access to two additional deductions beyond the normal deductions available to other cooperatives).

217. See I.R.C. § 521(b)(1) (2000) (stating that a cooperative must be organized to market the goods of members or producers or to purchase supplies for such members); INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 4.44.1.2.3-4 (2003) (citing caselaw that defines "members" and "producers" under Section 521). Note that Section 521 imposes no size limitation on the farmers belonging to qualified cooperatives. However, large farms do not depend on collectivization for market power. Rather, small farmers are likely to be the primary participants in cooperatives of the type defined in Section 521. Section 521 also fails to limit its benefits to family farm cooperative members. Despite this fact, family farmers remain the

Thanks to their preferential treatment, agricultural cooperatives may avoid taxation altogether at the cooperative level.²¹⁸ Although a pure non-521 cooperative could in theory qualify for total pass-through taxation, in reality, the cooperative must pay certain taxes like any other business entity.²¹⁹ The additional deductions available under Section 521 therefore increase the attractiveness of the agricultural cooperative as a business entity, help to ensure its survival, and increase the likelihood that its important services will be available to small family farmers.²²⁰

In sum, Congress's tax policy toward agricultural cooperatives helps farmers help themselves. Such cooperatives serve a number of valuable functions for their small farmer members including the marketing of farm products, the purchasing of inputs, and the provision of services. These important services help counteract the market domination of large farms and agribusiness that drives many small family farms out of business. Likewise, shifting market power from large farms and agribusiness to collectively organized family farms does not cost consumers the benefits of agricultural efficiency. Congress generally taxes cooperatives on a pass-through basis. But Congress allows special tax deductions for qualified agricultural cooperatives, giving them an extra economic boost. Congress targeted this special tax treatment to true farmer cooperatives, whose members are typically small family farmers. Thus, through the provision of direct tax benefits to an appropriate entity, Congress has taken important action to protect the small family farmer.

primary beneficiaries of the section because most small farms are family-run businesses. See THE ERS FARM TYPOLOGY, *supra* note 29, at 2 (stating that 98% of America's farms are family farms).

218. See NAT'L AGRIC. LAW CTR., COOPERATIVES—AN OVERVIEW, at <http://www.nationalaglawcenter.org/assets/overviews/cooperatives.html> (last visited Nov. 17, 2004) ("With these additional exclusions, a Section 521 cooperative is likely to have little, if any, taxable income.") (on file with the Washington and Lee Law Review).

219. See INTERNAL REVENUE CODE SECTION 521, *supra* note 162, at 82 (arguing that Section 521 cooperatives are taxed like other cooperatives in that the Code allows cooperatives to reduce their gross income on an item-by-item basis through specific deductions, with the remaining income being taxable to the cooperative); Cook et al., *supra* note 215 ("Cooperatives are taxed just as any other business corporation is taxed, except that the IRS allows certain deductions from otherwise taxable cooperative income.").

220. See INTERNAL REVENUE CODE SECTION 521, *supra* note 162, at 2–4 (stating that the special tax treatment of farmer cooperatives "reflects the desire of Congress to help farmers" and "is based on economic and social concerns, not strictly tax policy"). The special tax policy toward farmers' cooperatives developed early in the twentieth century when both Congress and the public were especially sympathetic to the needs of farmers. *Id.*

IV. EGTRRA and Its Impact on the Family Farm

If Congress passed EGTRRA to save the family farm, the legislation should not only offer better tax benefits for farmers than the previous Code, but it should also provide strong remedies to the crisis in family farming. EGTRRA accomplishes neither. On the one hand, the Act frees a small number of large farms from the estate tax, which does not benefit smaller farms. On the other hand, the Act removes strong tax incentives for family farmers to stay in the business and ignores more fundamental problems in agriculture.

For years, policymakers and legal scholars have argued that estate tax repeal will save family farming.²²¹ The enactment of a law that attempts to test this idea in practice, however, is somewhat more noteworthy. EGTRRA repeals the estate, gift, and generation-skipping transfer taxes in 2010, only to bring them back into effect the following year if Congress takes no prior action.²²² In place of the estate tax, Congress imposes a modified carryover basis regime in 2010 whereby the heir of appreciated property will be taxed on the gain in its value.²²³ Despite imposition of the carryover basis regime, the manager of the decedent's estate is entitled to increase the basis of selected appreciated assets by a maximum of \$1.3 million and an additional \$3 million for property transferred to a surviving spouse.²²⁴ Between enactment of the Act

221. See, e.g., Death Tax Elimination Act of 2000, H.R. 8, 106th Cong. 101 (attempting to eliminate the estate tax by 2010 that was vetoed by President Clinton); Taxpayer Refund and Relief Act of 1999, H.R. 2488, 106th Cong. 601 (attempting to phase out the estate tax that was vetoed by President Clinton); see JOINT COMM. ON TAXATION, DESCRIPTION AND ANALYSIS OF PRESENT LAW AND PROPOSALS RELATING TO FEDERAL ESTATE AND GIFT TAXATION 20-21 (2001) (discussing the history of the estate tax and various legislative attempts to repeal the tax); M.C. Mirow & Bruce A. McGovern, *An Obituary of the Federal Estate Tax*, 43 ARIZ. L. REV. 625, 625-26 (2001) (discussing prior failed attempts to eliminate the estate tax).

222. See Economic Growth and Tax Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, § 501(a), 115 Stat. 38, 69 (codified at 26 U.S.C. § 2210 (2000)) (requiring repeal of the estate tax for persons dying after December 31, 2009); *id.* § 901(a)(2), 115 Stat. at 150 (codified at 26 U.S.C. § 1 (2000)) (returning the estate tax and other provisions of the Code changed by EGTRRA to the form they held in 2001); see also H.R. CONF. REP. No. 107-84, at 157 (2001) (explaining the provisions of EGTRRA related to the estate tax repeal).

223. See EGTRRA §§ 541-542 (treating property inherited from a decedent as a gift for tax purposes and instituting a modified carryover basis system). Under the current federal estate tax system, an heir acquiring property at a decedent's death is entitled to a step-up in basis. See I.R.C. § 1014(a)(1) (2000) (allowing a step-up in basis for property transferred by a decedent to its fair market value at the time of the decedent's death). A step-up in basis means that the heir pays no income tax on the appreciated value from the time the decedent acquired the property until its transfer at the decedent's death. The decedent's estate, however, must pay estate tax on this appreciated value.

224. See EGTRRA § 542 (allowing a step-up in basis for selected estate assets of up to

in 2001 and the repeal in 2010, Congress will gradually phase out the estate tax by lowering the maximum tax rate²²⁵ and raising the unified credit over time to \$3.5 million in 2009.²²⁶

Compared to the detailed provisions of Sections 2031(c) and 2032A, the sections of EGTRRA affecting the estate tax are relatively simple.²²⁷ However, the Act is aimed, in part, at preventing the same problem addressed in those sections—the forced liquidation of family farmland to pay the estate tax. Drafters and supporters of the Act repeatedly cited this issue as justification.²²⁸ Supporters of EGTRRA also asserted that an outright repeal of the estate tax is an additional benefit of the Act. These individuals argued that even farmers who pay no estate tax must spend substantial sums of money on estate planning and that current Code provisions targeted to family farms and businesses merely add to that burden because of their complexity.²²⁹ Under this view, the

\$1.3 million and an additional \$3 million step-up for property transferred to decedent's spouse); see also Steven R. Akers, *Estate Planning Under the 2001 Tax Act—Planning and Drafting Strategies in an Uncertain Environment*, SH022 ALI-ABA 903, 913 (2002) (describing the modified carryover basis system under EGTRRA).

225. See EGTRRA § 511 (reducing the estate tax rates gradually between 2001 and 2010).

226. See *id.* § 521(a) (increasing the unified credit from \$1 million in 2002 to \$3.5 million in 2009). The federal estate tax is a tax paid out of the wealth that a decedent transfers at death. See JOINT COMM. ON TAXATION, *supra* note 221, at 5 (describing the federal estate tax). Under the current estate and gift tax regime, Congress sets a unified credit that reduces estate tax liability by the credit amount. I.R.C. § 2010(c) (2000); see also STEPHENS ET AL., *supra* note 100, ¶ 3.02 (discussing the unified credit against the estate tax). For a decedent dying in 2003, the statutory exclusion amount was \$1 million. I.R.C. § 2010(c). In a simplified example, for an estate valued at \$1 million, the taxes due without the credit would be \$345,800. See STEPHENS ET AL., *supra* note 100, ¶ 3.02 n.5 (providing a numerical illustration of the effect of the unified credit). The unified credit exactly offsets the tax liability so that the estate owes no tax. *Id.*

227. Compare *supra* Part III.A.1 (explaining Section 2031(c)), and *supra* Part III.A.2 (explaining Section 2032A), with *supra* notes 221–26 and accompanying text (explaining the sections of EGTRRA that modify the estate tax).

228. See, e.g., H.R. REP. NO. 107-37, at 25 (2001) (stating that the Committee on Ways and Means believes the estate, gift, and generation-skipping taxes unduly burden taxpayers, particularly farming businesses, and explaining the repeal of the estate tax beginning in 2011); 147 CONG. REC. E238 (daily ed. Feb. 28, 2001) (statement of Rep. Mink) (stating that current estate tax exemption levels are too low and that "[n]o small family-owned farm or small family-owned business should have to be sold by the children to pay an inheritance tax").

229. See, e.g., *Hearing on President's Tax Relief Proposals*, *supra* note 17 ("Because it is often difficult to predict the future net worth of a farm or ranch operation, many farmers and ranchers feel compelled to spend money for estate planning and/or life insurance. This expense is a drain on ongoing farm operations and for some the cost prohibits estate tax planning."). Stallman also claimed that provisions providing relief exclusively to family-owned businesses are too complex to work on a wide scale and that they raise estate planning costs. *Id.*; see also WOLFF, *supra* note 159, at 2 (stating that special estate tax relief provisions applicable only to farms may reduce the number of farm estates paying taxes but may cost a considerable amount

costs of estate planning may be the straw that breaks the camel's back, helping to drive family farmers out of the business.²³⁰

Whether EGTRRA results in an outright repeal of the estate tax or merely a reduction in the overall tax, small family farmers will receive limited additional benefits and may lose incentives to stay in business. EGTRRA's phase out of the estate tax supposedly provides benefits above and beyond those of Sections 2032A and 2031(c). Sections 2032A and 2031(c) offer family farmers a potential reduction in their gross estates.²³¹ Under EGTRRA, increasingly larger estates will be exempt from the tax because of the higher unified credit, and any tax assessed will be calculated based on lower rates.²³² For example, a family farmer could receive a substantial reduction in his taxable estate by electing special-use valuation, but his heirs could still face estate tax liability on the remainder.²³³ EGTRRA could hypothetically reduce or eliminate this remaining burden.²³⁴ Similarly, the benefits of the existing sections primarily reach farmers in areas where there is a large gap between agricultural value and highest and best use valuation.²³⁵ An overall reduction in estate tax rates and an increase in the unified credit under EGTRRA would benefit farmers in all locales.²³⁶

of time and money in the form of estate planning and administration).

230. See *It's Time to Bury the Death Tax*, WEEKLY COLUMN, June 7, 2000 (citing the burden of estate tax filing and administration on family farmers).

231. See *supra* Part III.A (discussing the potential reduction of a decedent farmer's gross estate available from Section 2031(c) qualified conservation easements and Section 2032A special-use valuation).

232. See Akers, *supra* note 224, at 913 (describing rate reductions resulting from the enactment of EGTRRA); cf. *Hearing on President's Tax Relief Proposals*, *supra* note 17 (stating that the estate tax repeal will primarily benefit individuals with larger estates).

233. Section 2032A allows a reduction in a decedent's gross estate of up to \$840,000 in 2003. I.R.C. § 2032(A)(2) (2000). Prior to EGTRRA, Congress set the unified credit at \$700,000 in 2003. Without EGTRRA, if the remaining estate is valued at greater than \$700,000, the estate would be subject to the tax. See H.R. REP. NO. 107-37, at 20 (2001) (stating that under prior law, the unified credit was set at \$700,000 in 2003).

234. EGTRRA increases the unified credit from \$700,000 to \$1 million in 2003, meaning that an additional portion of the hypothetical decedent's estate would be exempt from the tax. See Economic Growth and Tax Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, § 521(a), 115 Stat. 38, 71 (codified at 26 U.S.C. § 2010(c) (2000)) (setting the unified credit at \$1 million in 2003).

235. See *supra* note 140 and accompanying text (arguing that special-use valuation under Section 2032A has its greatest potential for estate tax reduction when the value based on the highest and best use of a property is substantially greater than its value based on agricultural use).

236. Cf. *Hearing on President's Tax Relief Proposals that Affect Individuals Before the House Comm. on Ways and Means*, <http://waysandmeans.house.gov/legacy/fullcomm/107cong/3-21-01/107-6final.htm> (last visited Nov. 28, 2004) (prepared statement of Scott McInnis,

In reality, the combination of existing provisions of the Code targeted to family farmers²³⁷ and the pre-EGTRRA unified credit²³⁸ adequately protected the small family farmers most in need of estate tax relief.²³⁹ Due to a lack of targeting, any benefits derived from EGTRRA primarily reach large farms. Few small family farms actually face estate tax liability at the death of the owner.²⁴⁰ In 1998, only 2% of farms with annual sales of less than \$100,000 and farm assets in excess of nonfarm assets owed any estate tax.²⁴¹ On the other hand, farm estates with net assets exceeding \$5 million account for about two-thirds of federal estate taxes paid by farmers.²⁴² Thus, among family farms, large farms are the primary beneficiaries of a reduced estate tax burden. Allowing the owners of large farms to pass their property intact to the next generation only adds to the plight of the small farmer by increasing the concentration of wealth in fewer hands and does nothing to counteract the advantages that larger farms currently have.

In addition to a lack of overall estate tax liability among small family farmers, the pre-EGTRRA regime, consisting of the unified credit,²⁴³ the

Member, House Comm. on Ways and Means) (describing EGTRRA as a "broad tax cut for Americans") (on file with the Washington and Lee Law Review).

237. See *supra* Part III.A (describing valuation discounts available to family farmers under Section 2031(c) and Section 2032A); *infra* note 244 and accompanying text (discussing the Qualified Family-Owned Business Interest Deduction).

238. See H.R. REP. NO. 107-37, at 20 (2001) (listing the unified credit amounts by year under the law prior to EGTRRA).

239. See JOEL FRIEDMAN & ANDREW LEE, CTR. ON BUDGET AND POLICY PRIORITIES, PERMANENT REPEAL OF THE ESTATE TAX WOULD BE COSTLY, YET WOULD BENEFIT ONLY A FEW, VERY LARGE ESTATES 12 (2003) ("Current estate tax law already provides sizeable special tax breaks for family farms and businesses."); Warren Rojas, *Family Farmers: Congress Should Dig Deeper Than Estate Tax Help*, TAX NOTES, Sept. 1, 2003, at 1094 (stating that planning strategies existing before EGTRRA that utilize the rising exemption rates and farm specific valuation breaks, among other methods, could effectively bypass the estate tax).

240. The numbers indicate that only a small fraction of estates contain farm property. See Neil Harl, *Federal Estate Taxation of Farm and Ranch Estates*, AGRIC. LAW DIG., Sept. 23, 2003, at <http://www.extension.iastate.edu/agdm/articles/harl/HarlNov03.htm> (last visited Nov. 17, 2004) (stating that out of the total number of deaths in 2001, only 0.11% reported some farm property in the taxable estate) (on file with the Washington and Lee Law Review). Likewise, in 1998 only 3% of estates actually subject to the estate tax were such that family farm or business property made up the majority of the estate. *Hearing on President's Tax Relief Proposals*, *supra* note 17. Note, however, that only a small fraction of the population is currently employed in farming. See *supra* notes 30–32 and accompanying text (discussing the shift away from farming as an occupation).

241. ECON. RESEARCH SERV., U.S. DEP'T OF AGRIC., *Status Report: Small Farms in the U.S.*, AGRIC. OUTLOOK, May 1998, at 22, 25.

242. Rojas, *supra* note 239, at 1092.

243. See H.R. REP. NO. 107-37, at 20 (2001) (listing the unified credit amounts by year under the law prior to EGTRRA).

Qualified Family-Owned Business Interest (QFOBI) deduction,²⁴⁴ and the Code sections allowing valuation discounts,²⁴⁵ offered substantial estate tax protection for small farmers. Additional benefits will accrue only to the owners of large farms. For example, without EGTRRA, the estate of a decedent dying in 2004 would have been eligible for up to \$1.3 million of tax relief through the combination of the Section 2057 QFOBI deduction and the unified credit.²⁴⁶ Under EGTRRA, the credit increases to \$1.5 million.²⁴⁷ In 2004, therefore, the Act would provide additional exemption only for farms with estates worth more than \$1.3 million or for those failing to qualify for the QFOBI or valuation discount provisions. Such farms are likely to be large farms rather than the small family farms most in need of tax relief.²⁴⁸ One estimate shows that only a small percentage of all farm estates would exceed the \$1.3 million threshold of the pre-EGTRRA regime.²⁴⁹ If a farm fails to qualify for the QFOBI or valuation discounts, it is because the entity does not meet the requirements of

244. See I.R.C. § 2057 (2000) (providing for a deduction from decedents' estates that include qualified family-owned businesses); STEPHENS ET AL., *supra* note 100, ¶ 5.08 (describing the family-owned business deduction). Prior to 2004, the Code provided the estates of persons engaged in a family-owned businesses with a deduction of up to \$675,000. I.R.C. § 2057(a) (2000). Congress enacted this section in 1997 intending to protect family-owned farms and businesses from forced liquidation due to the estate tax. S. REP. NO. 105-33, at 40 (1997) ("The Committee believes that a reduction in estate taxes for qualified family-owned businesses will protect and preserve family farms and other family-owned enterprises, and prevent the liquidation of such enterprises in order to pay estate taxes.").

245. See *supra* Part III.A (describing valuation discounts available to family farmers under Section 2031(c) and Section 2032A).

246. See I.R.C. § 2057(a) (2000) (setting the maximum exemption from the estate tax available through the combination of the family-owned business deduction and the unified credit at \$1.3 million in 2002 and 2003); STEPHENS ET AL., *supra* note 100, ¶ 5.08(4)(b) (describing the deduction limitation). This amount does not include any exclusions from the decedent's gross estate resulting from election of special-use valuation or the donation of a qualified conservation easement. Note that due to the increased unified credit under EGTRRA, the QFOBI does not apply to decedents dying after December 31, 2003. See Economic Growth and Tax Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, § 521(d), 115 Stat. 38, 72 (codified at 26 U.S.C. § 2010 (2000)) (repealing the QFOBI deduction effective December 31, 2003).

247. See *id.* § 521(a) (increasing the estate tax unified credit).

248. Rather than providing empirical data to illustrate the effect of the estate tax on family farmers, supporters of EGTRRA sentimentalized the impact of the tax by referring to specific examples. See, e.g., *Hearing on President's Tax Relief Proposals*, *supra* note 17 (telling the story of a Colorado ranching community where the "death tax" forced a number of young ranchers to sell property bequeathed from older generations).

249. See WOLFF, *supra* note 159, at 2 (estimating that in 2011, only 8% of farm estates would be large enough to exceed the pre-EGTRRA threshold amount of \$1.3 million).

the respective sections. This means that Congress has determined that the farm is not worthy of special tax benefits.²⁵⁰

Besides a reduction in the estate tax, EGTRRA offers the potential for a complete repeal of the tax.²⁵¹ Such action would add minimal estate tax relief to small family farmers and would remove specific tax incentives to preserve their farms as family businesses. As the pre-EGTRRA Code already offered substantial estate tax relief for the small family farmer, a repeal of the estate tax would primarily benefit large farms.²⁵² Additionally, the existence of the estate tax creates incentives for family farmers to escape tax liability through provisions such as Section 2032A special-use valuation and the Section 2057 QFOBI. Such provisions require farmers to continue their operations or lose any ensuing tax benefits.²⁵³ A repeal of the estate tax could eliminate farmers' incentives to seek such protections and lead them to voluntarily sell their property.²⁵⁴ Finally, although elimination of the estate tax would undoubtedly impact the costs of estate planning, the imposition of the modified carryover basis regime under EGTRRA would create new planning costs for farmers.²⁵⁵

250. See *supra* Part III.B.2 (describing how Congress set out detailed requirements for Section 2032A special-use valuation). There were similar requirements for the Section 2057 family-owned business deduction. See STEPHENS ET AL., *supra* note 100, ¶ 5.08(1) (comparing and contrasting Sections 2032A and 2057).

251. See EGTRRA § 501(a) (requiring repeal of the estate tax for persons dying after December 31, 2009); see also Karen C. Burke & Grayson M.P. McCouch, *Estate Tax Repeal: Through the Looking Glass*, 22 VA. TAX REV. 187, 189 (2002) (discussing the uncertainty over whether Congress will render the estate tax repeal permanent prior to EGTRRA's 2011 sunset).

252. See *supra* notes 243–50 and accompanying text (describing how the increased unified credit under EGTRRA fails to provide additional tax relief to small family farms beyond the pre-EGTRRA unified credit, QFOBI, and valuation discounts but instead primarily benefits larger farms).

253. See *supra* Part III.A.2 and accompanying text (discussing the qualifications for Section 2032A that require a decedent to pass farm property to a member of the family and mandate that the heir materially participate in the operation of the farm or risk being subject to a recapture tax). While in existence, Section 2057 had similar continuation requirements. See I.R.C. § 2057(f)(1) (2000) (imposing an additional tax if the heir of a family-owned farm or business fails to materially participate in the operation of the business or disposes of the business within ten years of the transfer of the property); see also STEPHENS ET AL., *supra* note 100, ¶ 5.08(5) (describing the recapture rule).

254. See Roberta Mann, *Waiting to Exhale?: Global Warming and Tax Policy*, 51 AM. U. L. REV. 1135, 1196 (2002) (arguing that eliminating the estate tax does not protect land from heirs that hope to profit from the development of the land they inherit). Mann claims that with the existence of the estate tax, landowners are more likely to seek protection from the tax by donating conservation easements. *Id.* Repeal of the estate tax "stick" takes away the incentive to seek the conservation easement deduction "carrot." *Id.*

255. See *President's Tax Relief Proposals: Tax Proposals Affecting Individuals: Hearing Before the House Comm. on Ways and Means*, 107th Cong. 150, 151–52 (2001) (prepared statement of Linda Goold, Tax Counsel, National Association of Realtors) (discussing the

Likewise, the uncertainty inherent in EGTRRA increases the difficulty and cost of estate planning.²⁵⁶ Such costs could largely offset any gains from tax repeal.

In sum, EGTRRA will not live up to its advocates' promise of protecting family farms. Supporters claim that the Act offers relief from the estate tax in addition to that provided by prior Code protections and helps to reduce estate-planning costs. In reality, such additional protection is not needed, as the pre-EGTRRA unified credit, QFOBI, and valuation discounts provided adequate estate tax relief for small family farms. Congress essentially targeted EGTRRA's tax benefits to large estates and farms by setting a high unified credit and by threatening to repeal the estate tax altogether. Rather than helping small farmers, such action leads to higher concentration of farmland in fewer hands. Likewise, outright repeal of the estate tax removes tax incentives that encourage farmers to continue farming. Finally, the carryover basis regime and overall uncertainty that come with EGTRRA will likely add to estate planning costs and will neutralize any potential savings derived from repeal of the estate tax. Thus, EGTRRA is not the savior of America's small family farms.

V. *Improvements and Alternatives*

There is no single answer to the problems of the small family farm that will ensure its survival. The Code provisions discussed in this Note provide a number of important tax benefits for such farmers.²⁵⁷ These Code sections, however, also have notable shortcomings. Three proposed remedies would substantially improve the effectiveness of the previously mentioned Code provisions as means of saving small family farms. One proposal is to limit the small ethanol producer credit to farmer-owned cooperatives. A second proposal is to specifically exempt all small family farmers from the estate tax.

practical difficulties and added complexity resulting from a carryover basis regime); Mirow & McGovern, *supra* note 221, at 626 (stating that the imposition of the modified carryover basis regime under EGTRRA will bring with it extensive administrative, tracing, record keeping, and reporting requirements).

256. See Klooster, *supra* note 17, at 660–61 (arguing that the EGTRRA removes certainty from estate planning and thereby complicates the process).

257. See *supra* Part III.A.1 (discussing qualified conservation easements under Section 2031(c)); *supra* Part III.A.2 (describing special-use valuation under Section 2032A); *supra* Part III.B.1 (discussing the small ethanol producer credit); *supra* Part III.B.2 (discussing special deductions for farmer cooperatives). This Note's discussion of Code provisions benefiting family farmers is far from complete. To discuss each provision that applies to family farms in detail would be beyond the scope of the Note. The provisions analyzed in this Note, however, highlight some of the successes and failures of attempts to save family farms through the Code.

A third proposal is to keep the estate tax, but set the exemption, QFOBI deduction, and valuation discounts to exclude all but the largest family farms.

A. Ethanol and Cooperatives

Ethanol plants and agricultural cooperatives are two farmer-oriented businesses subsidized by the federal Code.²⁵⁸ Tax expenditure on these entities has counteracted some of the forces driving small family farmers out of business without depriving consumers of the benefits of efficient food production. On the other hand, the tax treatment of ethanol producers and farmers' cooperatives also illustrates how the benefits for family farmers provided by separate sections of the Code can be combined to produce even greater protection.

Small ethanol plants, subsidized through the small ethanol producer credit,²⁵⁹ wrest market power away from agribusiness, enable small farmers to market their crops locally, and reduce the need for federal farm subsidies.²⁶⁰ Farmer cooperatives, entitled to special income tax deductions,²⁶¹ enable small family farmers to pool their resources and to increase their market power as purchasers, sellers, and providers of services.²⁶² Until a recent Code amendment, however, cooperatives owning ethanol plants were ineligible for the small ethanol producer credit.²⁶³

One of the shortcomings of the small ethanol producer credit is that even with the recent amendment, Congress has not specifically targeted its benefits to plants owned by small family farmers.²⁶⁴ When the amendment takes effect

258. See Mann, *supra* note 75, at 220 (defining tax expenditure as "a special income tax provision that acts like a direct spending program").

259. See I.R.C. § 40(b)(4) (2000) (providing a small ethanol producer tax credit of ten cents per gallon of qualified ethanol production).

260. The small ethanol producer credit supports small ethanol plants, many of which are owned by local farmers. Besides the benefits to their owners, such plants create local markets for corn and thereby increase the prices farmers can receive. See *supra* Part III.B.1 (describing how the benefits of the small ethanol producer credit reach small family farmers).

261. See I.R.C. § 521 (allowing special income tax deductions for qualified farmers' cooperatives).

262. See *supra* Part III.B.2 (describing how various types of farmers' cooperatives benefit their farmer patrons).

263. See *supra* note 183 and accompanying text (discussing Section 313 of Pub. L. No. 108-357, 118 Stat. 1418 (2004), which allows cooperatives to pass the ethanol credit on to their patrons).

264. See *supra* notes 181-84 and accompanying text (citing the lack of targeting to small farmers as a shortcoming of the small ethanol producer credit).

in 2005, ethanol plants owned by both large agribusiness corporations and farmer-owned cooperatives will be eligible for the Credit.²⁶⁵ This lack of discrimination hurts small farmers by allowing dominant corporations to accumulate even more power and has little advantage for consumers, who benefit from ethanol production regardless of plant ownership.²⁶⁶

Congress's choice to extend the Credit to cooperatives will benefit farmers having an ownership interest in ethanol cooperatives.²⁶⁷ This action has put farmer cooperatives on the same footing as corporations, encouraging cooperative members to simultaneously seek the economic advantages of collectivization and the business opportunities of ethanol production. But, Congress could have taken better advantage of the synergy between agricultural cooperatives and ethanol production by limiting the credit to farmer-owned ethanol facilities, thereby excluding agribusiness corporations. Alternatively, rather than totally excluding large corporations, Congress could increase the credit exclusively for farmer-owned ethanol plants. By giving farmers' cooperatives such an advantage, Congress could sustain the rewards of ethanol production for small family farmers without affecting its benefits to the general public.

B. Specifically Exempting Small Family Farmers from the Estate Tax

Supporters of EGTRRA and permanent estate tax repeal claim one of the primary evils of the tax is the damage it does to family farms and businesses.²⁶⁸

265. See Pub. L. No. 108-357, § 313, 118 Stat. 1418 (2004) (amending Section 40 to allow cooperatives to pass the ethanol credit on to their patrons); David Morris, *The Ethanol Glass Is Still Only Half Full*, ETHANOL TODAY, Sept. 2003, <http://www.ilsr.org/columns/2003/et0903.html> (last visited Nov. 17, 2004) (questioning whether the lack of differentiation in federal incentives between farmer-owned ethanol plants and facilities owned by huge corporations will allow "bigger players" to gain dominance over the industry) (on file with the Washington and Lee Law Review). Admittedly, a primary purpose of the producer credit is to create incentives for ethanol production without regard to plant ownership.

266. See *supra* note 185 and accompanying text (describing how agribusiness domination of ethanol production would hurt small family farmers).

267. See 149 CONG. REC. S1745 (daily ed. Jan. 29, 2003) (statement of Sen. Fitzgerald) (arguing that Congress intended the ethanol credit to maximize the country's ethanol output "by aiding small producers that otherwise may not be able to compete with larger companies, an unintended glitch in the law bars small farm cooperatives from passing this credit on to their farmers . . . this glitch stifles production and penalizes farmers who join cooperatives").

268. See *supra* note 228 and accompanying text (discussing the supporters' arguments in favor of EGTRRA); see also 148 CONG. REC. E1058 (daily ed. June 14, 2002) (statement of Rep. Cramer) (arguing in favor of the Permanent Death Tax Repeal Act of 2002 and claiming that the "death tax" places a tremendous burden on small family farms and businesses); 148 CONG. REC. H3075-76 (daily ed. June 4, 2002) (statement of Rep. Pitts) (stating that "[f]or

So why not simply exempt these entities from the tax? One proposal is to do just that.²⁶⁹ A comprehensive estate tax exemption for small family farmers could free the few farm estates currently subject to the tax and thereby put an end to the forced liquidation of family farm property.

The main hurdle with implementing such an exemption would be finding an appropriate statutory definition of the family farm to determine eligibility for the provision.²⁷⁰ Any definition would have to account for the varying characteristics of family farms and to determine what subclasses of farms should be eligible.²⁷¹ One alternative would be to borrow the definition of the family farm from Section 2032A.²⁷² This definition effectively targets tax benefits to small family-owned and operated farms and excludes many hobby and retirement farms but comes at the cost of enormous complexity.²⁷³

Additional problems with a specific family farm estate tax exemption are its potential impact on incentives and its bias towards larger farms. The current Code includes incentives for the family to continue the operation of its farm after the owner's death.²⁷⁴ By removing the estate tax, Congress would also eliminate these incentives.²⁷⁵ Additionally, because most small family farmers pay no estate tax, the exemption would likely benefit larger farms.²⁷⁶ These issues illustrate why a seemingly simple Code solution can have many unintended consequences.

years, the death tax has taken as much as 55 to 60 percent of the value of a family farm or small business just to pay the taxes" and that it "is a terrible tax and we should get rid of it for good").

269. See Weber, *supra* note 12, at 135 (discussing the option of a comprehensive estate tax exemption for small family-owned farms).

270. See *id.* ("Of course much contention would rise here concerning any statutory definition of a small farm.").

271. See *supra* Part II.B (discussing the issues related to defining the family farm).

272. See I.R.C. § 2032A (2000) (providing for special-use valuation of qualified farm property and limiting this benefit to small family farmers); Weber, *supra* note 12, at 135 (suggesting the incorporation of the definitions of Section 2032A as a means of targeting the proposed exemption to the proper constituents); *supra* notes 142–58 (discussing the definition of family farming in relation to the requirements for Section 2032A special-use valuation).

273. See *supra* note 144 and accompanying text (discussing the complexity and strictness of the qualifications for Section 2032A special-use valuation).

274. See *supra* Part III.A (discussing the Section 2032A special-use valuation and the Section 2031(c) qualified conservation easements).

275. See *supra* notes 252–54 and accompanying text (arguing that the existence of the estate tax creates incentives for farmers to avoid the tax through specifically targeted provisions such as special-use valuation and qualified conservation easement discounts, which Congress designed to preserve the family farm). Note, however, that Congress could tailor the statutory definition of the family farm to create incentives for farmers to fit that definition.

276. See *supra* notes 240–42 and accompanying text (noting that few small family farmers actually face estate tax liability).

C. Setting Appropriate Exemptions

After EGTRRA, the fight for a permanent estate tax repeal gained considerable momentum. Supporters of this move claim that gradual elimination of the tax under EGTRRA will not act quickly enough to save many family farms and that the specter of estate tax sunset in 2011 will bring back the tax's substantial problems.²⁷⁷ If protecting the interests of family farmers is really a policy goal, however, Congress should look backward instead of forward when deciding how to proceed after EGTRRA.

The pre-EGTRRA estate tax regime offered substantial protection to small family farmers through the combination of the unified credit, the QFOBI deduction, and valuation discounts.²⁷⁸ Legislative actions such as substantial increases in the unified credit or permanent repeal of the tax will not create additional benefits for this group.²⁷⁹ Instead, Congress should settle on an exemption level that eliminates estate tax liability for small farm estates but continues to subject wealthier estates to the tax.²⁸⁰

The combination of an appropriate exemption level, the QFOBI deduction, and valuation discounts has several advantages over EGTRRA. First,

277. See WOLFF, *supra* note 159, at 2–3 (arguing that the exemption levels under the sunset provision would expose more medium-sized farms to the estate tax, and claiming "[r]einstating death taxes in 2011 would, in a single year, reverse a decade of declining farm death taxes"); NAT'L SMALL BUS. ASS'N, PERMANENT REPEAL OF THE ESTATE (DEATH) TAX, at <http://www.nsba.biz/content/printer.90.shtml> (Mar. 1, 2003) (citing the benefits of estate tax relief under EGTRRA but advocating full repeal) (on file with the Washington and Lee Law Review).

278. See *supra* notes 243–50 and accompanying text (describing the provisions available under the pre-EGTRRA regime).

279. See Rojas, *supra* note 239, at 1093 (citing the statement of Minnesota farmer and advocate Marvin Jensen, who claims that most private farm estates are valued at between \$500,000 and \$3 million, and that any tax breaks beyond that amount are a "gift to the rich"); *supra* Part IV (discussing the limited marginal estate tax relief for small family farmers under EGTRRA); see also JOINT COMM. ON TAXATION, *supra* note 221, at 42–45 (listing various bills proposed to repeal or alter the estate tax). One alternative to EGTRRA would have immediately set the unified credit at \$2 million per individual and \$4 million per married couple. H.R. REP. NO. 107-37, at 194 (2001) (stating the dissenting views on the Death Tax Elimination Act of 2001 and claiming that a \$2 million credit would eliminate estate tax liability for 99% of farms). This plan would have ultimately raised the unified credit to \$2.5 million per person. *Id.*

280. See Rojas, *supra* note 239, at 1093 (citing statements by several farmers asserting that an estate tax exemption of \$1–2 million would adequately protect most family farmers); Weber, *supra* note 12, at 135–36 (claiming that by setting the unified credit at an appropriate level, Congress could continue to collect the estate tax on the wealthiest estates without endangering small family farms). *But see* WOLFF, *supra* note 159, at 2 (arguing that an exemption level of greater than \$1.3 million is needed to prevent the taxation of medium to large family farms). Note that setting the unified credit at a level that excludes small family farmers but taxes larger estates would entail finding a correlation between farm income and estate size.

excluding only small family farmers from the estate tax would help to level the agricultural playing field. If the tax forces large farms to sell off portions of their holdings, all the better for their smaller rivals.²⁸¹ Second, setting the exemption at an appropriate level would preserve beneficial incentives built into the current estate tax regime rather than gradually eliminating them. Third, this move would be honest. Small family farmers would no longer be a political football for wealthier advocates of estate tax repeal. Instead, Congress would in fact be working to save the family farm.

VI. Conclusion

One hundred years ago, small family farmers dominated American agriculture.²⁸² Today, a crisis in family farming threatens their existence.²⁸³ But where will American family farming stand one hundred years from now? Does Congress have the ability to reverse the decline in small family farming without disrupting the gains that arise from efficient food production? This Note concludes that Congress can save many of America's small family farms through intelligent tax reform.

The formulation of successful family farm tax policy requires an understanding of the transformation of American farming. Agriculture in the United States has changed from a system of small and independent producers to a technologically advanced, corporation-dominated, and globally-oriented system of food production.²⁸⁴ Although modern agriculture provides U.S. consumers with the benefits of efficient and low-cost food production, these benefits come at the cost of many of the nation's small family farmers.²⁸⁵ Protecting family farms from extinction is good policy because their existence benefits the public in a number of ways.²⁸⁶ This Note concludes, however, that government solutions to the problems of family farmers must not stand in the

281. See Weber, *supra* note 12, at 135–36 (stating that the unified credit could be set so as to tax large corporate farms, preventing them from escaping estate tax liability purely on the basis of their farm status).

282. See *supra* notes 24–32 and accompanying text (describing the decline in family farming during the twentieth century).

283. See *supra* Part II.A (describing the crisis faced by the modern family farmer).

284. See *supra* Part II.A (discussing the transformation of agriculture that occurred over the twentieth century).

285. See *supra* notes 56–59 and accompanying text (arguing that the same forces that gave rise to modern efficient food production created the problems faced by small family farmers).

286. See *supra* notes 10–14 and accompanying text (discussing the public benefits derived from the existence of small family farms).

way of efficient food production.²⁸⁷ The best solutions, therefore, will benefit small farmers without hurting consumers.

Valuation discounts such as those provided by Sections 2031(c) and 2032A, used in conjunction with the unified estate tax credit, allow small family farmers to escape the liquidation problem.²⁸⁸ By their nature, estate tax solutions to the problems of family farms do not jeopardize efficient low-cost food production.²⁸⁹ Congress's pre-EGTRRA tax policy—consisting of the unified credit, QFOBI deduction, and valuation discounts—provided small family farmers with sufficient protection from the liquidation problem.²⁹⁰ EGTRRA primarily benefits larger farms and therefore fails to improve on the prior Code as a solution to the liquidation problem.²⁹¹ Instead of repealing the estate tax, Congress should design a comprehensive exemption for small family farm estates or, alternatively, return to the pre-EGTRRA estate tax regime, setting credits and deductions at levels that exclude all but the largest family farms.²⁹²

Income tax benefits offer even greater potential for saving family farms. This Note concludes that the most effective income tax solutions are those that counteract the market dominance of agribusiness and help to re-establish local markets and stable prices for small family farmers. Likewise, tax policy that shifts market power from corporate middlemen to small farmers does not harm consumers. The Code sections that encourage ethanol production and collectivization through cooperatives are examples of tax policy that succeed in these regards.²⁹³

287. See *supra* Part II.A (arguing that in designing tax policy, Congress must balance the interests of small farmers with those of the general public).

288. The liquidation problem occurs when a farmer dies and bequeaths his farm to family members. Because farmland is often the most valuable asset in a small family farm estate and such property is generally illiquid, heirs may be forced to sell the family farm to satisfy estate tax liability. See *supra* notes 98–103 and accompanying text (discussing the liquidation problem).

289. See *supra* notes 115–17 and accompanying text (arguing that the tax benefits for the donation of a conservation easement under Section 2031(c) benefit the public rather than harming it); *supra* note 141 and accompanying text (arguing that special-use valuation does not impact agricultural markets, which are the source of benefits to consumers).

290. See *supra* notes 243–46 and accompanying text (discussing the estate tax benefits for family farmers under the pre-EGTRRA Code).

291. See *supra* Part IV (arguing that EGTRRA fails to provide additional tax relief for small family farmers but instead primarily benefits larger farms).

292. See *supra* Part V.B–C (suggesting alternatives to EGTRRA for protection against the liquidation problem).

293. See *supra* Part III.B (discussing the small ethanol producer credit and the special income tax deductions for farmer cooperatives).

To make successful tax policy, Congress must also target tax benefits to the right group of family farmers. This Note concludes that the family farms most in need of tax relief are small businesses that are owned and operated by the family.²⁹⁴ This group should be defined to exclude farms that do not depend on agriculture for sustenance, such as hobby farms and retirement farms.²⁹⁵

When Congress allocates tax benefits, the distinction between large and small family farms is key because small farmers suffer disproportionately in the modern agricultural economy.²⁹⁶ This Note concludes that Congress should define the distinction between large and small farms based on the gross receipts of such farms.²⁹⁷ If Congress chooses to distinguish large farms from small farms on the basis of estate value, Congress should seek a correlation between estate size and gross receipts.

Of the four Code sections considered in this Note, Section 2032A most effectively targets the appropriate group of small family farms.²⁹⁸ While Section 2032A contains effective targeting, it is also an illustration of the link between specific targeting and Code complexity.²⁹⁹ Despite this shortcoming, this Note concludes that the definition of the family farm contained in Section 2032A could be imported into other Code provisions to improve their targeting.

Congress can also create successful tax policy by targeting benefits to businesses that help farmers. Congress currently supports both ethanol producers and farmers' cooperatives.³⁰⁰ To shift the benefits of the small ethanol producer tax credit toward smaller family farmers, Congress should limit the Credit to farmer-owned ethanol plants or, alternatively, offer a higher credit exclusively to such plants.³⁰¹

294. See *supra* Part II.B (discussing the appropriate definition of the family farm for the purposes of tax reform).

295. See *supra* notes 84–87 and accompanying text (listing several reasons why individuals own small family farms).

296. See *supra* Part II.A (discussing the problems faced by small family farmers).

297. See *supra* note 82 and accompanying text (calling for Congress to distinguish between large and small farms based on gross annual receipts).

298. See *supra* notes 142–58 and accompanying text (describing how Congress targeted the benefits of Section 2032A to the appropriate group of small family farmers).

299. See *supra* note 159 and accompanying text (arguing that the detailed requirements of Section 2032A make the provision exceedingly complex and add to estate planning costs).

300. See *supra* Part III.B (discussing the small ethanol producer credit and special tax deductions for farmer cooperatives).

301. See *supra* Part V.A (suggesting ways that Congress could improve the targeting of the small ethanol producer credit).

Saving the family farm through federal tax policy is easier said than done. Congress has the tools for the job in many of the current Code provisions that benefit farmers. But, the survival of the small family farm may depend on Congress's ability to pick the right tools and apply them to the job at hand.