Planning Agricultural Estates: The Impact of Estate and Gift Tax Sections of the 1976 Tax Reform Act

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Planning Agricultural Estates: The Impact of Estate and Gift Tax Sections of the 1976 Tax Reform Act

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While the Tax Reform Act of 1976[1] has had an enormous impact upon estate planning generally, the impact upon agricultural estate planning is especially noteworthy because of particular agricultural provisions in the new law and because of the very nature of agriculture. The complexity of the estate and gift tax provisions of the Act raises some very basic questions. What provisions are of particular concern to agricultural estate planners? How do these provisions generally affect traditional estate planning techniques? What new techniques and considerations are necessitated by these provisions? Are agricultural clients any better or any worse off then they were under prior law?

The following discussion of post-1976 agricultural estate planning will address the basic questions noted above. The central meaning and thrust of those provisions especially relevant to agriculture will be noted.[2] Particular estate planning techniques such as gift giving programs will be discussed with special emphasis upon the need to modify these techniques in the post 1976 era. Some new estate planning considerations will be identified. Finally, an overall assessment of the Act as it relates to agricultural clients will be attempted.

I. Significant Provisions

Particular sections of the Act are of special importance to agricultural estate planning.[3] These include sections relating to the unified

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1. Act of Oct. 4, 1976, Pub. L. No. 94-455, 90 Stat. 1520.

2. The reader may wish to examine other references for a detailed interpretation and technical discussion of the Act. *See* J. McCord, 1976 Estate and Gift Tax Reform: Analysis, Explanation and Commentary (1977); RIA Complete Analysis of the '76 Tax Reform Law, 11-52 (1976).

3. For a general overview of the estate and gift tax provisions of the Tax Reform Act of 1976, *see* Johnson, *The Effect of the 1976 Federal Estate and Gift Tax Changes on Estate Planning Objectives*, 1976 S. Ill. U.L.J. 299.

rate and credit structure for gifts and estates, the marital deduction for gifts and estates, the limited new joint tenancy rule, the special valuation for certain farmland, the new option for delayed payment of estate tax, the new generation skipping tax, and the new basis rules for the income tax. In analyzing the impact of the 1976 Tax Reform Act upon farm estate planning, it will be helpful to briefly review the general content of these particular provisions.

A. *Unified Estate and Gift Tax System*

The Act establishes a single federal transfer tax system that applies to both taxable gifts and the taxable estate. As cumulative taxable transfers increase, whether in the form of taxable gifts or as part of the taxable estate, progressively higher transfer tax rates will apply to each additional taxable transfer.[4]

The new federal transfer tax system also establishes a unified credit against the transfer tax[5] which replaces the old $30,000 lifetime gift tax exemption and the old $60,000 estate tax exemption.

B. *Marital Deductions*

For post-1976 gifts to donor's spouse which exceed the $3,000 annual exclusion, the new gift tax marital deduction is 100 percent of the value of the first $100,000 of gifts. When cumulative post-1976 gifts to donor's spouse range between $100,000 and $200,000, no additional marital deduction is available. But when the donor's cumulative post-1976 gifts to his spouse exceed $200,000, a marital deduction of 50 percent of the value of such gifts is allowed.[6] Prior to the 1976 Tax Reform Act the gift tax marital deduction was limited to 50 per-

4. I.R.C. §§ 2001, 2502.

5. The new $47,000 credit is being phased in according to the following schedule:

a) Estate Tax, where decedent dies in:
1977—$30,000
1978—$34,000
1979—$38,000
1980—$42,500
1981—$47,000

I.R.C. § 2010.

b) Gift Tax, in cases of gifts made
after Dec. 31, 1976 and before July 1, 1977—$ 6,000
after June 30, 1977 and before Jan. 1, 1978—$30,000
after Dec. 31, 1977 and before Jan. 1, 1979—$34,000
after Dec. 31, 1978 and before Jan. 1, 1980—$38,000
after Dec. 31, 1979 and before Jan. 1, 1981—$42,500
after Dec. 31, 1980 —$47,500

I.R.C. § 2505.

6. I.R.C. § 2523(a).

cent of all gifts to donor's spouse. Thus, the Act increases the gift tax marital deduction for the post-1976 gifts up to $200,000, but once the cumulative post-1976 gifts to the spouse exceeds $200,000, the 1976 Act will have no effect since the old 50 percent rule will again apply. For decedent's dying after 1976, the maximum estate tax marital deduction is the greater of $250,000 or 50 percent of the adjusted gross estate.[7] Under prior law the maximum estate tax marital deduction was limited to 50 percent of the adjusted gross estate. Thus, the Act increases the maximum estate tax marital deduction for adjusted gross estates under $500,000, but does not alter the maximum estate tax marital deduction for larger estates.[8]

C. *New Joint Interests Rule*

The law regarding the inclusion of joint tenancy property in decedent's gross estate was altered by the new Act. Under the new rule, only one-half of the value of joint tenancy property is included in the estate of the first joint tenant to die, *provided* the joint tenancy was created between husband and wife after 1976 and *provided* the creation of the joint tenancy was a gift for gift tax purposes.[9] It should be noted that the new rule has only this limited application. In other cases, the entire value of joint tenancy property is generally included in the decedent's gross estate, except for that portion which can be shown to have originally belonged to the surviving party and never to have been acquired from the decedent for less than an adequate and full consideration.[10]

D. *"Actual Use" Valuation for Certain Farmland*

As a general rule, property is included in the gross estate of an individual at its fair market value, regardless of its actual use. However, the Tax Reform Act of 1976 provides for an "actual use" valu-

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7. I.R.C. § 2056(c).

8. It should be noted that the use of the gift tax marital deduction may reduce the maximum amount of estate tax marital deduction available to an estate. I.R.C. § 2056 (c)(1)(B).

9. I.R.C. § 2040(b). The specific requirements are as follows:

(A) such joint interest was created by the decedent, the decedent's spouse, or both,

(B) (i) in the case of personal property, the creation of such joint interest constituted in whole or in part a gift for purposes of Chapter 12, or

(ii) in the case of real property, an election under section 2515 applies with respect to the creation of such joint interests, and

(C) in the case of a joint tenancy, only the decedent and the decedent's spouse are joint tenants.

10. I.R.C. § 2040(a).

ation for certain qualifying real property, which may be elected by the executor or administrator. Where applicable, a special formula can be used to determine the "actual use" valuation.[11] That formula is as follows:

$$\text{"Actual use"}^{13}\ \text{valuation per acre} = \frac{\text{Average net cash rents}^{12}\ \text{over the past five years for comparable property in the community.}}{\text{Average interest rate for new Federal Land Bank loans over the past five years.}}$$

If appropriate data for the formula is not available, the new law provides for additional factors to be considered in determining the "actual use" valuation. These factors include capitalization of income over a reasonable period, capitalization of fair rental value, assessed values in states which provide a differential or use value assessment for farmland, comparable sales (for farming purposes) in the same area, plus any other factor which fairly values the farmland.[14] The actual use valuation cannot reduce the value of the estate by more than $500,000.[15]

A number of tests must be met in order for farmland to qualify for the special valuation:[16]

1. Real and personal property used in farming and passing to members of the decedent's family[17] must comprise at least 50 percent of the adjusted value of the gross estate.[18]

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11. I.R.C. § 2032A(e)(7).

12. Net cash rent equals gross cash rent minus state and local real estate taxes. It is possible that Treasury regulations, when issued, will allow conversion of crop-share rents into their equivalent cash rents. I.R.C. § 2032A(e)(7).

13. For example, assume that average net cash rent has averaged $80 per acre and that the interest rate on new Federal Land Bank Loans has averaged 8 percent. The special valuation per acre would be: $\frac{\$80}{.08} = \$1,000.$

14. I.R.C. § 2032A(e)(8).

15. I.R.C. § 2032A(a)(2).

16. I.R.C. § 2032A(b)(1).

17. The definition of family member includes decedent's spouse, any ancestor or lineal descendant of the decedent, a lineal descendant of decedent's grandparent, or the spouse of any lineal descendant. The definition includes, for example, the decedent's children, wife, parents, grandparents, aunts, uncles, nieces, and nephews. I.R.C. § 2032A(e)(2).

18. The adjusted value of the gross estate is the fair market value of property included in the gross estate less unpaid indebtedness on that property.

2. Real property used in farming and passing to a qualified family member must comprise at least 25 percent of the adjusted value of the gross estate.
3. The decedent or a member of the decedent's family must have owned the real property for five of the eight years preceding death and must have materially participated[19] in the management of the farming operation for at least five of the preceding eight years.
4. Each person in being with an interest in the property must consent to the special valuation and its further implications.

The major drawback to this provision is that any estate tax savings resulting from the use of the special valuation can be recaptured if certain conditions occur.[20]

E. *Delayed Payment of Estate Tax*

The Tax Reform Act of 1976 provides for a special delayed payment of some estate tax. A fifteen-year period for the payment of the estate tax attributable to the decedent's interest in a farm or other closely held business is allowed if the value of the closely held business in the decedent's estate comprises at least 65 percent of the adjusted gross estate.[21] Up to ten annual installment payments of the deferred tax can be made starting not later than the sixth year following decedent's death.[22] But an acceleration of the deferred tax payments will occur if all or a significant portion of the closely held business is disposed of or liquidated.

A special four percent interest rate is allowed on the deferred tax attributable to the first million dollars of closely held farm business property. Interest on the deferred tax exceeding this amount will bear

19. Material participation will be determined in a manner similar to that used for purposes of determining self-employment tax liability on crop-share leases. I.R.C. § 2032A(e)(6).

20. For example, this can occur if during the fifteen year period following the decedent's death a qualified heir does not meet the material participation requirements established by the new law. I.R.C. § 2032A(c)(7). In general, the potential for recapture will cease if the family member acquiring the property dies without having disposed of the property to non-family members or without having converted it to a non-farming use, or if a period of fifteen years passes after the decedent's death. I.R.C. § 2032A(c). A special federal lien is placed on any real property for which the special valuation is used in order to insure the government's ability to recapture the tax savings if recapture is triggered. I.R.C. § 6324B.

21. I.R.C. § 6166(a)(1).

22. I.R.C. § 6166. The less lengthy § 6166A is available for those businesses or farms which qualify under its terms.

the regular rate of interest on deferred tax payments.[23] Interest payments must be made annually, even during the first five years.[24]

F. *New Generation Skipping Tax*

The tax saving advantages of successive life interests were substantially limited by the Tax Reform Act of 1976 which created a "special generation skipping tax."[25] In effect, the new provision taxes the "skipped generation" as if the non-exempt portion of the property was a part of the income beneficiary's estate. However, $250,000 in income producing property per child is exempt from the tax if the income is paid to a child of the grantor and a grandchild will receive the property after the child's death.[26]

G. *New Basis Rules for the Income Tax*

The Tax Reform of 1976 changes the rule regarding the basis of property in the hands of an heir. Under the new rule, an heir's basis in inherited property will generally be equal to the decedent's basis in the property plus an upward adjustment for a part of the estate and inheritance taxes paid on the property.[27] The gain subject to income taxation generally will be much greater under the new "carryover" basis rule than it was under the old "stepped-up" basis rule.

A special rule applies where the property in a decedent's estate had been acquired before 1977. In such circumstances, the law allows a tax free "step-up" in basis to the value of the property on December 31, 1976.[28] This tax free "step-up" is called the "Fresh Start Rule." For assets such as farmland, livestock, machinery, or closely held stock, the law provides a formula for determining the "fresh start" basis.[29]

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23. I.R.C. § 6601(j).

24. I.R.C. § 6166(g). Note also that a special lien has been created for estate tax deferred under the new provision. I.R.C. § 6324A.

25. I.R.C. § 2601 *et seq.*

26. I.R.C. § 2613(b)(6).

27. I.R.C. § 1023. It should be noted that the new provision provides a minimum carryover basis of $60,000 (if the present fair market value exceeds that amount) which will be advantageous to the beneficiaries of small estates. The provision also exempts personal or household effects up to $10,000, life insurance, and income in respect of a decedent from the carryover basis rules.

28. I.R.C. § 1023(h).

29. *Fresh Start Basis Example.* Assume that *A* purchased a farm on January 4, 1968, for $200,000. When *A* died on January 1, 1978, the farm was valued at $600,000 for estate tax purposes. The fresh start basis would be determined as follows:

II. Agricultural Impact Upon Typical Estate Planning Techniques

Numerous estate planning techniques and general rules regarding agricultural estates have evolved under prior law. These techniques and general rules have included *inter alia* avoiding large joint tenancy holdings, balancing the estates of a husband and wife, planning a program of gifts between spouses and from one generation to the next, utilizing life income interests to provide income without the burden of additional estate taxes, and utilizing the marital deduction to minimize gift and estate taxes. The above list is not all inclusive, but it does reflect many basic techniques. The 1976 Tax Reform Act affects many of these techniques and general rules. Some need to be modified; others have become of greater importance; still others are no longer of much value. Each needs to be analyzed in light of the new law.

A. *Avoiding Large Joint Tenancy Holdings*

Agricultural estates usually include substantial amounts of farmland. In many cases, much of this farmland is held in joint tenancy between husband and wife. Generally, estate planners have recommended that these large joint tenancy holdings be avoided because they created substantial tax problems under prior law.

One of the estate tax problems created by joint tenancy under prior law involved the taxation of joint tenancy property in the estate of the first joint tenant to die. Generally, the full value of the joint tenancy property was included in the gross estate of the deceased joint tenant reduced by the portion attributable to the original consideration provided by the surviving joint tenants.[30] This "consideration fur-

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Holding period before January 1, 1977 (*i.e.*, holding period under old law)	3285 days
Holding period before death (*i.e.*, total holding period)	3650 days
(90% of ownership was under the old law prior to 1977)	$\frac{3285}{3650} = .90$

Heir's Basis = \$200,000 (decedent's basis) + 90% of \$400,000 (appreciation allocated to the pre-1977 holding period) + estate and inheritance tax adjustments.
= \$560,000 + Tax Adjustments

The new carryover basis rules will be particularly troublesome for the executor. He is required by law to determine the basis of every carryover basis item in the estate and to advise the appropriate beneficiaries and the Secretary of this information. I.R.C. § 6039A. The law provides for penalties not to exceed \$5,000 for failure to furnish the required carryover basis information to the Secretary, and for penalties not to exceed \$2,500 for failure to furnish the information to the heirs. I.R.C. § 6694.

30. I.R.C. § 2040(a) (prior to the Tax Reform Act of 1976).

nished" test applied even though the original creation of the joint tenancy was treated as a gift for gift tax purposes. Because contribution was difficult to prove, especially by a surviving farm wife, most of the value of the joint tenancy property was typically subject to taxation in the decedent joint tenant's estate.

The second estate tax problem created by joint tenancy under prior law was the unnecessarily large estate of the second spouse resulting from outright ownership of the property previously held in joint tenancy. In order to avoid the taxation of the same property in both a husband's and a wife's estate, a life estate or a life income interest in property would have been desired. However, because of the right of survivorship aspect of joint tenancy property, there was no opportunity to employ a life income interest to avoid this "double tax" unless the joint tenancy was severed prior to death.[31] This inflexibility was probably the greatest disadvantage of joint tenancy property in many estates. Because of these disadvantages under the prior law, the accumulation of large joint tenancy holdings was discouraged by estate planners and existing joint tenancies were often terminated.

The 1976 Act revised some of the law applicable to joint tenancies. The new law provides for different treatment of joint tenancy property in the estate of the decedent joint tenant in some limited circumstances. Under new Internal Revenue Code section 2040 (b), a qualified joint interest in property is treated as belonging 50 percent to each spouse for estate tax purposes. Thus, for qualified joint interests, the troublesome "consideration furnished" test has been eliminated. But to qualify for section 2040(b) treatment, the joint tenancy must be solely between husband and wife, must be created after 1976 by either the husband or wife,[32] and its creation must constitute a gift in whole or in part.[33]

The questions created by the new Act are whether section 2040(b) makes joint tenancy ownership desirable from an estate tax standpoint and whether a client should elect section 2040(b) treatment. There appears to be two advantages in qualified joint interests.

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31. Extreme care was required to avoid unnecessary gift tax when a joint tenancy was terminated. *See* Treas. Reg. § 25.2515(1)(d) (1972).

32. Pending legislation would allow § 2040(b) treatment where a post-'76 gift tax return was filed electing to treat a pre-'77 joint tenancy as a gift. Thus, § 2040(b) treatment could be obtained for old joint tenancy property without terminating and recreating the joint tenancy. Technical Correction Bill of 1977, § 3(k)(2), H.R. 6715, 95th Cong., 1st Sess. (1977) *amending* I.R.C. § 2040.

33. For real estate, the donor spouse must elect gift tax treatment under I.R.C. § 2515.

First, probate expenses may be reduced because the joint tenancy property is not a part of the probate estate. (Of course, this is true whether the joint interest is qualified or not.) Second, a qualified joint interest results in the inclusion of only 50 percent of the value of the property in the donor's gross estate. In terms of total transfer tax saving, such action would avoid transfer tax on one-half of the post gift appreciation in value.[34] Yet, it is interesting to note that this second advantage could also be accomplished with a tenancy in common where a fractional interest rule has been in existence for some time.

There are also a number of disadvantages associated with creating qualified joint interests. First, creating a qualified joint interest may involve a taxable gift; the lifetime gift is not advantageous under the new unified rate and credit structure, except for the $3000 annual exclusion and the post-gift appreciation in property value.[35] Second, if the donee spouse dies first, a potential "triple exposure" problem is present: the property is subject to taxation when the joint tenancy is created; the property is subject to taxation at the death of the donee spouse;[36] the property is subject to taxation at the later death of the donor spouse.[37] The third disadvantage relates to the inflexibility noted earlier—the inability to utilize a life income interest for the surviving spouse. The new joint tenancy provision does nothing to alleviate this latter problem—the most severe disadvantage of joint tenancy property.[38]

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34. Assuming the donor spouse provides 100 percent of the consideration for the property and disregarding the marital deduction and annual exclusion for gifts, the creator of the joint tenancy would generate a tenative gift tax on 50 percent of the value at the time of gift. The other half of the property (at its appreciated value) would be subject to estate tax at the death of the donor spouse. Thus, the action would avoid taxation on one-half the total post gift appreciation.

35. See section II (C) and (C)(1) *infra*.

36. It is questionable whether the gift tax paid by the donor spouse when the joint tenancy was created could be applied against the tentative estate tax of the donee spouse. I.R.C. § 2001(b)(2) only allows a deduction for gift taxes *payable* with respect to gifts made by the decedent.

37. Query: Will the regulations allow the donor spouse to claim a § 2001(b)(2) deduction for the gift taxes paid when the joint tenancy was created?

38. The inflexibility disadvantage can be illustrated best with an example. Assume that a farmer dies in 1981 and his spouse survives until 1991. Assume further that the husband's only asset is farmland worth $500,000, that the land does not appreciate in value during 1981-1991, and that the surviving spouse has no additional property except for that received at the death of the farmer. If the $500,000 had been held in joint tenancy between the spouses, the federal estate taxes payable at the death of the second spouse would be $108,800 (assuming no prior taxable gifts). If the property had been owned outright by the farmer and he had bequeathed to his spouse a half interest outright and a life income interest in the other half, the federal extate tax payable at the death of the second spouse would be $23,800 (assuming no prior taxable gifts). The

In weighing the advantages and disadvantages of large joint tenancy holdings, even where the joint tenancies are qualified joint interests under section 2040(b), it appears that large joint tenancy holdings should still be avoided as a general rule and that many existing joint tenancies should still be terminated. The general exceptions would be joint tenancies created for convenience, such as joint ownership in a home, or joint tenancies involving less than half of the total property. As will be apparent in the gift giving program discussion to follow, there may be greater opportunity to terminate joint tenancies and create equal tenancies in common without paying gift tax, because of the expanded marital deduction and unified credit of the new Act. Thus, in most farm estates the real impact of the new Act in reducing joint tenancy problems may be the greater opportunity to terminate joint tenancies and to establish balanced estates between husband and wife, rather than making joint tenancies more advantageous.

B. *Balanced Estates of Husband and Wife*

The desirability of balancing the estates of a husband and wife during their lifetime was based upon three features of prior law. First, each spouse had an opportunity to pass $60,000 worth of property to succeeding generations without the burden of any estate tax because of the old estate tax exemption. If the estates were balanced during lifetime, each spouse would have an opportunity to utilize all or part of the $60,000 exemption, regardless of which spouse died first.

Second, the old estate tax rates, like the present unified rates, were progressive. Less total estate tax would be paid if the taxable estates of the husband and wife were approximately equal. This same principle is illustrated in income tax planning. Less income tax is paid if the sole wage earner of a family files a joint income tax return which effectively allocates the taxable income equally between two taxpayers.

The third feature of prior law which encouraged the lifetime balancing of estates was the inherent limitation of the marital deduction. The allowance of a marital deduction for up to half of the adjusted gross estate would equalize taxable estates only if the wealthy spouse died first. Since the timing of death is an uncertainty in "lawful" estate planning, the estate tax marital deduction could not be relied upon as a technique for balancing the taxable estates. Thus, spouses

inflexibility cost of joint tenancy in this example is $85,000 and occurs at the death of the second joint tenancy. The inflexibility cost would be present whether the joint tenancy was a qualified joint interest or not.

were encouraged to acquire property so that their holdings during lifetime were balanced. Nearly equal taxable estates would then be possible regardless of which spouse died first.[39]

Generally, establishing balanced estates between husband and wife remains a desirable estate planning technique. Although the $60,000 exemption was repealed, a unified credit has been added which allows each spouse to transfer up to $175,625 to succeeding generations without transfer tax.[40] Although tax rates have changed, the new unified rate structure is still progressive. Similarly, a marital deduction is still available under the new law and the uncertainty regarding timing of death remains. Thus, those features of prior law and the uncertainty of life which initially encouraged balanced estates still exist today, for both agricultural and other estates.

Although the Act has not altered the general rule regarding the desirability of balanced estates, it has reduced the need for balancing. For example, under prior law, balancing the estates could be useful any time the total assets of a husband and wife exceeded the old $60,000 estate tax exemption. Under the new law, balancing the estates of husband and wife would not be useful until the assets of the family reach the "equivalent exemption" of $175,625 in 1981, assuming that the unified credit had not been used for lifetime gifts.[41] Of course, in the smaller estate, the increased "equivalent exemption" of the new law has reduced the need for many "tax minimization" estate planning techniques, not just the technique of balancing estates.

C. *Gift Giving Programs*

Under prior law, a gift giving program could help minimize transfer taxes for three primary reasons: (1) It allowed nontaxable transfers through a separate system of exemptions and exclusions. (2) Taxable gifts were subject to lower rates—only three-fourth of comparable estate tax rates. (3) Taxable gifts did not affect the estate tax rates that would apply to the taxable estate at death (one could use the lowest gift tax rates *and* use the lowest estate tax rates under the dual rate structure of prior law). Under prior law, however, transfers of property by gift did have one major disadvantage. Such a transfer

39. Marital deduction planning will be developed more fully in section II(E) *infra*.

40. $175,625 is the equivalent exemption of the $47,000 unified credit available in 1981 and thereafter. House Conference Report No. 94-1515 at 607. *See* note 5 *supra*.

41. If the unified credit had been utilized during the lifetime of a spouse, the "add back" provision of the unified structure (I.R.C. § 2001(b)(2)) would make balanced estates desirable even though current assets of the family were less than $175,625.

resulted in a "carryover" basis for the property in the hands of the donee, whereas the property would have a free "step up" in basis if transferred at death. The *net* effect of prior law was to encourage gifts by farm families in order to avoid or minimize total transfer taxes.

The 1976 Tax Reform Act has drastically altered the law affecting gift giving programs, eliminating many incentives for making gifts. For example, the $30,000 gift tax exemption was repealed along with the old $60,000 estate tax exemption, substituting the unified credit and its equivalent exemption. Thus, a separate lifetime gift tax exemption is no longer forfeited if unused. Similarly, under the new unified rate schedule, gifts are no longer subject to a separate rate schedule which was 25 percent lower than the estate tax rate schedule. (Remember, gift tax rates were three-fourths of estate tax rates under prior law.) Finally, the application of the new unified rate structure to *cumulative* taxable transfers (taxable gifts and the taxable estate) means that the opportunity to use two low tax brackets, one for gifts and one for estates, is no longer forfeited by failure to make taxable gifts. On the other hand, the implementation of a carryover basis concept for property transferred at death will place transfers by gift and transfers at death on an equal footing as far as tax basis in the hands of an heir is concerned,[42] at least in the long run.[43] Thus, many of the previous advantages of gift transfers have been eliminated and one of the previous disadvantages of gift transfers has been mitigated. These changes will significantly effect agricultural gift giving strategies.

(1) Using the Annual Exclusion

Although many of the primary reasons for making pre-1977 gifts have been eliminated by the new Act, other reasons and tax-saving opportunities do exist. For example, the annual $3,000 exclusion per donee was not altered by the new law.[44] In fact, this exclusion is even more useful under the new law, because it can be used right up to the time of death. Only gifts exceeding the $3,000 annual exclusion are

42. Prior to 1921, property transferred by gift received a free step up in basis just as property transferred at death prior to 1977 does now. *See* I.R.C. § 1015(c). From 1921 thru 1976, property transferred by gift had a carryover basis (§ 1015(a)) while property transferred at death continued to receive a free step up in basis. After 1976, not only does property transferred by gift have a carryover basis, but property transferred at death will also be subject to a carryover basis (§ 1023), except that the December 31, 1976, fresh start basis will apply to some property transferred at death (§ 1023(h)).

43. The fresh start rules that allow a partial free step up to December 31, 1976 values for property transferred at death will be of decreasing significance as time passes.

44. I.R.C. § 2503(b).

brought back into the estate under the new automatic three-year rule.[45] For a married couple, the $3,000 annual exclusion may be combined under the "split gift" provision,[46] just as under prior law.

A problem associated with the use of the annual exclusion in farm estate planning occurs when farm clients may be "land rich and cash poor." Even though a farm couple could give $18,000 per year to three children tax free, the couple often does not have the $18,000 in cash or other liquid assets. The Illinois land trust has been a vehicle for utilizing the annual exclusion to effectively transfer interests in land.[47] The 1976 Act has had an impact upon utilizing the Illinois land trust for such purposes.

The greatest potential disadvantages of transferring beneficial interests in a land trust by gift are related to the actual use valuation for farmland potentially available in many agricultural estates. Assuming that the actual use valuation will result in a lower estate tax valuation than would occur if the fair market value were used, and further assuming that the taxes saved by the lower valuation would more than offset the disadvantages of the actual use valuation,[48] the lifetime transfers of beneficial interest can cause two problems.

The first disadvantage occurs because the actual use valuation for farmland is only available for property included in the gross estate—not for property transferred by gifts. To the extent that a farmer might utilize his $3,000 annual exclusion for gifts of beneficial interest in lieu of other property, he retains property that will be taxed at fair market value in his estate in lieu of retaining land that might qualify for actual use valuation in his estate. To the extent that a farmer utilizes his marital deduction or unified credit for lifetime transfers of beneficial interests, he is "consuming" his marital deduction[49] and unified credit

45. I.R.C. § 2035(b)(2). *But see* Technical Corrections Bill of 1977, § 3(f), H.R. 6715, 95th Cong., 1st Sess. (1977), *amending* I.R.C. § 2035(b), transfers with respect to a life insurance policy made within three years of death would not be excluded from the gross estate.

46. I.R.C. § 2513.

47. For an excellent treatise of the Illinois Land Trust, *see* H. KENOE, LAND TRUST PRACTICE (1974).

48. The disadvantages include, for example, the burden of a tax lien on the property, I.R.C. § 6324B, and a lower "fresh start" basis for the property because of the lower valuation in the estate. I.R.C. § 1023(h). Further discussion of the advantages and disadvantages of the "Actual Use Valuation" appear in section III (A) *infra*.

49. The concept of "consuming" the marital deduction applies where the farmer's adjusted gross estate is less than $500,000. In such a case, the farm is utilizing an artifically high (compared with the old law) finite maximum estate tax marital deduction of $250,000. Beyond an adjusted gross estate of $500,000, the marital deduction is no longer finite.

based upon fair market value of the land. If the land stayed in his estate, the marital deduction and unified credit would be "consumed" based upon the presumably lower actual use valuation.

The second disadvantage relates to the real property not transferred by gift. If too much land is given away during a farmer's lifetime, he may have insufficient farmland to meet the 25 percent qualified real property test required for the actual use valuation in his estate.[50] In effect, if a farmer transfers too much land via a land trust during his lifetime, his remaining real property may be disqualified from the advantages of actual use valuation in his estate.

There is another disadvantage that would appear to be present when beneficial interests are transferred as gifts. This apparent disadvantage is related to the fresh start basis rules. Where the farmer purchased the land prior to 1977, the farmer's heir will obtain a fresh start basis in the property when the farmer dies sometime after 1976. On the other hand, if the farmer transfers the land by making gifts of beneficial interests, the donee would have a carryover basis in the property. Thus, it would appear that the opportunity to obtain the fresh start basis is forfeited if the property interest is transferred by gift. This apparent problem only arises, however, if the donee sells the property triggering recognition of gain. If the donee dies owning the property, the basis in the hands of the donee's heir will be a fresh start basis because the donee's basis "reflects the adjusted basis [of the land] on December 31, 1976" as required by section 1023(h)(2). In effect, since the donor's basis would qualify for a "fresh start" if the donor had died owning the property, and since the donee takes the donor's basis, the donee's heir gets a fresh start basis approximating the December 31, 1976, value of the property.[51] Thus, the apparent forfeiture of a fresh start basis will not materialize if the donee of real estate or beneficial interest in real estate (or his subsequent donee) transfers the property at death. The Illinois land trust should therefore remain a valuable tool in farm estate planning, although care must be taken not to jeopardize potential actual use valuation or special delay payment of estate taxes.

(2) Gift Splitting

Under prior law the splitting of gifts to third parties by a husband

50. I.R.C. § 2032A(b)(1)(B) reads in relevant part: "25 percent or more of the adjusted value of the gross estate consists of the adjusted value of real property . . . ."

51. With an additional upward adjustment for all federal and state estate taxes paid attributable to any appreciation on the value of the property since December 31, 1976. I.R.C. § 1023(C).

and wife had several advantages. A husband and wife could "pool" the annual exclusion per donee even though only one spouse was actually making the gift. The split gift election also allowed the utilization of two sets of gift tax rates—husband's and wife's—so that twice as much property could be transferred in each tax bracket before the next higher bracket was reached.

Under the new law these advantages remain. In addition, the husband and wife can effectively "pool" their unified credits and transfer twice as much property as taxable gifts without incurring a "tax payable."[52] To the limited extent that it is advantageous to utilize the unified credit for gifts, rather than for transfers taking effect at death,[53] the split gift election can double this advantage where only one spouse owns property.

Where there is a likelihood that the spouse with property of his own will die within three years of the gift, it may be unwise for the other spouse to elect the split gift treatment of section 2513. Under new section 2035, the *entire* gift will be fully included in the gross estate of the property-owning spouse if the spouse dies within three years of the gift.[54] But, the unified credit of the other consenting spouse will not be restored unless a pending amendment becomes law.[55]

(3) Making Taxable Gifts

If one assumes that inflation will continue in the long run, there is some advantage in utilizing all or part of one's $47,000 credit for lifetime taxable gifts. If property inflates in value with the passage of time, the unified credit will allow a greater quantity of property to be transferred "tax free" today than could be transferred "tax free" in the future, because the future per unit value of property would be inflated.[56] Furthermore, the income stream from the property will accrue to the donee of the property, rather than to the donor. These

52. The "tax payable" is the tenative tax generated by the taxable gifts, less the available unified credit. In 1981 and later years each person can make taxable gifts of up to $175,625 and have zero "tax payable" because of the $47,000 unified credit and its "equivalent exemption" of $175,625. *See* note 5 *supra*.

53. See discussion in section II(c)(3) *infra*.

54. Less the $3,000 annual exclusion, in some circumstances.

55. The new Act makes no provision for the restoration of the consenting spouse's credit in such a circumstance. However, a proposed amendment would restore the consenting spouse's credit where the split gift is included in the gross estate of the donor spouse as a transfer within three years of death. Technical Corrections Bill of 1977, § 3(h), H.R. 6715, 95th Cong., 1st Sess. (1977) *amending* I.R.C. § 2001.

56. Stated differently, the $47,000 credit is worth more in real dollars now than it will be worth in real dollars in the future, assuming a continuation of inflation.

limited advantages of using the unified credit for lifetime gifts must be weighed against the donor's loss of income and security because of the pre-death transfer of property.[57]

(4) Kinds of Property to Give

Under prior law the best known general rule regarding the kind of property to give was probably the basis rule—transfer high basis property by gift and low basis property at death.[58] The purpose of this rule, of course, was to maximize the free step up in basis available under prior law for property transferred at death.

In the post-1976 era there are at least three general rules to be followed. It is desirable to transfer high basis property by gift rather than low basis property, just as under prior law. Although the 1976 Act eliminates the full free step up in basis except for certain property, the fresh start rule will still allow a partial free step up to the approximate value on December 31, 1976, for assets purchased prior to 1977. This partial step up will continue to be very significant for the very low basis property, especially farmland that may have been purchased in the 1940s or before. In order to maximize the partial free step up in basis available under the fresh start rule, the property with a very low basis should generally be transferred at death rather than by lifetime gift or sale.[59]

As a general rule, it is also desirable to transfer non business property by gift, rather than business property. This is because section 2032A, actual use valuation of farmland, requires that closely held business property comprise at least 50 percent of the adjusted gross estate,[60] while section 6166, alternate extension of time for payment of estate taxes, requires that the value of an interest in a closely held business exceed 65 percent of the adjusted gross estate.[61] To insure the avail-

57. There may even be some advantage in making taxable gifts of property after the $47,000 credit has been used. To the extent that these gifts are made prior to the last three years of donor's life, the gift tax paid will not be brought back into decedent's estate under the gross up rule of new § 2035. The net saving in transfer tax is the gift tax paid multiplied by the marginal estate tax rate.

58. Actually, the rule should be stated as follows: Where a person owns property with a high basis relative to its current value, and property with a low basis, relative to its current value, the person should transfer the high basis property by gift and the low basis property at death.

59. The benefits of a fresh start basis will not necessarily be lost if the property is transferred by gift. However, the likelihood of the sale by the donee rather than a transfer taking place at donee's death is increased, especially if the donee is much younger than the donor. See the Illinois Land Trust discussion, section II (c)(1) *supra*.

60. I.R.C. § 2032A(b)(1).

61. I.R.C. § 6166(a)(1).

ability of these potentially preferential sections, a farmer must not transfer business property by gift to the extent that his estate will no longer meet the tests noted above.

If business property is transferred by gift it is also desirable as a general rule to transfer business personal property by gift rather than business real property, assuming the actual use valuation of section 2032A is desired. The actual use valuation only applies to real property transferred at death. If real property is transferred by gift in amounts that exceed the $3,000 annual exclusion, the transfer tax will be based upon the full value of the real property rather than the actual use value which would have been available had the property been transferred at death.

D. *Utilizing Successive Life Income Interests*

The new generation skipping tax will substantially reduce the tax saving effectiveness of successive life income interests in large estates. However, the effect of the new tax on most farm estates will probably be negligible.

Agricultural estate plans often utilize a life income interest in a surviving spouse, remainder interest in children. In this situation the new generation skipping tax will not apply at the death of the surviving spouse because both spouses are deemed to be of the same generation. Thus, no generation has been skipped. Where children receive a life income interest, remainder interest in grandchildren, the $250,000 exemption per child for property passing to grandchildren will be sufficient to shield the property from the generation skipping tax in most agricultural estates.[62] Only where life income interests are extended to grandchildren or where the decedent has an exceptionally large estate or few children will the new generation skipping tax be a potential problem. In these cases, the use of successive life income interests will be reduced. But because of the size of the typical farm estates, the propensity of farm couples to have children, and the reluctance of most farm families to utilize life income interests beyond one succeeding generation, the new generation skipping tax will probably not affect most farm estate plans.

E. *Using the Marital Deduction*

Three fundamental questions are related to marital deduction planning in the post-1976 era. What is the optimum total marital de-

62. I.R.C. § 2613(b)(6).

duction to be used and how much of this optimum marital deduction should be used for gifts rather than left for the estate? How should the estate tax marital deduction be obtained: direct bequest to spouse, marital deduction trusts, fractional share formula, pecuniary formula? Do existing marital deduction clauses need to be amended?

(1) Optimizing the Marital Deduction for Gifts and Estates

The primary goals of marital deduction planning have been, and remain, twofold: minimize the total transfer tax that must be paid by husband and wife as they transfer assets to succeeding generations, or delay the payment of transfer tax that must ultimately be paid by a husband and wife. The following discussion will assume that tax minimization is the primary goal rather than delay in tax payment.[63]

Most of the principles related to the marital deduction were noted in the earlier discussion of balanced estates.[64] These include using the optimum marital deduction at death to minimize total transfer taxes of husband and wife by creating equal amounts subject to tax and using the marital deduction for gifts to insure that the nonpropertied spouse has a taxable estate of at least $175,625 to utilize the maximum "equivalent" exemption. Using these principles as guidelines, some general rules can be formulated regarding the post-1976 era. The rules of thumb will vary depending upon the size of assets held by husband and wife. The following discussion assumes that all deaths occur after 1980 when the full $47,000 unified credit is available and assumes (for the sake of simplicity) that assets do not appreciate in monetary value over time. Implicitly, these general rules of thumb also assume that the surviving spouse could be given a life income interest in property not qualifying for the marital deduction.

(a) *Combined Net Assets of Less Than $175,625*

Where the combined assets of husband and wife are less than

63. Theoretically, total transfer taxes will be minimized if the sum of the taxable estate plus adjusted lifetime taxable gifts (hereinafter called adjusted taxable estate) is equal for a husband and wife. However, this theoretical approach disregards the time value of money. When one spouse pre-deceases the second spouse by many years, one would prefer a smaller adjusted taxable estate for the first spouse and a larger adjusted taxable estate for the second spouse. Total transfer taxes paid will be larger under this scheme, but the first installment (taxes payable because of the death of first spouse) will be smaller. Thus, the surviving spouse will have the use of additional money during her lifetime. The time value of this additional money will usually more than offset the additional total transfer tax paid because of unequal adjusted taxable estates. Nevertheless, the discussion that follows will assume that equal adjusted taxable estates are theoretically optimum unless otherwise noted.

64. See section II (B) *supra*.

$175,625, marital deduction planning is irrelevant. The unified credit of either spouse is sufficient to completely shelter the transfer of these assets to succeeding generations. Under prior law, the threshold for marital deduction planning was $60,000—the amount of the estate tax specific exemption.[65]

(b) *Combined Net Assets from $175,625 to $351,250*

Where the combined assets of husband and wife are between $175,625 and $351,250, complete avoidance of transfer taxes can be obtained if the marital deduction is employed to give the first spouse to die a taxable estate of $175,625. When the first spouse devises his estate to his heirs, there will be no transfer taxes payable in his estate because of the $47,000 credit. Likewise, there will be no taxes payable in the estate of the second spouse when she bequeaths her estate to her heirs because of her $47,000 credit.

Where one spouse owns all or most of the property, a large gift to the nonpropertied spouse is desired. A gift of at least $100,000 should be considered because that amount can be transferred by gift without incurring a gift tax under the revised gift tax marital deduction.[66] The large gift will minimize transfer taxes if the nonpropertied spouse should die first, because the donee spouse can transfer the $100,000 to the succeeding generation tax free by utilizing the uniform credit.

(c) *Combined Net Assets Exceeding $351,250*

Where net assets exceed $351,250, the complete avoidance of transfer taxes is not possible through marital deduction planning alone. Rather, the goal of marital deduction planning is transfer tax minimization or transfer tax delay. To minimize total transfer taxes, the marital deduction should be employed so as to equalize the amount in each spouse's estate subject to tax. Where the deceased spouse owned all of the property, this optimum marital deduction will be less than the maximum marital deduction of $250,000 available under new law for adjusted gross estates under $500,000.[67] Alternatively, if both

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65. If the old $30,000 exemption for gifts were also considered, the threshold would be $90,000.

66. I.R.C. § 2523(b). Additional gifts to the extent required to bring the assets of the donee spouse up to $175,625 should also be considered, even though such additional gifts will not qualify for any marital deduction under § 2523(b). *See* section II (c)(3) *supra*.

67. For example, assume a farmer dies with an adjusted gross estate of $250,000. If he bequeaths all of this property to a surviving spouse, the marital deduction will be

spouses are relatively young, an interim plan could delay taxes if the propertied spouse should die unexpectedly at a young age. Good marital deduction planning might employ the maximum marital deduction to the extent it does not reduce the amount subject to tax in decedent's estate below $175,625. This interim plan, designed to delay transfer taxes, should not be overlooked for agricultural clients who are involved in one of the more hazardous occupations. As the farm couple grows older, the marital deduction planning would shift back to a total tax minimization focus because the likelihood of great disparity in the timing of deaths would be reduced.

Where one spouse owns all or most of the property, a large gift to the nonpropertied spouse is desired (probably of at least $100,000) where combined net assets of the estate range from $175,625 to $351,250.[68]

(2) Choosing the Method to Implement the Optimum Marital Deduction in Estates[69]

Several options are available for implementing the marital deduction for an estate. Often, a direct devise to the surviving spouse is more suitable than some of the more complicated methods. Transfers in kind can be especially useful where one spouse owns a great deal of property such as farmland. A devise of a specific number of acres, rather than a fractional share of the estate, may be preferred, or undivided interests as tenants in common may also be utilized.

Another option involves the use of trusts. The typical marital deduction trust scheme contemplates two trusts, the "A" and the "B" with the spouse having a life estate in both with a general power of

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$250,000. Since the taxable estate is zero, there are no federal taxes at the death of the farmer. At the subsequent death of the surviving spouse, the federal estate taxes payable would be $23,800. Use of the maximum marital deduction has resulted in total estate taxes payable of $23,800.

If the farmer had bequeathed only $150,000 outright to his spouse, the marital deduction would be $150,000—less than the maximum. The farmer's taxable estate would be $100,000. The estate taxes payable after subtracting the unified credit would be zero. At the later death of the second spouse, the adjusted gross estate and the taxable estate would be $150,000. The estate taxes payable after subtracting the unified credit would be zero. By using less than the maximum marital deduction in the first estate, estate taxes were avoided completely. In contrast, where the maximum marital deduction was used, $23,800 in federal estate taxes were incurred.

68. *See* section II (e)(1)(b) *supra.*

69. Much of the following discussion is based upon material prepared by Gale W. Saint for a seminar on Farm Estate Planning and Business Organization sponsored by the Illinois Institute for Continuing Legal Education, Springfield, Illinois (June 10-11, 1977).

appointment over one and a limited or special power over the other.[70] A "fractional share of the residue" formula may be used to fund a marital deduction trust, or it also can be used to determine the size of the spouse's outright share of the residue.

The pecuniary formula[71] is another formula often used to fund a marital deduction trust. Even before the 1976 Act the use of a pecuniary formula to fund a marital deduction was troublesome. For example, the marital deduction might be denied if the pecuniary bequest could be satisfied in kind and was not carefully drafted.[72] The recognition of gain was another problem. If an executor distributed property to satisfy a pecuniary bequest in kind and if the property so distributed had increased in value, gain on the exchange was recognized.[73] Such a transaction would not generate gain under a fractional share formula. Both of these problems remain in the post-1976 era.[74]

The recognition of gain problem arising where a pecuniary bequest is satisfied in kind is especially troublesome if the property is farmland that was included in the estate at actual use value under section 2032A. New section 1040 would appear to recognize as gain the difference between actual use value and fair market value at date of distribution, rather than the difference between fair market value at death and fair market value at date of distribution. Since no gain would be recognized if a fractional share formula were used, the recognition of gain "penalty" associated with a pecuniary formula would appear to be even greater if the assets had been valued at their actual use valuation. This special problem for section 2032A assets would be corrected by the proposed technical amendment which limits the recognized gain to that actual amount accruing since the decedent's death, even if the property had been valued in the estate under section 2032A.[75]

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70. *See, e.g.*, Illinois Institute for Continuing Legal Education, Drafting Wills and Trust Agreements §§ 4.1-4.50 (1977). It also seems possible to set up a single fund marital deduction trust which gives the spouse a general power of appointment, over a fractional portion known as the "marital portion."

71. There are several kinds of pecuniary formulae. Under a true pecuniary formula, the dollar amount of the marital deduction is satisfied in cash or with assets valued at date of distribution. Under a tax value pecuniary formula, the dollar amount of the pecuniary formula is satisfied either in cash or in assets valued at federal estate tax values.

72. Rev. Proc. 64-19, 1964-1 C.B. 682.

73. The recognized gain was the difference between value at the time of distribution and value in the estate.

74. The recognition of gain problems would have been accentuated by the new carryover basis rules if § 1040 had not been added to limit the recognition of gain to post death appreciation. I.R.C. § 1040(a).

75. Technical Corrections Bill of 1977, § 3(d), H.R. 6715, 95th Cong., 1st Sess. (1977), *amending* I.R.C. §§ 2032A, 1040.

(3) Changing Existing Wills

Existing wills which utilize a formula to provide for the "maximum marital deduction available" are particularly affected by the increased maximum marital deduction for estates under $500,000. In order to prevent the increased maximum deduction from automatically increasing the amount of property passing to a surviving spouse under such a formula or pecuniary clause, the 1976 Act provides a special transition rule. Where a decedent dies after 1976 and before 1979, the increased marital deduction will not apply for property passing under a "maximum marital deduction formula" contained in a will executed before 1977 unless the will was subsequently amended.[76] Thus, such a marital deduction clause must be amended if the increased maximum marital deduction is actually desired before 1979. Also, if a marital deduction which is less than the new maximum is desired, the will should be amended to so indicate.

III. New Agricultural Estate Planning Dimensions

The Tax Reform Act of 1976 has introduced some entirely new estate planning considerations in addition to modifying many traditional estate planning techniques. The new considerations include qualifying an estate for the actual use valuation of section 2032A, qualifying an estate for the section 6166 alternate extension of time to pay estate tax, and minimizing the detrimental impact of the new carryover basis provisions.

A. *Qualifying for Actual Use Valuation*

The actual use valuation of section 2032A has the potential to reduce the value of a taxable estate by up to $500,000.[77] This maximum reduction in valuation could result in an estate tax savings of up to $350,000 for a taxable estate exceeding $5,000,000. For an estate reduced from $2.5 million to $2.0 million, the estate tax savings would be $245,000. Of course, there are some disadvantages associated with the actual use valuation, for example, a reduced fresh start basis than would occur if fair market value were used,[78] and the burden of a tax

76. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, § 2002(d)(1)(B). *See also* RIA Complete Analysis of the '76 Tax Reform Law 19-20 (1976).

77. I.R.C. § 2032A(a)(2).

78. Under the formula for determining fresh start basis, the higher the value of the property in the estate, the higher the fresh start basis will be. *See* I.R.C. § 1023(h)(2); *see also* note 29 *supra*. To the extent that actual use evaluation reduces the value of the property in the estate, the fresh start basis will also be reduced.

lien upon the property.[79] Nevertheless, the potential tax saving is sufficient to warrant planning to insure that the estate will at least *qualify* for the actual use valuation. A later decision can always be made as to whether the executor should elect section 2032A valuation.

The 50 percent and 25 percent property tests and the material participation test should be easy to meet in typical farm estates where the farmer is owner-operator. In these typical estates, real and personal property usually comprise at least 50 percent of the adjusted value of the gross estate and real property usually comprises at least 25 percent of the adjusted value of the gross estate. Planning may be required, however, to avoid lifetime transfers of business property, particularly realty that could result in failure to meet these tests. The material participation test would also usually be met in the typical farm estate, either because the decedent had been the operator until death or because a relative became the operator after the decedent retired.[80]

Meeting the tests of section 2032A will require more subtle planning for atypical farm estates, such as that of the farm owner with substantial nonfarm assets such as stocks and bonds, or the estate of the "gentleman" farmer. To meet the 50 percent and 25 percent property tests, it may be necessary to transfer by gift substantial nonbusiness assets so as to indirectly increase the proportion of business assets in the estate. Alternatively, additional farm real estate could be purchased—financed with a modest down payment and additional debt secured by the nonbusiness assets. This alternative procedure would directly increase the proportion of business realty because the new farmland would be unencumbered with debt. Thus, the proportion of unencumbered farmland relative to total assets less total liabilities would be substantially increased.[81] Of course, any combination of the two above procedures could be employed.

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79. I.R.C. § 6324B.

80. Note that the material participation requirements of § 2032A can be met by either the decedent or a member of his family. I.R.C. § 2032A(b)(1)(C). *See* note 17 *supra*.

81. Suppose for example that an individual has a net worth of one million dollars—$200,000 in farmland; $200,000 in farm business personal property; $600,000 in stocks, bonds, and other non business assets; and no liabilities. He fails to meet both the 50 percent and 25 percent tests required of § 2032A(b). However, if he buys an additional $200,000 worth of farmland with cash and debt secured with his stocks and bonds his assets would be as follows: $400,000 in unencumbered farmland; $200,000 in unencumbered farm business personal property; and $400,000 in stocks, bonds, and other nonbusiness property ($600,000 face value less $200,000 indebtedness with respect to these assets). Thus, the farmer now has 60 percent in business real and personal property, and 40 percent in business real property. He meets the 50 percent and 25 percent tests. *See* I.R.C. § 2032A(b)(3).

The material participation test also poses a problem for the landlord whose land is operated by nonrelated tenants. Material participation by the decedent or member of decedent's family will be determined in a manner similar to the manner used to determine net earnings from self-employment.[82] Under section 1402(a) farm rental income is self-employment income if the rental agreement provides for material participation by the owner and the owner actually materially participates in management.[83] Thus, for the gentleman farmer who hopes to meet the material participation test, it may be necessary to amend farm leases to provide for material participation and to actually increase the level of management exercised by the landlord.[84] Even then, one cannot be certain that the Service will readily allow the actual use valuation. Assuming material participation is established where it would not otherwise be present, qualifying for the actual use valuation has potentially detrimental social security tax implications in the forms of payment of additional self-employment taxes and a reduction in social security retirement benefits because of high self-employment income after retirement.

A final requirement of section 2032A is a written agreement signed by each person in being who has an interest (whether or not in possession) in any qualified real property for which the use valuation is exercised.[85] This agreement must indicate the consent of each party to the application of the recapture tax and must be filed with the estate tax return. The interested persons may not wish to agree to such provisions if they are not the ones who will reap the tax savings. For example, property that could qualify for actual use valuation may be bequeathed in a specific bequest to children while the tax clause of the will indicates that estate taxes will be paid out of the residuary estate (which passes to the surviving spouse). Since the spouse bears the burden of the taxes, why should the children consent to the election and agree to potential recapture? Careful drafting of the tax clause may be required to give the recipient of potentially qualified property an incentive to agree to the actual use valuation. Alternatively, an *in terrorem* clause might be employed to insure the cooperation of the interested persons.

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82. I.R.C. § 2032A(e)(6).

83. It should be noted that I.R.C. § 1402(a)(1) states that material participation through an agent is not sufficient.

84. *See* Treas. Reg. § 1.1402(a)-(b) (1972) for a detailed discussion of what constitutes material participation.

85. I.R.C. § 2032A(d).

B. *Qualifying for the Section 6166 Alternate Extension for Payment*

The section 6166 alternate extension of time to pay estate tax has two desirable features. The estate tax attributable to the closely held business of the decedent can be deferred entirely for up to five years with the tax paid in up to ten annual installments following the five-year deferral. Thus, the final installment of estate tax can be delayed for fifteen years. Additionally, the interest on all or part of the unpaid tax is only 4 percent. These provisions of section 6166 are substantially more beneficial to the estate than the ten year payout provision of section 6166A.[86]

To qualify for the section 6166 alternate extension, the estate tax value of decedent's interest in a closely held business must comprise at least 65 percent of the adjusted gross estate. This requirement may affect the kind of property (business or non-business) to be transferred by gift and the kind of property to be purchased by the decedent during lifetime, just as the 50 percent and 25 percent tests of the actual use valuation affected these property selection decisions.

The requirement that the interest be in a closely held business may affect the business organization to be selected by the decedent. For purposes of section 6166, an "interest in a closely held business" means:

(A) an interest as a proprietor in a trade or business carried on as a proprietorship;
(B) an interest as a partner in a partnership carrying on a trade or business, if—
  (i) 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or
  (ii) such partnership had 15 or fewer partners; or
(C) stock in a corporation carrying on a trade or business if—
  (i) 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or
  (ii) such corporation had 15 or fewer shareholders.[87]

The definition is especially important when applied to a retired person who may be renting out his farmland since the Service has ruled that mere management of rental property is not a trade or business for purposes of the ten-year extension available under section 6166(c) prior

86. *Compare* I.R.C. § 6166 *with* I.R.C. § 6166A (15 years to pay versus 10). *Compare* I.R.C. § 6601(j) *with* I.R.C. § 6621 (4 percent interest versus market rate interest).

87. I.R.C. § 6166(b)(1).

to the 1976 Tax Reform Act.[88] The same rule will probably be applied for purposes of the fifteen year extension under the revised section 6166(c). In contrast, a retired farmer would seem to meet the trade or business test if the assets were held by a partnership or corporation and the retired farmer owned at least 20 percent of the partnership or at least 20 percent of the voting stock. Thus, a retired farmer can qualify for section 6166 treatment more easily if the farmer's business is in the form of a partnership or corporation.

C. *Minimizing Carryover Basis Problems*

Some planning to minimize carryover basis problems has already been mentioned. For example, under the gift giving discussion, it was noted that property with a relatively high basis should be transferred by gift in lieu of property with a relatively low basis, other things being equal. Such actions would maximize the partial free step up in basis afforded by the fresh start rules.

An additional consideration involves the interrelationship between carryover basis and the farmer's typical desire to treat all heirs fairly and preserve the farming unit as an operating entity. Nonfarming heirs may be reluctant to sell out to farming heirs because of the recognition of gain problems aggravated by the carryover basis; therefore, it may be necessary for the farm family or the estate to sell the farmland and other business property to the farming heir and distribute the proceeds of sale equitably among all heirs. An installment sale may be desired to spread the recognized gain over a number of tax years and thereby minimize the income tax on the total gain to be recognized. To qualify as an installment sale, the payments received from the purchaser in the taxable year of sale must not exceed 30 percent of the selling price.[89] Also, two or more payments in two or more years are required.[90]

The carryover basis provisions of 1976 Tax Reform Act also substantially increase the need for accurate, complete records. Under prior law, the fact that decedent's records were inadequate to determine decedent's basis in property was immaterial. The heir's basis in the property was determined by the value of the property in the decedent's estate. Under the carryover basis provision of section 1023, an heir's basis in most property will be related to the adjusted basis of the property immediately before the death of the decedent. Agricultural

88. Rev. Rul. 75-365, 1975-2, C.B. 471.
89. I.R.C. § 453(b).
90. Rev. Rule 69-462, 1969-2, C.B. 107.

clients must be advised at an early stage of the important need to determine the acquisition date and the basis of all major items of property, the depreciation taken on these items prior to 1977, and the value and date of any added capital improvements. Once compiled, these records must be kept up-to-date so that one's executor will have the necessary data to calculate the basis of property in the hands of an heir. Advising clients regarding the importance of such records must become a routine part of estate planning.

IV. Summary and Conclusion

The Tax Reform Act of 1976 has influenced traditional agricultural estate planning techniques and has added several new techniques for consideration. Of special significance are the new provisions relating to the unified rate and credit structure for gifts and estates, the expanded marital deduction, the limited fractional interest rule for joint tenancies, the special valuation for certain farmland, the new option for delayed payment of estate tax, the generation skipping tax, and the carryover basis.

Many of the traditional estate planning techniques were essentially unaffected by the 1976 Act. For example, in most cases large joint tenancy holdings between husband and wife should still be discouraged because the limited fractional interest rule for qualified joint interests offers little relief for the problems generated by such holdings. Similarly, balancing the estate of a husband and wife during lifetime should still be encouraged in most cases.

In contrast, the role of gifts in an estate planning program has been greatly affected by the Act. Under the new law there is much less incentive to make gifts which exceed the annual exclusion. An exception occurs for gifts to a spouse, because the expanded gift tax marital deduction offers increased opportunity to make tax free transfers to one's spouse. Also, the qualification requirements for actual use valuation and the alternate extension for payment of estate tax may discourage gifts of business interests, in general, and gifts of farmland, in particular.

Marital deduction planning in estates of under $500,000 has also become more intricate. Because of the increased maximum marital deduction for estates under $500,000 there is greater opportunity to delay taxes in the event of a spouse's early death. There is also increased danger that the maximum marital deduction will be employed in situations where it should not be used. But the transition rule for existing wills utilizing a "maximum marital deduction" will help prevent unintentional overuse of the expanded marital deduction until 1979. With the 1976 Act in mind, attorneys would be well advised to review the marital deduction provisions of wills which they have drafted.

New estate planning techniques to be considered in the post-1976 era include affirmative steps to insure that farmland in an estate will qualify for the actual use valuation and that the estate will qualify for the alternate extension for payment of estate tax. These affirmative actions will affect the kinds of property transferred or acquired and the management provisions of farm leases. Minimizing the problems created by the new carryover basis rules is also an important new estate planning dimension. Such planning should maximize the benefits of the fresh start rules by transferring at death property with a low basis relative to its fair cash value on December 31, 1976, and transferring by gift high basis property or cash. Also, where carryover basis property is sold, the installment method may be increasingly beneficial to spread the increased recognition of gain over a number of tax years. Such planning should also emphasize the extreme importance of good business recordkeeping and suggest immediate steps to locate and consolidate all existing information affecting tax basis, such as property costs, purchase dates, pre-1977 depreciation and improvements.

Clearly, the 1976 Tax Reform Act has had an enormous impact upon agricultural estate planning. Yet, one can seriously question whether agriculture clients are any better off in the post-1976 era. The principal benefits of the Act to agricultural clients seem to include the actual use valuation for farmland, the alternate extension for payment of estate tax, and a modest increase in the "equivalent exemption" when compared with the old $60,000 estate tax exemption and the $30,000 gift tax exemption. But these benefits were acquired at a very high price, namely the imposition of carryover basis on the estate. The short term costs of carryover basis will be cushioned by the fresh start rules. However, in the long run this cushion will become less and less beneficial. It can be argued that the 1976 Act may have benefited some modest farm estates in the $200,000 to $400,000 range, but most farm families are in no better position now than they were under the prior law.