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## Estate Planning and the Farmer: Planning Under Section 2032A of the Internal Revenue Code

The Estate and Gift Tax Reform Act of 1976<sup>1</sup> included section 2032A which, on its face, appears to be a great aid to farmers.<sup>2</sup> This section of the Internal Revenue Code provides for an actual use valuation of farmland for estate tax purposes.<sup>3</sup> The section has been described as having the following dual purposes: "(1) to provide relief for certain types of estates which typically face critical liquidity problems; and (2) to minimize the possibility that real property, particularly farmland, will be removed from agricultural production."<sup>4</sup> The actual use valuation is compared to the normally required valuation for estate tax purposes<sup>5</sup> for one to appreciate the potential tax savings. Section 2031(a) provides "value" to be the valuation of property in a decedent's estate. This is described as "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts,"<sup>6</sup> and the "highest and best use of property."<sup>7</sup> For example, in an area where the land is near an expanding metropolitan area, the "highest and best use" might value the property at the going rate for residential real estate. So, to allow "actual use" valuation rather than a "highest and best use" valuation will, in instances where property's use as farmland is less in value than the highest and best use, provide estate tax savings. This comment will discuss section 2032A and its application to the family farm situation. Special attention will be given to its applicability to North Carolina farmland.

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1. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified in scattered sections of I.R.C.).

2. I.R.C. § 2032A.

3. *Id.* § 2032A(a)(1):

(1) GENERAL RULE—If—

(A) the decedent was (at the time of his death) a citizen or resident of the United States, and

(B) the executor elects the application of this section and files the agreement referred to in subsection (d)(2), then, for purposes of this chapter, the value of qualified real property shall be its value for the use under which it qualifies, under subsection (b), as qualified real property.

4. J. McCORD, 1976 ESTATE AND GIFT TAX REFORM: ANALYSIS, EXPLANATION AND COMMENTARY 309 (1977).

5. I.R.C. § 2031(a).

6. Treas. Reg. § 20.2031-1(b) (1965).

7. H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. 21, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3364 (hereinafter cited as HOUSE REPORT).

*The North Carolina Situation*

North Carolina is a state in which the application of section 2032A could prove to be particularly beneficial. North Carolina has the second highest number of family farms in the United States on a per capita basis.<sup>8</sup> The impact that the actual use valuation under section 2032A could have on the estate taxes paid in the State will be very significant. In 1978, there were approximately 115,000 farms in North Carolina,<sup>9</sup> and 13,000,000 acres tied up in farms.<sup>10</sup> The average size of each farm was 114 acres.<sup>11</sup> This indicates that there were a large number of small farms in the State, most of which would qualify for a lower valuation under section 2032A.<sup>12</sup> On these farms, there were in October, 1977, 80,000 family workers,<sup>13</sup> and approximately 41,000 hired workers.<sup>14</sup> This indicates that the farms in North Carolina, to a large extent, fall under the rubric of "family farms" which section 2032A attempts to preserve. They are the small farms which are used in the production of land intensive commodities.<sup>15</sup> The land values as farms, therefore, are significantly less than their highest and best use valuation, which is generally required for estate tax purposes.<sup>16</sup>

*Origins of Section 2032A*

Section 2032A was a result of political pressures which resulted from disparate trends in the value of equity ownership in farmlands and the average realized net income from farms.<sup>17</sup> Between the years 1941 and

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8. Statement by the Honorable James Graham, Commissioner of Agriculture, State of North Carolina, Cary Agricultural Days Celebration (Nov. 24, 1979).

9. Table: Number of Farms, Land in Farms and Average Size of Farms for North Carolina and the United States, NORTH CAROLINA STATE GOVERNMENT STATISTICAL ABSTRACT 365 (4th ed. 1979) (hereinafter cited as STATISTICAL ABSTRACT).

10. *Id.*

11. *Id.*

12. I.R.C. § 2032A(b)(1).

13. This represents the average number of family and hired labor working on farms during a survey week. Family labor includes farm operators working on farms one hour or more plus other family members working 15 hours or more without receiving cash wages during the survey week. Hired workers include all persons working one hour or more for cash wages during the survey week.

Table: Average Number of Workers on Farms, STATISTICAL ABSTRACT, *supra* note 9, at 364.

The difference between family workers and hired workers for July, 1977 was 126,000 family workers and 175,000 hired workers. However, given the number of seasonal type farms in North Carolina, the more appropriate breakdown for determining family involvement in the farm work is the October figure. This becomes important in considering material participation of family members. See text accompanying notes 133-68 *infra*.

14. Table: Acreage of Major Crops and Inventories of Livestock, STATISTICAL ABSTRACT, *supra* note 9.

15. *Id.*

16. See text accompanying notes 5-7 *supra*.

17. Comment, *The Family Farm and Use Valuation—Section 2032A of the Internal Revenue Code*, 1977 B.Y.U.L. REV. 353, 354.

1975, while estate tax rates and the estate tax exemption remained unchanged,<sup>18</sup> the average equity ownership of farm proprietors increased from \$8,449<sup>19</sup> to about \$190,000.<sup>20</sup> However, the average realized net income from farms during those same years rose only from \$1,411 to \$8,079.<sup>21</sup> Value has increased twenty-one-fold and income only six-fold. These statistics describe the situation that resulted in the political pressures to "help the farmers."<sup>22</sup>

The other factor in this mounting political pressure was that the rise in the estate tax and the resulting liquidation of many family farms was removing farmland from agricultural production.<sup>23</sup> From 1960 to 1976, nearly ninety-one million acres of farmland were transferred to non-farm uses.<sup>24</sup> Examination of the legislative history of section 2032A reveals that these factors were determinant in passage of the section.<sup>25</sup>

Congress, under section 2032A, attempted to effectuate this dual legislative intent by writing into the section numerous limitations on its application, each of which discourages the use of the section when the qualified property will be or can be used in a way which eliminates it from family farm use or from agricultural use (qualified use). These various limitations will be discussed at length. An overriding problem, however, is whether the general application of section 2032A will, in

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18. HOUSE REPORT, *supra* note 7, at 10, 15.

19. ECONOMIC RESEARCH SERVICE, U.S. DEP'T. OF AGRICULTURE, AGRICULTURAL INFORMATION BULL. NO. 403, BALANCE SHEET OF THE FARMING SECTOR 1976, at 45 (1976) [hereinafter cited as BALANCE SHEET].

20. ECONOMIC RESEARCH SERVICE, U.S. DEP'T. OF AGRICULTURE, AGRICULTURAL FINANCE OUTLOOK 5, 20 (1976).

21. BALANCE SHEET, *supra* note 19.

22. These figures illustrate two important points: (1) the rising value of farm real estate has been the dominant force subjecting farms to a steadily increasing threat of substantial estate tax liability (This will be mitigated to some extent by the unified credit which will be fully phased in by 1981. See I.R.C. § 2011.), and (2) since farm income has lagged far behind the rise in farm values, it appears likely that many farms cannot generate sufficient income to pay off a substantial tax liability without extreme hardship or recourse to liquidation of farm assets. Comment, *supra* note 17.

23. J. MCCORD, *supra* note 4, at 309.

24. BALANCE SHEET, *supra* note 19, at 29.

25. Your committee believes that, when land is actually used for farming purposes or in other closely held businesses (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential 'highest and best use' especially since it is desirable to encourage the continued use of property for farming and other small business purposes. Valuation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, or the closely held business activities, not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes. Also, where the valuation of land reflects speculation to such a degree that the price of the land does not bear a reasonable relationship to its earning capacity, your committee believes it unreasonable to require that this 'speculative value' be included in an estate with respect to land devoted to farming or closely held businesses.

HOUSE REPORT, *supra* note 7, at 21-22.

fact, result in savings. One view is that if a farm is in an area where the surrounding land is farmland, then the highest and best use is its current use, and, therefore, section 2032A would not result in any savings.<sup>26</sup> This is not the case, however, because the application of the formula valuation method<sup>27</sup> (discussed below), still provides a forty to eighty percent reduction in the valuation of land even in purely agricultural areas.<sup>28</sup> This may suggest a policy question as to whether section 2032A should be limited to situations where non-farm value is a factor. As the section is presently written, however, any argument that the effectiveness of its application in a rural area is *de minimus* is spurious when one considers the actual figures when applying the statutory formula. This is of special importance to North Carolina rural areas because many of the family farms are totally surrounded by rural areas. Of course, the savings will be greater where farmland is situated among metropolitan areas or areas where a great deal of development is occurring.

Although the last few paragraphs give the broad parameters of congressional intent and motivating factors behind the section, there are a few very technical works on the overall economic impact of section 2032A.<sup>29</sup> It will suffice here to simply report that the purpose of the section is to lower the estate taxes where it is equitable to do so, and that, in many situations, application of section 2032A does just that. The thrust of the remainder of this comment is to aid the practitioner in determining when a section 2032A election should be made and in appropriate planning for the administration of qualified estates.

There are several factors the tax practitioner should consider before advising the election of the section 2032A valuation. An introductory look at the various provisions of the section will provide a mode of analysis for the practitioner and some solutions to the problems he will encounter.

As one analyzes the requirements of section 2032A, a rather narrow scheme of qualifications appears. This scheme may be described as technically pure in that, by following the scheme, a planner can define certain farms which will definitely qualify for a lower valuation. These farms will, of course, benefit from the application of section 2032A. As presently written, however, section 2032A confronts the planner with

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26. Case & Phillips, *Death and Taxes—The 1976 Estate and Gift Tax Changes*, 1976 ARIZ. ST. L.J. 321, 371.

27. Comment, *supra* note 17, at 383.

28. *Id.* at n.195.

29. The best of these works may well be the analysis written by the editors of the Brigham Young University Law Review. Comment, *supra* note 17, at 384-89. Such an extensive economic analysis is beyond the scope of this comment, but the reader may want to consider such an analysis in more detail.

many close issues for which answers are difficult. Since there is no present case law to help resolve these issues, the planner must be careful to take the best reasoned approach to each problem. Revisions of section 2032A within the Revenue Act of 1978<sup>30</sup> and regulations proposed in 1978<sup>31</sup> and 1979<sup>32</sup> help answer some of these questions. The following analysis of section 2032A will include references to these changes.

### *General Statement*

Section 2032A(a) is the statement of the general valuation rule. It provides that, as a preliminary matter, the decedent must have been a citizen or resident of the United States at the time of his death<sup>33</sup> and that his executor make an election under the section and file a requisite agreement<sup>34</sup> before the property will qualify for actual use valuation. Another preliminary matter is that the aggregate decrease in the value of property in an estate cannot exceed \$500,000.<sup>35</sup> These threshold requirements must be considered first to decide whether the executor can make the election. Then they set a limit on the available tax reduction.

### *Qualified Real Property*

Section 2032A(b) defines what constitutes "qualified real property" for consideration for the lower valuation.<sup>36</sup> Generally, this includes the

30. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2826 (codified in scattered sections of I.R.C.).

31. 43 Fed. Reg. 41039 (Treas. Reg. §§ 20.2032A-3, -4(a)(c)(d), -8, proposed 1978).

32. 44 Fed. Reg. 52696 (Treas. Reg. § 20.2032A-4(b), proposed Sept. 10, 1979).

33. I.R.C. § 2032A(a)(1)(A).

34. *Id.* § 2032A(a)(1)(B).

35. *Id.* § 2032A(a)(2). This means that only up to \$500,000 of any difference in the value of the property before making the § 2032A valuation and its value after the election will be deducted in valuing the estate.

36. *Id.* § 2032A(b);

#### (b) QUALIFIED REAL PROPERTY

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

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

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

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

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

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

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

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

requirement that the property be located in the United States and be, at the time of the decedent's death, used for a qualified use.<sup>37</sup> The 1978 revision added the words, "which was acquired from or passed from the decedent to a qualified heir of the decedent . . ."<sup>38</sup> to this section. There are two percentage tests which property must pass for the lower valuation. The first is that "fifty percent or more of the adjusted value of the gross estate consists of the adjusted value of real or personal property which—(i) on the date of the decedent's death, was being used for a qualified use, and (ii) was acquired from or passed from the decedent to a qualified heir of the decedent."<sup>39</sup> The second percentage test is that "twenty-five percent or more of the adjusted value of the gross estate consists of the adjusted value of real property" again, which is used for a qualified use.<sup>40</sup> For purposes of these tests, the

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

(2) QUALIFIED USE.—For the purposes of this section, the term "qualified use" means the devotion of the property to any of the following:

(A) use as a farm for farming purposes, or

(B) use in a trade or business other than the trade or business of farming.

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

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

(B) in the case of any real or personal property, the value of such property for purposes of this chapter (determined without regard to this section), reduced by any amounts allowable as a deduction in respect to such property under paragraph (4) of section 2053(a).

37. *Id.* § 2032A(b)(1). Qualified use is described below.

38. *Id.* See text accompanying notes 58-61 *infra*.

39. I.R.C. § 2032A(b)(1)(A)(i).

40. *Id.* § 2032A(b)(1)(B).

To illustrate the application of the 50 and 25 percent tests, consider the following hypothetical: Decedent A owned the following properties at his death with the following values (at highest and best use):

Qualified Farm Lands	\$ 500,000
Farm Machinery and Equipment	100,000
Stocks and Bonds	100,000
Investment Real Estate	100,000
Personal Use Assets	100,000
Other Assets	100,000

Total Assets	\$ 1,000,000
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Assume that all other requisites are met, and that A also had the following liabilities:

Farm Land Mortgage	\$ 150,000
Equipment Liens	30,000
Personal Use Asset Mortgages	50,000
Liens on Investment Property	40,000
Other debts	30,000

Total Liabilities	\$ 300,000
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For purposes of the fifty percent test, A's estate would have sixty percent of its gross value in the farm land and personal property used on the farm ( $600,000 - 180,000 / 1,000,000 - 300,000 = 420,000 / 700,000 = 60\%$ ) thereby meeting the fifty percent test. The twenty-five percent test would also be met by A's estate because the realty, by itself, would comprise fifty percent of A's total gross estate net of liens ( $\$500,000 - \$150,000 / \$1,000,000 - \$300,000 = \$350,000 / \$700,000 = 50\%$ ).

value of the property is determined without regard to its special use value.<sup>41</sup>

The next requisite for the property to be qualified real property is that during a period of eight years ending on the date of the decedent's death, there must have been periods aggregating five or more of these eight years in which the property was owned by the decedent or a member of the decedent's family and used for a qualified use.<sup>42</sup> Also, during the aggregate five-year period, there must have been material participation by the decedent or a member of the decedent's family in the operation of the farm or other business.<sup>43</sup> Just what constitutes material participation is one of the most perplexing problems facing the practitioner in interpreting section 2032A. Not only is it a problem here, but it is also a requirement for the qualified heirs after the property has passed.<sup>44</sup> This problem will be discussed in depth below so it will suffice for present purposes to state that section 2032A(e)(6) designates material participation to be determined "similar to the manner used for purposes of paragraph (1) of section 1402(a) (relating to net earnings from self employment).<sup>45</sup> This particular five of eight years requirement does offer the planner an opportunity to do some "pre-mortem" planning in that, here, he can make sure that the technical requirements are met. Especially in situations where there is an obvious "family farm" situation, the planner can, under the existing law, have property appropriately transferred, making sure the percentage requirements are maintained; also, he can make sure there is material participation by appropriate parties during the aggregate five year period. For instance, when the clients are an elderly farm couple who are planning retirement, the tax planner can suggest that appropriate amounts of property be transferred to a qualified heir, or that there continues to be material participation by a member of the decedent's family as required under section 2032A(b)(1)(C).

One last requirement for property to be qualified real property is that the executor must file an agreement signed by each person in being who has an interest in the property.<sup>46</sup> This agreement<sup>47</sup> is that the persons who have an interest will comply with the imposition of an additional estate tax in the event that the property is disposed of or ceases to be used for a qualified use within fifteen years after the death of the

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Case & Phillips, *supra* note 26, at 363-64.

41. Federal Estate & Gift Tax Report (CCH) § 6455 at 7163-3 (1979).

42. I.R.C. § 2032A(b)(1)(C)(i). Again, qualified use will be described below.

43. *Id.* § 2032A(b)(1)(C)(ii).

44. *Id.* § 2032A(c)(7)(B)(ii).

45. *Id.* § 1402(a) "NET EARNINGS FROM SELF-EMPLOYMENT."

46. *Id.* § 2032A(b)(1)(D), as defined by I.R.C. § 2032A(d)(2).

47. See text accompanying notes 70-77 *infra*.



decendent.<sup>48</sup>

### *Interpretation of Requirements of Qualified Real Property*

Even though the above requirements are laid out in section 2032A(6) in an organized manner, there are problems in interpreting each provision. Many of these problems can be solved by looking to the definitional sections of 2032A itself. Also, proposed regulations offer some guidance. The following paragraphs will give the practitioner a guide for interpreting these sections. Many of the terms and phrases used in section 2032A(b) are defined by cross-referencing sections 2032A(b), (c), (d), and (e).

A term that is used quite often in section 2032A(b) is "qualified use." This is broadly defined in section 2032A(b)(2) as "devotion of the property to any of the following: (A) use as a farm for farming purposes, or (B) use in a trade or business other than the trade or business of farming."<sup>49</sup> The term "farm" includes almost any type of farm imaginable, including a broader array of activity than is covered in the definition of "trade or business of farming" for income tax purposes.<sup>50</sup> The term "farming purposes" includes these three categories: (1) cultivating and raising of crops and animals,<sup>51</sup> (2) processing of agricultural or horticultural commodities so long as at least one half of these commodities are produced by the owner, tenant, or operator of the farm,<sup>52</sup> and (3)

48. I.R.C. § 2032A(c).

49. *Id.* § 2032A(b)(2)(A) & (B).

50. *Id.* § 2032A(e)(4):

"Farm.—The term 'farm' includes stock, dairy, poultry, fruit, furbearing animals, 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."

This, when added to the § 2032A(e)(5) definition of "farming purposes" (see notes 51-53 *infra*) is broader than the definition of the business of farming for income tax purposes.

The method described in section 175 is available only to a taxpayer engaged in "the business of farming". A taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. For the purpose of section 175, a taxpayer who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the business of farming. However, a taxpayer who receives a fixed rental (without reference to production) is engaged in the business of farming only if he participates to a material extent in the operation or management of the farm. A taxpayer engaged in forestry or the growing of timber is not thereby engaged in the business of farming. A person cultivating or operating a farm for recreation or pleasure rather than a profit is not engaged in the business of farming. For the purpose of this section, the term "farm" is used in its ordinary, accepted sense and includes stock, dairy, poultry, fish, fruit, and truck farms, and also plantations, ranches, ranges and orchards. A fish farm is an area where merely caught or harvested; that is, an area where they are artificially fed, protected, cared for, etc. A taxpayer is engaged in "the business of farming" if he is a member of a partnership engaged in the business of farming.

Treas. Reg. § 1.175-3 (1963).

51. "The term 'farming purposes' means—(A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm." I.R.C. § 2032A(e)(5)(A).

52. "(B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural

the production of timber for market.<sup>53</sup> The definitions of the terms "farm" and "farming purposes" are, of course, found in section 2032A(e)(4) and (5), and the practitioner should cross-reference sections 2032A(b) and (e) for the purpose of defining "qualified use" as a "farm." Because this comment is directed to planning for farm estates, the problems surrounding the use of section 2032A in a trade or business other than farming are beyond the scope of this work.<sup>54</sup>

Another term which is important to understand is "adjusted value." This must be clearly defined in making the percentage computation in sections 2032A(b)(1)(A) and 2032A(b)(1)(B). A cross-reference here is to section 2053(a) of the Internal Revenue Code. There, adjusted value is defined, in the case of the gross estate, as the value of the gross estate, reduced by any amounts allowable as a deduction under paragraph (4) of section 2053(a).<sup>55</sup> In the case of real or personal property, the value of such property will be reduced by a like amount.<sup>56</sup> For the tax practitioner this requirement is a simple step to take, but is specifically required and one should not overlook it.

For property to qualify as qualified real property, it is an essential requirement that it be acquired from or passed from the decedent to a "qualified heir of the decedent."<sup>57</sup> Again, a cross-reference in section 2032A(e) is required. Section 2032A(e)(9) was a revision adopted within the Revenue Act of 1978.<sup>58</sup> This section defines when property is considered to have been "acquired from or passed from the decedent."<sup>59</sup> The three basic sections of 2032A(e)(9) solve some of the specific problems associated with the qualification of property. Section 2032A(e)(9)(A) provides that property is considered acquired from a decedent if it is so considered under section 1014(b).<sup>60</sup> Generally speaking, this means that the decedent must have some interest in the property until his death, and therefore, some of the commentators' assertions that *inter vivos* gifts might qualify should be very carefully interpreted.<sup>61</sup> Section 2032A is unavailable for gift tax purposes<sup>62</sup> so any

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tural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated;" *Id.* § 2032A(e)(5)(B).

53. "(C)(i) the planting, cultivating, caring for, or cutting of trees, or (ii) the preparation (other than milling) of trees for market." *Id.* § 2032A(e)(5)(C).

54. See J. McCORD, *supra* note 4, at 321.

55. I.R.C. § 2032A(b)(3)(A); *Id.* § 2053(a)(4) provides:

the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts (4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate, allowed by the laws of the jurisdiction.

56. *Id.* § 2032A(b)(3)(B).

57. *Id.* § 2032A(b)(1).

58. Revenue Act of 1978, *supra* note 30.

59. I.R.C. § 2032A(e)(9).

60. *Id.* § 1014(b) "PROPERTY ACQUIRED FROM THE DECEDENT."

61. Case & Phillips, *supra* note 26, at 362.

savings attempted by making a gift should be examined to discover whether they might be offset by the gift tax. This is an even greater possibility when there is the possibility of a lower valuation of the property for estate tax purposes.

Section 2032A(e)(9)(B) qualifies property which is "acquired by any person from the estate in satisfaction of the right of such person to a pecuniary bequest."<sup>63</sup> In other words, if a qualified heir were to receive a pecuniary bequest, but the executor elected to satisfy this bequest with farm property, for purposes of section 2032A, that property is considered to be "property acquired from the decedent." Section 2032A(e)(9)(C) qualifies property "acquired by any person from a trust in satisfaction of a right (which such person has by reason for the death of the decedent) to receive from the trust a specific dollar amount which is the equivalent of a pecuniary bequest."<sup>64</sup> These three 1978 additions solve problems which would otherwise plague planners.

The "qualified heir" is defined as "a member of the decedent's family who acquired such property (or to whom such property passed) from the decedent." This also includes a member of the qualified heir's family who acquires his interest.<sup>65</sup> This, of course, begs the question, but, in the very next provision, the Internal Revenue Code defines "member of family" to be "with respect to any individual, only such individual's ancestor or lineal descendant, a lineal descendant of a grandparent of such individual, the spouse of such individual, or the spouse of any such descendant." Adoptive children qualify.<sup>66</sup> By bootstrapping the definition of "member of family," qualified heir is, therefore, a broader term than is often used by the Code.<sup>67</sup> Here, lineal descendants of grandparents are, unlike in these other sections, considered "members of the family," so aunts, uncles, nephews, nieces, great nephews, great nieces and cousins and their spouses—if lineal descendant's of the decedent's grandparents—are included, as well as brothers and sisters of the decedent.<sup>68</sup>

For purposes of defining real property for ownership requirement of section 2032A(b)(C), section 2032A(e) provides:

[R]esidential buildings and related improvements on such real property occupied on a regular basis by the owner or lessee of such real property

62. "The actual use valuation does not apply for gift tax purposes. This may make it advisable to hold qualified real property until death." J. CASNER & R. STEIN, ESTATE PLANNING UNDER THE TAX REFORM ACT OF 1976 166 (1977).

63. I.R.C. § 2032A(e)(9)(B).

64. *Id.* § 2032A(e)(9)(C).

65. *Id.* § 2032A(e)(1).

66. *Id.* § 2032A(e)(2).

67. See, e.g., *Id.* §§ 267(e)(4); 318(a)(1)(A); 544(a)(2); 4946(d) which only include the decedent's spouse, his lineal descendants and their spouses, and his ancestors.

68. See Case & Phillips, *supra* note 26, at 361.

or by persons employed by such owner or lessee for the purpose of operating or maintaining such real property, and roads, buildings, and other structures and improvements functionally related to the qualified use shall be treated as real property devoted to the qualified use.<sup>69</sup>

Since one of the requirements of qualified real property is that it be designated in the agreement referred to in subsection (d)(2),<sup>70</sup> the practitioner should be aware that section 2032(A)(d) provides that the election under section 2032A be made in timely manner,<sup>71</sup> as well as its provision that the agreement be filed.<sup>72</sup> A problem which has been mentioned by a few of the commentators is that of defining "each person in being who has an interest (whether or not in possession) in any property designated in the agreement," as designated in section 2032A(d)(2).<sup>73</sup> Many of these problems are addressed in proposed treasury regulation section 20.2032A-8(c)(2).<sup>74</sup> Generally, this proposed regulation incorporates local law into the determination of who has an interest. The regulation specifically excludes a person who has an interest in property solely by reason of a right to challenge a will. Also, creditors are excluded unless the section 2032A(d) election would subordinate a security interest or judgment lien to a lien imposed by section 6324B of the Internal Revenue Code.<sup>75</sup> The proposed regulations also allow for the representation by an agent under local law in

69. I.R.C. § 2032A(e)(3).

70. *Id.* § 2032A(b)(1)(D).

71. *Id.* § 2032A(d)(1) ELECTION.—"The election under this section shall be made not later than the time prescribed by section 6075(a) for filing the return of tax imposed by section 2001 (including extensions thereof), and shall be made in such a manner as the secretary shall by regulations prescribe." *Id.* § 6075(a) provides for filing of estate tax returns within nine months after the date of decedent's death.

72. *Id.* § 2032A(d)(2).

73. See J. McCORD, *supra* note 4, at 314; Comment, *supra* note 17, at 402; Matthews & Stock, *Section 2032A: Use Valuation of Farmland for Estate Tax Purposes*, 14 IDAHO L. REV. 341, 342 (1978).

74. Treas. Reg. § 20.2032A-8(c)(2) (proposed 1978) provides:

(2) *Persons having an interest in designated property.* An interest in property is an interest which, as of the date of the decedent's death, can be asserted under applicable local law so as to affect the disposition of the specially valued property by the estate. Any person in being at the death of the decedent who has any such interest in the property, whether present or future, or vested or contingent, must enter into the agreement. Included among such persons are owners of remainder and executory interests, the holders of general or special powers of appointment, beneficiaries of a gift over in default of exercise of any such power, and trustees of trusts holding any interest in the property. An heir who has the power under local law to caveat (challenge) a will and thereby affect disposition of the property is not, however, considered to be a person with an interest in property under section 2032A solely by reason of that right. Likewise, creditors of an estate are not such persons solely by reason of their status as creditors except that creditors having security interests in, or judgment liens against any specially valued property are persons with an interest in the property if, upon the making of the election, such interests or liens are subordinate to the lien imposed by section 6324B.

75. I.R.C. § 6324B liens will be discussed in detail below. Generally, this is the federal tax lien that arises on qualified real property upon the election of the special use valuation under § 2032A to secure any recaptured tax which might subsequently arise.

the execution of the section 2032A(d) agreement.<sup>76</sup> Problems which the regulations do not solve, however, still exist. They can be described by the following questions: "If a decedent transferred property under circumstances which resulted in its inclusion in his gross estate, why should the transferee agree to such an election? If an unknown heir cannot be discovered before the time for making the election, can there be any election? Might this not offer an opportunity to an unscrupulous person whose interest is remote to "hold-up" the estate?"<sup>77</sup> One can, of course, draft around these problems by careful limitations in the will. However, this kind of planning eliminates many options for testamentary disposition. The planner, however, should be aware of these problems.

In summary, for property to qualify as "Qualified Real Property" for special use valuation under section 2032A, the following prerequisites must be met:

- A. It must be real property;
- B. located in the United States;
- C. acquired from or passed from a decedent to a qualified heir of the decedent;
- D. being used for a qualified use;<sup>78</sup>
- E. fifty percent or more of the adjusted value of the gross estate must consist of the adjusted value of *real or personal property* used for a qualified use;<sup>79</sup>
- F. twenty-five percent or more of the adjusted value of the gross estate must consist of the adjusted value of *real property* being used for a qualified use;<sup>80</sup>
- G. the property must be in use in a qualified use and owned by the decedent or a member of the decedent's family with material participation by the decedent or a member of his family in the operation of the farm or other business for five of the eight years immediately preceding the death of the decedent; and<sup>81</sup>
- H. the property must be designated in an agreement<sup>82</sup> by all persons with an interest in the property,<sup>83</sup> agreeing to tax treatment of dispositions and failures to use for a qualified use.<sup>84</sup>

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76. 43 Fed. Reg. 30070 (Treas. Reg. § 20.2032A-8(c)(3), proposed July 11, 1978) provides: (3) *Consent on behalf of interested party.* If any person required to enter the agreement provided for by this paragraph either desires that an agent act for him or cannot legally bind himself due to infancy or other incompetency, a representative authorized under local law to bind such person in an agreement of this nature is permitted to sign the agreement on his behalf.

77. J. McCORD, *supra* note 4, at 315.

78. I.R.C. § 2032A(b)(1).

79. *Id.* § 2032A(b)(1)(A).

80. *Id.* § 2032A(b)(1)(B).

81. *Id.* § 2032A(b)(1)(C).

82. *Id.* § 2032A(b)(1)(D).

83. *Id.* § 2032A(d)(2).

84. *Id.* § 2032A(c).

*Recapture for Dispositions and Failure to Use for Qualified Use*

If one designates the decisions the tax practitioner must make and the suggestions he must give the client in helping him to insure that his property qualifies for the section 2032A valuation as pre-mortem planning, the decisions and considerations he must make in advising his clients (both the decedent and qualified heirs) concerning what happens to the property afterwards can be said to be post-mortem planning. Both pre-mortem and post-mortem planning considerations must go into the election<sup>85</sup> of the section 2032A valuations. Section 2032A(c) provides that if within fifteen years after the decedent's death and before the death of the qualified heir, the property acquired from the decedent either ceases to be used in the qualified use or is disposed of other than by disposition to a member of the qualified heir's family, an additional estate tax is imposed.<sup>86</sup> Cessation of qualified use is defined by a cross-reference to section 2032A(c)(7). This occurs whenever the property ceases to be used for the purpose for which it qualified under section 2032A(b).<sup>87</sup> Another disqualifying factor is that the property ceases its qualified use if there are periods aggregating three or more years in any eight year period ending after the decedent's death in which there is no material participation by the decedent or any member of his family prior to his death, or by the qualified heir or any member of his family.<sup>88</sup> If recapture is triggered, section 2032A(e)(2)-(4) are the subsections which provide for the computation of the additional tax. Section 2032A(e)(2) states the general proposition that a recapture event will trigger an additional tax which will be, with respect to any interest, the amount equal to the lesser of,

- (i) the adjusted tax difference attributable to such interest, or (ii) the excess of the amount realized with respect to the interest (or, in any case other than a sale or exchange at arm's length, the fair market value of the interest) over the value of the interest determined under subsection (a).<sup>89</sup>

"Adjusted tax difference attributable to interests"<sup>90</sup> is defined in this section. For the estate planner's purposes, this means that because the lesser of three alternative amounts is the valuation of the recaptured tax

85. There are, of course, many considerations which go into making such an election. However, discussion of the more serious problems surrounding this determination is deferred to text accompanying notes 121-26 *infra*.

86. I.R.C. § 2032A(c)(1)(A), (B).

87. *Id.* § 2032A(c)(7)(A). Presumably this means that a change to another qualified use would trigger recapture.

88. *Id.* § 2032A(c)(7)(B). Again, the phrase, "material participation," crops up. This is determined by § 2032A(e)(6) which provides, "material participation shall be determined in a manner similar to the manner used for purposes of paragraph (1) of section 1402(a)." See text accompanying notes 134-70 *infra*.

89. I.R.C. § 2032A(c)(2)(A).

90. *Id.* § 2032A(c)(2)(B).

and one of these three amounts is the "adjusted tax difference attributable to such interests," or the tax which was not paid as a result of the section 2032A valuation, the recaptured tax will never amount to more than the savings attained by the lower valuation. The other alternatives which may be used to measure the recaptured tax are as follows: (1), if the property is sold in an arm's length transaction, tax must be paid on the difference between the amount realized in the transfer and the special valuation elected under section 2032A; (2), if the property is subject to any other recapture event or a transfer other than at arm's length, the recaptured tax is the amount paid on the difference between the fair market value based on the property's highest and best use at the time of the recapture event. So, the recaptured tax computation can be anticipated by the planner at any time, and, therefore, should be used in making planning decisions.<sup>91</sup> Section 2032A(c)(3) allows for a phaseout of the amount of recaptured taxes if the triggering event occurs between the tenth and fifteenth years. Section 2032A(c)(4) provides only one additional tax for any one portion of an interest in the property in the event of recapture of different interests at different times. For instance, a future interest subject to the recaptured tax because it is transferred to a non-family member would not be subject to taxation if a subsequent transfer of the possessory interest in that same property is made to the same person. Section 2032A(c)(5) provides that the additional tax is due six months after the date of the triggering event. This is an important election consideration for the planner in the event that a potential recapture seems likely because there is a possibility of deferring the tax payments over time in the event section 2032A is not elected.<sup>92</sup>

A 1978 revision provides that the qualified heir may furnish a bond to offset any personal liability he would otherwise be subject to under this subsection.<sup>93</sup> Section 2032A(e)(11), which was added along with

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91. *Id.* § 2032A(c)(2)(C).

If a recapture event does occur, the least of the following three amounts is recaptured: First, the amount of estate tax which was deferred because of the special valuation rule and which is attributable to the property interest involved in the recapture event; second, if the property is 'sold or exchanged' in an arm's length transaction which is a recapture event, the amount realized on such sale or exchange less the special value of that property under section 2032A; or third, if the property is sold or exchanged in a transaction which is not at arm's length but which is a recapture event or if the property is otherwise disposed of in a recapture event, the fair market value (at the time of the recapture event and based on its then highest and best use) of the property involved in the event less the special value of that property under section 2032A.

Since the recapture will be the least of the foregoing amounts, the maximum amount that ever can be recaptured is the tax savings that resulted from the favorable valuation rules of section 2032A. (citations omitted)

See Case & Phillips, *supra* note 26, at 370-71.

92. I.R.C. § 6166A. This section is discussed at length below.

93. *Id.* § 2032A(c)(6).

section 2032A(e)(9), provides for the Secretary to determine the maximum amount of potential additional tax upon written request by the qualified heir and notify him of this liability. When the heir furnishes a bond in this amount, his personal liability is discharged.<sup>94</sup>

### *Tax Lien*

Another consideration for the estate planner is that upon making the section 2032A election, a federal tax lien arises in the amount of the adjusted tax difference between the tax which would be imposed if the section 2032A election is not made and the amount of the tax if it is.<sup>95</sup> This provision was added under the Revenue Act of 1978 and some of the problems surrounding it will be discussed below. It is, of course, a consideration because of the problems it raises concerning the marketability of the land.

The practitioner must make post-mortem considerations based upon how these specific limitations affect his clients. It can be argued that in the true family farm situation, there should not be a problem for the farmer—if, in fact, the property is to remain in use as farmland. However, the problems surrounding the recapture provisions can affect the operation of farms in that operating capital is more difficult to obtain when a farmer is subject to personal liability and the farmland is subject to a federal tax lien. Some of the 1978 changes mitigate these effects, however.<sup>96</sup>

### *Method of Valuing Farms*

If the requirements for qualified real property are met and the executor has determined that the recapture provisions will not unduly burden the qualified heirs, the actual use valuation can be made. One of the more easily interpreted aspects of section 2032A is the actual use valuation formula.<sup>97</sup> Generally, this provides that if the executor elects, he may value the property by dividing the excess of the average gross cash rental for comparable land used for farming purposes and located in the locality over the average local and state real estate taxes on comparable land by the average annual effective interest rate for all new Federal Land Bank Loans. Averages must be computed based on the rates for the five most recent calendar years ending before decedent's death.<sup>98</sup> A shorthand method of stating this is the formula  $\frac{R - T}{I}$  where R equals average gross cash rental, T equals real estate taxes,

94. *Id.*

95. *Id.* § 6324B(a), (b).

96. See text accompanying notes 190-201 *infra*.

97. I.R.C. § 2032A(e)(7).

98. *Id.* § 2032A(e)(7)(A).



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and I equals interest on Federal Land Bank Loans. So if the decedent died on January 1, 1980 the following hypothetical might be indicative of the computations for the North Carolina family farm:

YEAR	1979	1978	1977	1976	1975	AVERAGES
Average Rents (acre)	57	55	53	51	49	53
State & Local Taxes	4.00	3.50	3.00	2.50	2.00	3.00
Average Interest Rate for FLB Loans	9.75	9.50	9.25	9.00	8.75	9.25

Using these five year figures and applying the formula, the computation would be  $\frac{53}{9.25} \times 3$  equals \$540.00 per acre. This value could be much less than the value measured under the "highest and best use" approach.<sup>99</sup>

There has, of course, been criticism of this formula.<sup>100</sup> Often there is no comparable land in the area, or the executor may decide that the formula still values the land too highly. Section 2032A addresses these problems and offers an alternative valuation method.<sup>101</sup> Many of the other problems raised by various commentators, however, are addressed in regulations which have recently been proposed. The method the regulations use is to define and describe the various phases incorporated in the section 2032A(e)(7) formula.

### *Gross Cash Rental*

Section 20.2032A-4(b)<sup>102</sup> of the proposed regulations defines "gross cash rental" as "the total amount of cash received for the use of actual tracts of comparable farm real property in the same locality as the property being specially valued during the period of one calendar year." Only rentals which are totally for cash are acceptable for use in making the valuation, and the total rental amount cannot be diminished by any expenses or liabilities associated with the transaction. Generally, the rents must be the result of an arm's length bargaining

99. *Id.* § 2031A.

100. See Matthews & Stock, *supra* note 73, at 345. This article questioned the various vagaries of "locality" and what interest rate to use, citing the 12 different land bank districts as a point with which to deal.

101. I.R.C. § 2032A(e)(8). "METHOD OF VALUING CLOSELY HELD BUSINESS INTERESTS."

102. 43 Fed. Reg. 31039 (Treas. Reg. 20.2032A-4(a), proposed July 19, 1978); 44 Fed. Reg. 52696 (Treas. Reg. 20.2032A-4(b), proposed Sept. 10, 1979); 43 Fed. Reg. 31039 (Treas. Regs. 20.2032A-4(c), (d) & (e), proposed July 11, 1978).

transaction.<sup>103</sup> Any property that is involved in operations in which the lessor or any member of his family is involved (as defined by material participation under section 2032A) is disqualified from the "cash rental value" consideration. This is because the total amount received by the lessor would not reflect actual cash rental value.<sup>104</sup>

Under the proposed regulations, the executor must identify for the Internal Revenue Service the comparable land used to compute the average cash rental value.<sup>105</sup> If he cannot make the designation, an alternate valuation can be made using any appropriate means of valuation available to the executor.

Since an arm's length transaction is required, the proposed regulations explicitly exclude lands leased from the Federal Government or any state or local government. "Lands leased from the Federal Government, or any State or local government, which are leased for less than the amount that would be demanded by a private individual leasing for profit are not leased in an arm's length transaction."<sup>106</sup> The proposed regulation effectuates the section 2032A language by excluding leases between family members where the rents received are lower than comparable leases in the locality between unrelated parties.

In kind rents, statements of appraised rental value, and area averages cannot be used because they are not the measures of actual cash rental value.<sup>107</sup> Also, the property used must have been rented solely for cash for at least one year, and the property must be so identified in each of the five calendar years used to compute the average cash rental value.<sup>108</sup> However, different tracts of comparable property may be used in each year. If the leases used include the rental of personal property, there will be no adjustment for this reason unless the lease itself separates the amount attributable to this property.<sup>109</sup>

### *Comparable Real Property*

Section 20.2032A-4(d) defines comparable real property for use in the formula as comparable property situated in the same locality as the specially valued property, using real property valuation rules and not merely considering mileage or political division alone. The proposed regulation states that numerous factors must be considered and provides that if different segments have different uses of land characteris-

103. "Arms length transaction" is defined in proposed Treas. Reg. 20.2032A-4(b)(2)(ii) (proposed Sept. 10, 1979). 44 Fed. Reg. 52695.

104. *Id.* (Treas. Reg. 20.2032A-4(b)(1), proposed Sept. 10, 1979).

105. *Id.* (Treas. Reg. § 20.2032A-4(b)(2)(i), proposed Sept. 10, 1979).

106. *Id.* (Treas. Reg. § 2032A-4(b)(2)(ii), proposed Sept. 10, 1979).

107. *Id.* (Treas. Reg. § 2032A-4(b)(2)(iii), proposed Sept. 10, 1979).

108. *Id.* (Treas. Reg. § 2032A-4(b)(2)(iv), proposed Sept. 10, 1979).

109. *Id.* (Treas. Reg. § 2032A-4(b)(2)(v), proposed Sept. 10, 1979).

tics, comparable property for each segment must be used. A discount may be used to reflect the presence of multiple uses or other characteristics in one farm.<sup>110</sup>

### *Effective Interest Rate*

Section 20.2032A-4(e)(1) defines the appropriate effective interest rate for all new Federal Land Bank Loans to be "the average billing rate charged on new agricultural loans to farmers and ranchers in the farm credit district in which the real property to be valued under section 2032A is located." (This is to be adjusted pursuant to 20.2032A-4(e)(2), below.) This is to be computed annually for each of the five years preceding decedent's death to the nearest one-hundredth of one percent, reflecting proportionately changes during the year. The rates are to be obtained from the district director of Internal Revenue.<sup>111</sup> This amount will be adjusted to reflect any increase in the cost of borrowing because of any required purchases of land bank association stock.<sup>112</sup>

### *State and Local Real Estate Taxes*

Section 20.2032A-4(e)(2) specifies that the state and local taxes to be used in the formula are those which are allowable deductions under section 164 of the Internal Revenue Code. Any special rates for farmland are to be used.

If these regulations are adopted, the formula for deriving the special use value will be one which lends a great degree of objectivity to the valuation of farmlands in areas where there is comparable property in

110. *Id.* (Treas. Reg. § 2032A-4(c), proposed Sept. 10, 1979);

While not intended as an exclusive list, the following factors are among those to be considered in determining comparability—

(1) Similarity of soil as determined by any objective means, including an official soil survey reflected in a soil productivity index;

(2) whether the crops grown are such as would deplete the soil in a similar manner;

(3) the types of soil conservation techniques that have been practiced on the two properties;

(4) whether the two properties are subject to flooding;

(5) the slope of the land;

(6) in the case of livestock operations, the carrying capacity of the land;

(7) where the land is timbered, whether the timber is comparable to that on the subject property;

(8) whether the farm as a whole is unified or whether it is separated, the availability of the means necessary for movement among the different sections;

(9) the number, types, and condition of all buildings and other fixed improvements located on the properties and their location as it affects efficient management and use of property and value per se;

(10) availability of, and type of, transportation facilities in terms of cost and of proximity of the properties to local markets.

111. 43 Fed. Reg. 31039 (Treas. Reg. § 20.2032A-4(e)(1), proposed July 19, 1978).

112. *Id.* (Treas. Reg. § 20.2032A-4(e)(2), proposed July 19, 1978).

the same locality. If care is used in applying the formula, there will be a tax savings in many cases and the measure of this savings will be predictable. In North Carolina, for instance, the average market value for farmland in 1975 was \$603.00 per acre while the actual use valuation using the formula was \$276.00 per acre.<sup>113</sup>

If there is no comparable land from which an average annual gross cash rental may be determined or if the executor elects not to use the formula,<sup>114</sup> the valuation may be determined by a method which is used in valuing closely held business interests<sup>115</sup> under section 2032A valuation. This is a method whereby the executor values the qualified real property using a variety of factors. Several of these factors are directed primarily at valuing farmland, so it is appropriate to discuss this section for the purposes of this comment. Specifically listed as factors which "shall apply in determining the value of any qualified real property"<sup>116</sup> under this multiple factor valuation are:

- A. the capitalization of income which the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and similar factors;
- B. the capitalization of the fair rental value of the land for farmland or closely held business purposes;
- C. assessed land values in a State which provides a differential or use value assessment law for farmland or closely held businesses;
- D. comparable sales of other farm or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price; and
- E. any other factor which fairly values the farm or closely held business value of the property.<sup>117</sup>

When comparing these two valuation methods with each other, one quickly observes that the two have opposing liabilities. The rather inexact and speculative aspects of the multiple factor method are not problems with the formula method. However, the heavy burden to derive accurate average cash rental values for the formula method is not placed upon the executor when using the multiple factor method. Of course, the executor may simply elect to use one over the other,<sup>118</sup> but he cannot avoid one set of problems or the other.

One of the major criticisms of the formula method is that, in many

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113. Matthews & Stock, *supra* note 73, at 346.

114. I.R.C. § 2032A(e)(7)(B).

115. *Id.* § 2032A(e)(8).

116. *Id.*

117. *Id.* § 2032A(e)(8)(A)-(E).

118. *Id.* § 2032A(e)(7)(B)(ii).

areas, deriving cash rental values for comparable land is very difficult.<sup>119</sup> The list of factors to be considered when determining comparability<sup>120</sup> are certainly burdensome to an executor. In fact, whereas these factors can be said to offer tremendous guidance to the estate planner who is doing pre-mortem or post-mortem planning, they may be a determining factor in an executor's decision to elect the multiple factor method. The proposed regulation, in attempting to give objective criteria with which to apply the formula, overburdens the executor with too much of a fact finding function.

### *Election*

Once all of the above variables are considered, section 2032A(d)(1) provides that "the election under this section shall be made not later than the time prescribed by section 6075(a)<sup>121</sup> for filing of tax imposed by section 2001<sup>122</sup> (including extensions thereof), and shall be made in such a manner as the Secretary shall by regulation prescribe." On July 11, 1978, regulations were proposed to effectuate this section.<sup>123</sup> The proposed regulations provide that once the election is made, it is irrevocable.<sup>124</sup> Generally they require that a timely estate tax return contain statements setting out facts which support the requirements for a section 2032A valuation.<sup>125</sup> If the estate does not qualify because the qualified real property tests are not met, a protective election may be

119. See letter from Robert M. Frederick, Legislative Director of the National Grange to the Commissioner of Internal Revenue (Sept. 3, 1978).

120. Treas. Reg. § 20.2032A-4(d)(1)-(10) (proposed 1978).

121. "(a) ESTATE TAX RETURNS.—Returns made under 6018(a) (relating to estate taxes) shall be filed within 9 months after the date of decedent's death."

122. "IMPOSITION AND RATE OF TAX."

123. 43 Fed. Reg. 30070 (Treas. Reg. § 20.2032A-8 proposed July 11, 1978).

124. *Id.* (Treas. Reg. § 20.2032A-8(a)(1) proposed July 11, 1978). But see *Id.* (Treas. Reg. § 20.2032A-8(d), proposed July 11, 1978): "Special Rule for Estates for Which Elections Under Section 2032A are made on or before the Date Which is 30 Days after Publication of this Regulation." If the election is made during this time frame, it may be revoked by filing a notice of revocation with the Internal Revenue Service where the original return was filed within six months after publication of the regulation, along with payment of estate tax based on a valuation of the property at its highest and best use.

125. *Id.* (Treas. Reg. § 20.2032A-8(a)(2), proposed July 11, 1978):

(i) The decedent's name and taxpayer identification number as they appear on the estate tax return;

(ii) The relevant qualified use;

(iii) The items of real property shown on the estate tax return to be specially valued pursuant to the election (identified by schedule and item number);

(iv) The fair market value of the real property to be specially valued under section 2032A and its value based on its qualified use (both values determined without regard to the adjustments provided by section 2032A(b)(3)(B));

(v) The adjusted value (as defined in section 2032A(b)(3)(B)) of all real property which is used in a qualified use and which passes from the decedent to a qualified heir;

(vi) The items of personal property shown on the estate tax return that pass from the decedent to a qualified heir and are used in a qualified use under section 2032A (identified by

made,<sup>126</sup> which will permit special use valuation if the finally determined values meet the requirements of section 2032A.

### *Miscellaneous Provisions of Section 2032A*

The above analysis is complete in giving practical guidelines for applying section 2032A, but there are some provisions of special interest to the practitioner. There is a statutory period in which the assessment of any additional or recaptured tax can be made.<sup>127</sup> This is three years from the date the Secretary is notified of disposal of the property, cessation of the property's qualified use, or involuntary conversion of the property.<sup>128</sup>

Another section which was added along with the 1978 revisions is entitled, "Special Rules for Involuntary Conversions of Qualified Real Property."<sup>129</sup> As this is a rather technical provision which will apply in isolated cases, it will be dealt with only very generally here. This subsection provides that if property which has been valued under section 2032A is involuntarily converted,<sup>130</sup> it may be replaced either totally or in part with replacement property.<sup>131</sup> When this is done, there will only be a tax assessment for the amount of the converted property which is not replaced.<sup>132</sup> Any replacement property will be treated in the same manner as the property it replaced except that the fifteen year period for required qualified use may be extended when there is a delay in the election to replace the property.<sup>133</sup>

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schedule and item number) and the total value of such personal property adjusted as provided under section 2032A(b)(3)(B);

(vii) The adjusted value of the gross estate (as defined in section 2032A(b)(3)(A));

(viii) The method used in determining the special value based on use;

(ix) Copies of written appraisals;

(x) The date on which the decedent (or a member of his family who held the property before the decedent) acquired the property and on which he or a member of his family commenced the qualified use (if different from the date of acquisition);

(xi) Any periods following commencement of the qualified use during which the decedent or a member of his family did not own the property, use it on a qualified use, or materially participate in the operation of the farm or other business within the meaning of section 2032A(e)(6); and

(xii) The name, address, taxpayer identification number, and relationship to the decedent of each person taking an interest in each item of specially valued property, and the value of the property interests passing to each such person based on both fair market value and qualified use.

126. *Id.* (Treas. Reg. § 20.2032A-8(a)(2), proposed July 11, 1978).

127. I.R.C. § 2032A(f).

128. *Id.* § 2032A(f)(1).

129. *Id.* § 2032A(h).

130. The definition for involuntary conversion is the same as that found in I.R.C. § 1033.

131. *Id.* § 2032A(h)(1)(A)(i).

132. *Id.* § 2032A(h)(1)(B).

133. *Id.* § 2032A(h)(2).

*Special Problems**Material Participation*

The most vexing problem the commentators have had in attempting to analyze section 2032A is trying to determine what, exactly, is meant by "material participation." As the previous analysis points out, the section requires material participation in two distinct situations. First, the decedent or a member of his family must materially participate in the operation of the farm for five of the eight years immediately preceding the decedent's death in order for the property to be qualified real property. The second situation in which material participation is required is that there must be material participation during five years of any eight year period ending after the decedent's death either by the decedent or a member of his family while he held the property, or by a qualified heir or a member of his family in order for the property to be maintained in a qualified use to avoid the imposition of an additional estate tax.<sup>134</sup> Section 2032A, by way of guidance, only provides that "material participation" shall be determined in a manner similar to the manner used for purposes of paragraph (1) of section 1402(a) (relating to net earnings from self employment).<sup>135</sup> Section 1402(a) material participation defines that degree of participation for which self employment earnings are taxed under the social security tax structure, and if the self employment earnings are over a certain amount, social security benefits are diluted. So the problem which initially arises from the material participation requirement of section 2032A is that an elderly farmer who materially participates to meet the requirement for his farm's receiving actual use valuation is, at the same time, reducing his social security benefits and subjecting himself to social security taxation. Other questions which arise in considering "material participation" are: Is the definition of material participation for the decedent and his family the same as for the qualified heir and his family? What, exactly, is "material participation" under section 1402(a)? Is "material participation" on one farm the same as on another farm with different farming methods, growing seasons, etc.?

As a starting point in considering these problems, the practitioner should begin with what is predictable. A strict statutory construction would be that, since "material participation" is defined in only one place in section 2032A,<sup>136</sup> its meaning is the same in the "qualified real property" setting as in the "qualified use" setting. To be safe, therefore, material participation in either setting should be very narrowly construed. The second "fact" is that, conflicting purposes notwith-

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134. *Id.* § 2032A(b)(1)(C)(ii).

135. *Id.* § 2032A(c)(7)(B).

136. *Id.* § 2032A(e)(6).

standing, "material participation" under section 2032A and "material participation" under 1402(a) are substantially the same. The problem is to define material participation under section 1402(a), and to be able to advise a client what he has to do to meet the requirements.

"Material participation" under section 1402(a) has had an extensive case history<sup>137</sup> and there are now regulations<sup>138</sup> which set out in detail the various categories of "material participation." "They indicate that material participation means actual participation 'to a material degree in the production or in the management of the production of . . . commodities' or participation in both production and management of production to the extent that both types of activities combined constitute participation to a material degree."<sup>139</sup> To further complicate the determination of "material participation," not only can the property be owned directly by the decedent, it may also be owned indirectly through ownership of an interest in a corporation, a partnership, or a trust,<sup>140</sup> if the interest qualifies under the tests of section 6166(b)(1)<sup>141</sup> as an interest in a closely held business, in addition to meeting the sec-

137. Case law has been immensely important in determining what "material participation" is required for section 1402(a) purposes. The most extensive treatment was given in the case of *Foster v. Celebreeze*, 313 F.2d 604 (8th Cir. 1963), which resulted in Treas. Reg. § 1.1402(a)-4(b) (1963). Other cases which led to the various aspects of "material participation" are: *Bridie v. Ribicoff*, 194 F. Supp. 809 (N.D. Iowa 1961) (joint venture with equal decision making input is material participation); *Bryant v. Celebreeze*, 229 F. Supp. 329 (D.S.C. 1964) (no material participation when half of the costs are borne but there is no decision making involvement); *Vance v. Ribicoff*, 202 F. Supp. 790 (E.D. Tenn. 1961) (leasing property and giving advice on the running of the business is material participation); *Hoffman v. Gardner*, 369 F.2d 837 (8th Cir. 1966) (Here, an agency set-up was held to be material participation, but even though the regulations still reflect this decision (Treas. Reg. § 1.1402(a)-4(b)(5) (1963), the words, "as determined without regard to any activities of an agent of such owner or tenant" were added to I.R.C. § 1402(a)(1)(B) in 1974. Act of Aug. 7, 1974, Pub. L. No. 93-368, § 10(b), 88 Stat. 422. An agency will not be enough for material participation of the employer.); *Conley v. Ribicoff*, 294 F.2d 290 (9th Cir. 1961); *Whitlow v. Celebreeze*, UNEMPL. INS. REP. (CCH) 16,140 (S.D. Ill. 1964) (200 hours involvement over a 5-week period was material participation); *Celebreeze v. Miller*, 333 F.2d 29 (5th Cir. 1964) (Here, a total effect "catch all" defined material participation. A mutual undertaking involving 1/3 cost, consultation three or four times a month, and 1/3 return was held to be material participation.).

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

139. Comment, *supra* note 17, at 396. Treas. Reg. 1.1402(a)-4(b)(4) further provides:

If the owner or tenant shows that he periodically advises or consults with the other person, who . . . produces the agricultural or horticultural commodities, as to the production of any of these commodities and also shows that he periodically inspects the production activities on the land, he will have presented strong evidence of the existence of the degree of participation contemplated by section 1402(a)(1). If, in addition to the foregoing, the owner or tenant shows that he furnishes a substantial portion of the machinery, implements, and livestock used in the production of the commodities or that he furnishes or advances funds, or assumes financial responsibility for a substantial part of the expense involved in the production of the commodities, he will have established the existence of the degree of participation contemplated by section 1402(a)(1) and this paragraph.

140. I.R.C. § 2032A(g).

141. *Id.* § 6166 is one of the sections of the Internal Revenue Code which is important in an analysis of whether a § 2032A valuation should be elected. See text accompanying notes 171-84 *infra*.



tion 2032A tests. However, material participation is required in this context also, and the practitioner should be advised that qualification for the section 2032A valuation under this fact situation does not preclude material participation. That is, the decedent or a qualified heir or members of their respective families must materially participate in activity carried on by the corporation, partnership, or trust for the property to qualify. For the practitioner to be sure he is giving adequate advice, referral to the regulations under section 1402(a) will give him rules to go by at the present time. Included in the proposed section 2032A regulations of July 19, 1978, was a list entitled, "Material Participation Requirements for Valuation of Certain Farm and Closely Held Business Real Property."<sup>142</sup> These proposed regulations would give a degree of guidance for section 2032A purposes beyond the section 1402(a) regulations. Presently, therefore, material participation is defined by Section 2032A(e)(6), itself, the regulations promulgated under Section 1402(a), and some consideration can be given to the proposed regulations.

To be safe, the best definition, for practical reasons, of material participation in the context of the family farm situation was issued by the Internal Revenue Service.<sup>143</sup> In a tax guide for farmers specifically addressing material participation in the self employment context, the Internal Revenue Service developed the following tests:

Test No. 1. You do any three of the following: (1) advance, pay, or stand good for at least half the direct costs of producing the crop; (2) furnish at least half the tools, equipment, and livestock used in producing the crop; (3) advise and consult with your tenant periodically; and (4) inspect the production activities periodically.

Test No. 2. You regularly and frequently make or take an important part in making management decisions substantially contributing to or affecting the success of the enterprise.

Test No. 3. You work 100 hours or more spread over a period of 5 weeks or more in activities connected with producing the crop.

Test No. 4. You do things which, considered in their total effect, show that you are materially and significantly involved in the production of the farm commodities.<sup>144</sup>

If these tests are used, the farm owner or member of his family should contribute a significant amount of work and involvement to ensure that he has materially participated. The problem, of course, is that there are many farm situations in which this kind of participation is not being done, but which would otherwise qualify for the section 2032A valua-

142. 43 Fed. Reg. 31039 (Treas. Reg. § 20.2032A-3, proposed July 19, 1978).

143. INTERNAL REVENUE SERVICE, FARMER'S TAX GUIDE, INCOME AND SELF-EMPLOYMENT TAX, IRS PUBLICATION 225 (1973).

144. *Id.* at 53-54 *paraphrased in* (1977) FEDERAL TAX GUIDE (CCH) 796.

tion. However, for purposes of giving advice, the practitioner is best advised to stay within the framework.

This advice, does not, however, solve the very serious problem which arises when an elderly owner has self employment income to the extent that his social security benefits are lessened. Unless he materially participates to the extent that he has self employment income under section 1402(a), his farmland may not qualify for the section 2032A valuation. Rental income from a farm will not be considered self employment income,<sup>145</sup> as a material participation. So, as the present law stands as interpreted by the regulations accompanying section 1402(a), there is no way to get around the problem of the divergent effects on the owner.<sup>146</sup> Robert M. Frederick, Legislative Director of the National Grange has suggested a regulation under section 2032A that activities of agents and/or employees on behalf of the owner be considered material participation.<sup>147</sup> Only in 1974 did the law on self employment income exclude the agency/employee relationships from material participation treatment—a welcomed change for social security purposes.<sup>148</sup> However, a different interpretation of material participation for section 2032A purposes would greatly alleviate a burdensome requirement in many situations.

Another problem which applies to elderly farm owners is that the material participation requirement may eliminate many farms from the lower valuation consideration because the farm owner is retired, disabled, and in advancing years and is not able to involve himself in the farming operations. The section, itself, attempts to alleviate this problem somewhat by requiring material participation for only five of the eight years immediately preceding the death of the decedent.<sup>149</sup> However, there is a real problem in many cases despite this section. Help may be forthcoming. In a letter to the Commissioner, John Sledge of the North Carolina Farm Bureau specifically requested consideration of the problem by the Internal Revenue Service.<sup>150</sup> In a response to Mr. Sledge's concerns, the acting Assistant Secretary of the Department of the Treasury responded that the Treasury would not oppose an

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145. 42 U.S.C. § 411(a)(1) (Supp. V 1975).

146. See HOUSE REPORT, *supra* note 7, at 23.

147. Letter from Robert M. Frederick, Legislative Director of the National Grange to the Commissioner of Internal Revenue (Sept. 3, 1978). This letter accompanied six position papers of recommended changes to proposed regulations for I.R.C. § 2032A.

148. I.R.C. § 1402(a)(1).

149. *Id.* § 2032A(b)(1)(C)(ii). In fact, the transcript of the hearings in the House of Representatives Ways and Means Committee on § 2032A reveals that this is precisely the reason for the five of eight year requirement. *Federal Estate and Gift Taxes: Public Hearings and Panel Discussions Before the House Committee on Ways and Means*, 94th Cong. 2d Sess. 860 (1976) (statement of Rep. Marvin Esch).

150. Letter from John Sledge, North Carolina Farm Bureau Federation to the Commissioner of Internal Revenue (Sept. 15, 1978).

amendment to section 2032A to relax the threshold requirements so as to permit qualification where the decedent materially participated in the operation of the farm over an extended period of time, but did not meet the "five of eight year" rule because of a lack of participation in the period immediately preceding death.<sup>151</sup> Presumably, this would apply in the case of the decedent and not in the case of the material participation of the qualified heir. Certainly such a change would enable more predictable estate planning.

As mentioned above, there are now in existence, proposed regulations under section 2032A to help define "material participation."<sup>152</sup> An analysis of these proposed regulations must be made being mindful of the express language of section 2032A(e)(G) that "material participation shall be determined in a manner *similar* to the manner used for purposes of paragraph (1) of section 1402(a) . . . ." Presumably, the word "similar" connotes that section 2032A "material participation" may be interpreted differently to some extent than that under section 1402(a). The proposed regulations, however, do not diverge from the section 1402(a) interpretation in their present form. One of the troublesome passages is found in section 20.2032A-3(d)(1). That passage provides, "(t)he regulations under section 1402(a)(1) are applicable for purposes of this section to the extent they are not inconsistent with its express requirements."<sup>153</sup> This is troublesome in that it pre-supposes that some of the proposed regulations might be inconsistent with section 1402(a)(1) regulations.<sup>154</sup> The upshot of the language is that it provides the more optimistic observer with the hope that the regulations for section 2032A will be less restrictive for valuation purposes. Such an interpretation would certainly be in keeping with the policy of encouraging "the continued use of property for farming and other small business purposes."<sup>155</sup> However, the ways in which the proposed section 2032A regulations, as written, are inconsistent with the section 1402(a) regulations seem to place more restrictions on the kinds of "material participation" that will qualify under section 2032A.<sup>156</sup> One writer takes the position that the more restrictive tests should be used to

151. Letter from Emil M. Sunley, Acting Assistant Secretary of the Department of the Treasury to John Sledge (May 25, 1979). This letter refers to § 6 of S.2466, 95th Cong. 2d Sess. as the report in which the assertion was made. In the same letter, Mr. Sunley said that Treasury would also support an amendment to allow relaxation of the material participation requirement as it refers to qualified heirs by allowing agents to act in the place of children, disabled, elderly and incompetents.

152. 43 Fed. Reg. 41039 (Treas. Reg. § 20.2032A-3, proposed 1978).

153. *Id.* (Under the heading, "Required Activities").

154. One of the commentators has asked the Commissioner to spell out where these differences lie, if in fact there are any. Letter from Donald A. Gillies, Chicago Bar Assoc. to the Commissioner of Internal Revenue (Nov. 17, 1978).

155. HOUSE REPORT, *supra* note 7, at 22.

156. *See* text accompanying notes 157-68 *infra*.

effectuate an easier administration of the section, the policy of preserving only the true family farms, and the policy of discouraging arrangements contrived solely to achieve a tax savings under section 2032A.<sup>157</sup> The proposed regulations, at this point, do not appear to offer very much in the way of effectuating either policy.

At the time these particular section 2032A regulations were proposed, many tax practitioners and commentators criticized them. The following is an attempt to correlate the most often mentioned criticisms and suggestions as to what regulations should be adopted in the future. Generally, section 1402(a) regulations have used a "multiple factor" approach when "material participation" was analyzed in a situation where the individual did not actually operate the farm himself. The basic three factors involved are: (1) the amount of physical work performed, (2) the degree of management responsibility exercised, and (3) the financial contribution to the activity."<sup>158</sup> A recurring criticism of the proposed section 2032A regulations is that the language takes some of the isolated factors which are among these multiple factors and makes each of them mandatory. For instance, one of the paragraphs<sup>159</sup> begins by providing, "[n]o single factor is determinative of the presence of material participation . . . ." However, in the next sentence, the language is, "[a]s a minimum, the decedent and/or a family member *must* regularly advise or consult with the other managing party on the operation of the business."<sup>160</sup> Such consultation was previously thought to be only one of several factors. However, the language of the proposed regulation makes this as well as some other factors<sup>161</sup> absolute as a requirement. One of these factors required by the proposed section 2032A regulations which several writers criticized as more restrictive than any found in the regulations under section 1402(a) or in

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157. See, Comment, *supra* note 17, at 398;

[C]ertain restrictive tests, such as the requirement that the owner or a member of his family provide the primary source of management of the farm or business and devote a substantial portion of his vocational activities thereto, would probably harmonize the policies of equity, neutrality, and preservation of family farms and businesses. Although this test may reduce the amount of land that qualifies for use valuation, it would do so primarily by screening out hobby farms and bad faith attempts to gain the benefit of use valuation.

158. These factors were isolated in a letter from Mervyn Schliefort to the Commissioner of Internal Revenue (Aug. 12, 1978).

159. 43 Fed. Reg. 31039 (Treas. Reg. § 20.2032A-3(d)(2) proposed July 19, 1978).

160. This is one of five specific "minimum qualifications" isolated in a letter from Tom Normand of Bowmer, Courtney, Buleson, Pemberton, and Temple, Texas, to the Commissioner of Internal Revenue (Sept. 13, 1978). These minimum requirements make the regulation too restrictive and according to Normand, it should be withdrawn. Other minimum qualifications this letter refers to are that, "the owner must participate in making substantial numbers of final management decisions, the owner should regularly inspect the production activities, and funds must be advanced or financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm."

161. *Id.*

the cases which have interpreted "material participation,"<sup>162</sup> is that, "[i]n the case of a farm, a substantial portion of the machinery, implements, and livestock used in the production activities should be furnished by the owner and other family members."<sup>163</sup> This seemed to be particularly objectionable because of the number of situations where there is substantial material participation in the operation of the farm but the farming operation itself was directed by a manager. The manager may be managing several farms and use his own equipment. In these situations, the decedent or heir did not purchase any equipment. The gist of these criticisms is that if there must be a material participation requirement analogous to the one in section 1402(a), the multiple factor approach should be similar. That is, no one factor should be fatal to the party seeking to gain the status of having materially participated. It may be that, since the Commissioner is arguing for material participation in most section 1402(a) cases and against material participation in section 2032A cases, a divergent set of regulations is inevitable. The practitioner, however, needs guidelines which are predictable and the present reference within section 2032A to section 1402(a) will be difficult to interpret if section 2032A regulations are more (or less) restrictive.

Another often mentioned criticism of the proposed section 2032A regulations is one mentioned above in connection with the social security dilemma.<sup>164</sup> That is, many commentators feel that an agent or employee working for an owner or landlord should, in certain circumstances, be considered to have vicariously materially participated for the owner.<sup>165</sup> These situations include ones in which a widow and children are left holding the family farm. Also, another compelling situation is where the qualified heir is a child, disabled person, or incompetent. Regulations should be written to cover these situations. It is inadequate to use regulations written basically to define material participation of social security tax payers and recipients in many of

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162. See note 137 *supra*.

163. 43 Fed. Reg. 31039 (Treas. Reg. § 2032A-3(d)(2) proposed July 19, 1978). This particular factor raised the ire of persons and organizations from individual farmers to the National Grange. See, e.g., Letter from Donald A. Gillies, Chicago Bar Assoc., Chicago, Ill., to the Commissioner of Internal Revenue (Nov. 17, 1978); Letter from Richard J. Dalton of Gridley, Illinois to H.B. Hartly, Legislative and Regulation Division, Office of Chief Counsel, Internal Revenue Service (Sept. 20, 1978); Letter from Robert M. Frederick, Legislative Director, National Grange, Washington, D.C., to the Commissioner of Internal Revenue (Sept. 13, 1978); Letter from Tom Normand, note 160 *supra*.

164. See text accompanying note 147 *supra*.

165. Letter from Robert M. Frederick, note 147 *supra*. Letter from Theodore J. Hopkins, McNair, Konduros, Corley, Singletary & Dibble, Columbia, S.C., to the Commissioner of Internal Revenue (Nov. 11, 1978). Mr. Hopkins expressly mentioned the situations where the farmer died leaving a widow and children with no option to materially participate. Letter from Nat H. Turner, National Cattlemen's Assoc., Denver, Colorado, to the Commissioner of Internal Revenue (Sept. 12, 1978). Letter from John Sledge, note 150 *supra*.

these other situations. The policy considerations which make a finding of no material participation in one case are not even relevant to material participation in the case of a section 2032A valuation.

Another recurring criticism of the proposed regulations is that they restrictively provide that "in determining whether the required participation has occurred, periods of less than 30 days during which there is no material participation may be disregarded."<sup>166</sup> This dispensation is given however, only if the 30 day periods are "both preceded and followed by periods of more than 120 days in which there was uninterrupted material participation."<sup>167</sup> The obvious concern of the Internal Revenue Service here is that section 2032A will be used by persons other than farmers who might use farms as tax shelters. By using a 30 day out of 270 day period as a standard, the practice of owning a farm, materially participating during a vacation, and claiming the section 2032A valuation can be effectively avoided. However, this is criticized as being totally out of touch with the realities of the nature of many "true" farm operations.<sup>168</sup> Many farms have definite growing and harvesting periods in which there is a heavily labor-intensive working period while other times of the year require no participation at all, let alone material participation. There may be ways for the Internal Revenue Service to alleviate its fears and for truly seasonal farmers to take advantage of the 2032A valuation. One commentator suggests that there be a double standard, one set of rules for the true farmer and one for the not so true farmer.<sup>169</sup> The problem with this is that there are close situations in which the non-true farmer or person who is seeking a tax shelter actually is participating on the same level as the true farmer. How would they be distinguished? The proposed section 2032A regulations could be interpreted as defining "material participation" by the kind of operation involved. The work requirement should be no more stringent than the operation calls for. However, the regulation could be explicit on this point, eliminating the need for any manipulative interpretations. That a few tax shelters might be built in the process of furthering the goals of section 2032A should not be of great concern in administering an admittedly non-revenue raising tax.

In summary, the definition of "material participation" is a perplexing problem surrounding section 2032A. The safest way for an estate planner to interpret the phrase is to use the letter of the regulations

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166. 43 Fed. Reg. 31039 (Treas. Reg. § 20.2032A-3(c), proposed July 19, 1978).

167. *Id.*

168. Letter from Robert J. Hester, Atty., Mote, Wilson, and Welp, Marshalltown, Iowa, to the Commissioner of Internal Revenue (Sept. 16, 1978). Before setting any 30 day inactivity rule, the nature of the farming operation should be considered.

169. Interview with Professor George Carey, North Carolina Central University School of Law (Jan. 21, 1980).

under section 1402(a) along with the Internal Revenue's interpretation in the *Farmer's Tax Guide*.<sup>170</sup> There are proposed regulations specifically interpreting material participation under section 2032A, but they are generally overly restrictive, in many cases more so than those of section 1402(a). The planner should watch for future regulations, however, as there is significant sentiment for redefining "material participation" for certain persons. There are many questions surrounding "material participation" left unanswered. However the planner can take solace in the fact that by using the restrictive requirements, there is a degree of predictability to his decisions.

### *Section 2032A and Its Relationship to Other Estate Tax Provisions*

#### *Relationship with Section 6166 and Section 6166A*

Several problems estate planners may have in giving advice concerning the election under section 2032A involve analysis of how the section relates to other sections of the Internal Revenue Code. Section 6166 and section 6166A are two other sections which relate to section 2032A. Section 6166<sup>171</sup> and section 6166A<sup>172</sup> are provisions which, in certain situations, allow an extension of time for the payment of estate taxes on estates with special liquidity problems. The problem this presents in the context of the section 2032A valuation is that for an estate to qualify for extended payments, the value of a closely held business, as the business of a family farm, must exceed thirty-five percent of the gross estate of the decedent, or fifty percent of the taxable estate of the decedent in section 6166A,<sup>173</sup> or sixty-five percent of the gross estate in section 6166.<sup>174</sup> The "value" of the closely held business "shall be the value determined for Federal estate tax purposes."<sup>175</sup> If the "value" of the property has been determined pursuant to the use valuation of section 2032A, the ratio of the value to the estate may not meet any of the section 6166 or section 6166A percentage requirements. This situation can be illustrated by the following example. If the decedent's gross estate is valued at \$570,000 and the value of the farm property (including farmhouses and other structures)<sup>176</sup> is \$285,000 the thirty-five percent of the gross estate test is met. (This also meets the section 2032A percentage requirement.) However, if the farm is valued

170. See note 143 *supra*.

171. I.R.C. § 6166. "ALTERNATE EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX WHERE ESTATE CONSISTS LARGELY OF INTEREST IN CLOSELY HELD BUSINESS."

172. *Id.* § 6166A. "EXTENSION OF TIME FOR PAYMENT OF ESTATE TAX WHERE ESTATE CONSISTS LARGELY OF INTEREST IN CLOSELY HELD BUSINESS."

173. *Id.* § 6166A(a).

174. *Id.* § 6166(a).

175. *Id.* § 6166A(a).

176. *Id.* § 6166(b)(3).

at \$105,000 under the actual use valuation alternative, the estate would not qualify under section 6166 or section 6166A for deferred or extended payments. The executor in this situation is placed in the position of making an election on the basis of whether "the estate's liquidity problems mitigated under section 6166 (or section 6166A) outweigh the tax avoided under section 2032A."<sup>177</sup>

Another way these two sections relate to section 2032A occurs in the event there is an imposition of an additional estate tax during the fifteen year period after the decedent's death due to disposition of the property or a cessation of its qualified use.<sup>178</sup> Recaptured estate tax is due and payable on the day which is six months after the date of the disposition or cessation referred to in section 2032A(c)(1).<sup>179</sup> This recaptured tax does not qualify for extended payment under section 6166 or section 6166A because installment payments are on deficiencies in tax imposed by section 2001.<sup>180</sup> The recapture tax, however, is imposed by section 2032A(e)(1).<sup>181</sup> Of course, the decision this problem presents can only be based upon an assessment of the amount of the potential recaptured tax and the propensity for the recapturing event to occur. At best, this is guess work, but the planner and the executor should be aware of the problem.

When a decedent had an interest in a partnership, corporation, or trust, that interest can receive section 2032A treatment if it is an interest in a closely held business.<sup>182</sup> Section 2032A(g) provides that for purposes of section 2032A, closely held businesses are defined by section 6166(b).<sup>183</sup> Again, a relationship between the two sections arises. A close analysis of section 6166(b) reveals that the interest must be in a

177. Note, *Estate Planning for Farmers and Ranchers Under Section 2032A*, 55 DEN. L.J. 347, 359 (1978).

178. I.R.C. § 2032A(c).

179. *Id.* § 2032A(c)(5).

180. *Id.* § 6166(h)(1); I.R.C. § 6166A(a).

181. "[T]here is hereby imposed an additional estate tax."

182. I.R.C. § 2032A(g). This also applies to application to I.R.C., which places the special lien for additional estate taxes attributable to farms and § 6324B to interests in partnerships, corporations and trusts.

183. *Id.* § 6166(b)(1):

(1) INTEREST IN CLOSELY HELD BUSINESS.—For purposes of this section, the term "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.



trade or business.<sup>184</sup> This, of course, is consistent with the purpose of section 2032A in that protection of other activities for the production of income would not be important in the preservation of the family farm. Consistent, also, is proposed section 2032A regulation section 20.2032A-3(b) which provides, “[n]o trade or business is present even though an office and regular hours are maintained for management of income producing assets, as the term ‘business’ is not as broad under section 2032A as under section 162.” This is a little confusing in that there are activities listed under section 2032A(e)(5) which might not be within the “trade or business of farming” under section 162. However, the activities in which the decedent or qualified heir must involve themselves with regards to any type of trade or business are much more limited under section 2032A. The point of this paragraph, however, is that section 2032A(g) cross-references section 6166(b) for definitional purposes.

### *Relationship with Section 6324B*

Included in the package of revisions in the Tax Reform Act of 1976 was section 6324B. This section provides that upon an election under section 2032A, a lien arises in favor of the United States in the amount of the adjusted tax difference attributable to the property valued under section 2032A.<sup>185</sup> This provision is, at least implicitly, tied to the personal liability provisions under section 2032A(c)(6).<sup>186</sup> They are, of course, methods of assuring payment of any recaptured tax. The lien imposed by section 6324B is in effect “until the liability for the tax under (e) of section 2032A with respect to such interest (the recaptured tax) has been satisfied or has become unenforceable by reason of lapse of time, or until it is established to the satisfaction of the Secretary that no further tax liability may arise under section 2032A(e) . . . .”<sup>187</sup>

Early in the development of section 6324B, commentators wrote of the burdensome effect that the lien would have on the farm operations. This is because of the difficulty such a lien would cause in the procurement of credit for farm improvements, operations, etc.. However, these reservations apparently come from a superficial analysis of the section 6324B lien. The lien imposed by the section is “not valid against any purchaser, holder of a security interest, mechanic’s lien, or judgment

184. *Id.* § 6166(b)(1)(A), (B).

185. *Id.* § 6324B(a).

186. “LIABILITY FOR TAX; FURNISHING OF A BOND.—The qualified heir shall be personally liable for the additional tax imposed by this subsection with respect to this interest unless the heir has furnished bond which meets the requirements of subsection (e)(11).”

187. *Id.* § 6324(b)(1), (2). “The legislative history of 2032A contains no hint as to what state of facts is intended to be sufficient to satisfy ‘the Secretary’ that no further tax liability may arise. This clause is likely to be virtually no use to taxpayers.” Comment, *supra* note 17, at 419.

lien creditor" until notice is filed.<sup>188</sup> Even after the appropriate notice<sup>189</sup> is filed, the lien is not valid against real property tax and special assessment liens, mechanic's liens for repairs and improvements, or security interests for financing construction or improvements.<sup>190</sup> So, most financing arrangements necessary for the operation of the farm gave the holder of the interest priority over the section 6324B liens.

The Revenue Act of 1978 offered even further aid against the lien. Revisions included a provision which allows a security to be substituted for the lien imposed by section 6324B.<sup>191</sup> Also, the Secretary was given the power to issue a certificate of subordination of the section 6324B lien upon a determination that the United States will be adequately secured after the subordination.<sup>192</sup> This certificate of subordination is "conclusive that the lien or interest to which the lien of the United States is subordinated is superior to the lien of the United States."<sup>193</sup>

Another change made by the Revenue Act of 1978 was to allow the furnishing of a bond by the heir pursuant to requirements imposed by section 2032A(e)(11)<sup>194</sup> in lieu of personal liability for recaptured tax.<sup>195</sup> So the "double club"<sup>196</sup> of the imposition of personal liability and the Federal tax lien has been mitigated to some extent by the 1978 changes.

### *Section 1023—No Longer a Problem*

One of the problems anticipated in the administration of section 2032A was how to determine the basis of the property which was valued under section 2032A under the carryover basis rules of section 1023. Especially intriguing are the problems that the adjustment to basis for December 31, 1976, fair market value would present.<sup>197</sup> How-

188. I.R.C. § 6324A(d)(1) (incorporated by I.R.C. § 6324B(c).

189. *Id.* § 6323(f).

190. *Id.* § 6324A(d)(3).

191. *Id.* § 6324B(d).

192. *Id.* § 6324B(d)(3).

193. *Id.* § 6325(f)(1)(C).

194. *Id.* § 2032A(e)(11);

(11) BOND IN LIEU OF PERSONAL LIABILITY.—If the qualified heir makes written application to the Secretary for determination of the maximum amount of the additional tax which may be imposed by subsection (c) with respect to the qualified heir's interest, the Secretary (as soon as possible, and in any event within 1 year after the making of such application) shall notify the heir of such maximum amount. The qualified heir, on furnishing a bond in such amount and for such period as may be required, shall be discharged from personal liability for any additional tax imposed by subsection (c) and shall be entitled to a receipt or writing showing such discharge.

195. *Id.* § 2032A(c)(6).

196. The "double club" was coined by Cox, *Estate Planning for Farmers After the Reform Act of 1976*, 14 WAKE FOREST L. REV. 577, 609 (1978). Professor Cox also points out that in spite of the mitigation of the financing problem by the certificate of subordination, the "real" problem of marketability of title continues to exist.

197. I.R.C. § 1023(h).

ever, since section 1023 has been repealed, the basis of property in the hands of a person acquiring the property from a decedent is the stepped up amount provided in section 1014.<sup>198</sup> For purposes of property valued under section 2032A this will be the value determined under section 2032A.<sup>199</sup>

### *Summary*

Section 2032A can best be approached by an estate planner by a consideration of the election the executor has to make.<sup>200</sup> By using the election as a starting point, a comprehensive treatment of section 2032A will be given because only by considering each aspect of the section can an election be made. Whether there is "qualified real property"<sup>201</sup> is an initial determination that must be made. If the property is qualified, the consideration of how to make the actual use valuation—the formula method,<sup>202</sup> or the multiple factors method<sup>203</sup>—can be made. The planner will consider the propensity for post-mortem disposition or cessation of a qualified use of the property,<sup>204</sup> for deciding on the election. He will determine the problems surrounding the location of all the interested parties for signing the agreement with the election.<sup>205</sup> And, the planner must determine whether the decedent or a member of his family materially participated in the operation of the farm for the requisite amount of time,<sup>206</sup> and if there is a likelihood that the qualified heir or a member of his family will do so after the property has passed to him.<sup>207</sup> After these considerations are made, advice as to estate planning as well as an election under section 2032A(d)(1) can be given. Some thought should be given to the method of insuring material participation by the heirs by way of post-mortem advice and counseling so as to protect the parties involved. Likewise, close scrutiny of when the heir might want to post the requisite bond or seek a certificate of subordination for management purposes is a good idea.

### *Some Proposed Changes*

Basically, section 2032A is a valid attempt to reach the goals for

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198. *Id.* § 1014. "BASIS OF PROPERTY ACQUIRED FROM A DECEDENT."

199. *Id.* § 1014(a)(3).

200. *Id.* § 2032A(d)(1).

201. *Id.* § 2032A(b).

202. *Id.* § 2032A(e)(7).

203. *Id.* § 2032A(e)(8).

204. *Id.* § 2032A(c).

205. *Id.* § 2032A(d)(2).

206. *Id.* § 2032A(b)(1)(C).

207. *Id.* § 2032A(c)(7)(B)(ii).

which it was promulgated. A quick review shows those goals to be, "(1) to provide relief for certain types of estates which face liquidity problems and (2) to minimize the possibility that real property, particularly farmland, will be removed from agricultural production."<sup>208</sup> We have seen how these two goals can be conflicting in that a liberal interpretation of "material participation" can further the latter goal while a restricted interpretation can selectively further the interests and needs of the farmer.<sup>209</sup> The technical requirements for implementation of section 2032A seem to be where problems arise. The most obvious area that needs attention is in the interpretation of "material participation." There are two distinct views of how to change the present interpretations.<sup>210</sup> One is that the term itself should be rigidly defined. This will give planners some standard to adhere to. However, such a standard can itself be a planner's albatross as he cannot plan for the unforeseen situation where an elderly farmer becomes disabled for more than three years before death. Here, the very standard the planner was using to make long term plans for this farmer's estate traps him into having to change the plan because a rigid restrictive interpretation of "material participation" precludes any argument to sustain the plan. The logical extension of the second view of how to change the interpretation is to liberalize it to the point that material participation is defined by ownership so as to make it illusory.

Perhaps a mode for interpretation of "material participation" should be to separate the "material participation" required of the decedent or a member of his family from that required of a qualified heir or a member of his family. By doing this, two separate sets of rules could be developed so that the situations complained of in the earlier section on "Material Participation" would not be as problematic. For instance, a set of rules for a decedent over the age of sixty-two could be written so that after a set number of years of active involvement in the operation of the farm (perhaps defined by the rules under 1402(a)), there would be no material participation required other than ownership and the perpetuation of the operation of the farm by any means. The problem with social security benefits, the disabled person, the widow, and the incompetent could be alleviated. The set of rules for the heir or a member of his family could be analogous to the present section 1402(a) regulations, with appropriate modifications for agency relationships, in the child heir situations.<sup>211</sup>

Another problem which arises is that of defining and locating per-

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208. See McCord, note 4 *supra*.

209. See text accompanying notes 154-57 *supra*.

210. See text accompanying the heading *Material Participation supra*.

211. *Id.*

sons in being who have an interest in the property for the purpose of signing the agreement to the section 2032A election.<sup>212</sup> Of course clear drafting of will provisions can help solve problems surrounding this, but, in many cases, there are several interests to consider. Also, even clear drafting cannot solve the problem of premature death leaving children who have interests. One proffered solution to this problem has been to change proposed regulation section 20.2032A-8(c)(2) to read, "[t]he consent of a minor should be made by the minor or by his legal guardian or his natural guardian if no legal guardian has been appointed."<sup>213</sup> This would solve problems concerning the expense of having to have guardians appointed. Another recommended change here would be to provide a notice procedure to aid the executor by providing a statutory means of notification and a statutory period after which the election could be made without the signature on the agreement.

Another troublesome area in section 2032A and in the proposed regulation is that of actual valuation of the property. While the formula method<sup>214</sup> offers a standard objective means of valuating the property, the proposed regulations make the procedure for filling in the formula overly burdensome on the executor.<sup>215</sup> The Service needs to write regulations which would give the executor an area breakdown based upon property use values for different areas of the country.

The multiple factor method<sup>216</sup> offers an opportunity for the executor to use a more reasoned approach to the valuation. However, it probably gives the typical executor the kind of discretion he is not capable of using, as if anyone would be. A proposed change here is to have the district land banks prepare area tables for each of the factors in section 2032A(e)(8). These would be made available to executors and estate planners so that this means of valuing land will become more dependable.

### *Conclusion*

Section 2032A provides a meaningful way of valuing farmland so as to prevent the sale of the family farm to pay estate taxes. Problems associated with the section are ones which apply generally only to the marginal situations. As the section is presently written, a large number of traditional family farms can benefit from it.

With the modifications that are sure to come in the future, more

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212. I.R.C. § 2032A(d)(2).

213. Letter from Thurston Reynolds, Smith, Baker, Field & Clifford, Inc., Lubbock Texas, to H.B. Hartley, Legislative and Regulation Division, Office of Chief Counsel, Internal Revenue Service (Aug. 13, 1978).

214. I.R.C. § 2032A(e)(7).

215. 43 Fed. Reg. 31039 (Treas. Reg. § 20.2032A-4(d)(1)-(10), proposed July 19, 1978).

216. I.R.C. § 2032A(e)(8).

farms will fall under its shelter and some encouragement for family farm retention should evolve.

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