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Estate Planning for Farmers and Ranchers under Section 2032A

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ESTATE PLANNING FOR FARMERS AND RANCHERS UNDER SECTION 2032A

INTRODUCTION

The Estate and Gift Tax Reform Act of 1976 added to the Internal Revenue Code the most significant estate tax legislation ever enacted for the farmer or rancher—section 2032A.[1] The congressional intent underlying section 2032A was simple: minimize inflated valuation of farmland when determining the farmer's gross estate.[2] Consequently, this new law was designed to reduce a farmer's estate tax liability if certain requirements are satisified.[3] This reduction in estate tax is accomplished by an alternative method of valuing the farmer's real estate—valuation of farmland at its current use as a farm rather than at its "highest and best use." Proper implementation of section 2032A should result in the transmission of the small family farm between generations without creating burdensome estate taxes.[4] Thus, farm families are not forced to liquidate the farm assets to cover the estate tax liability.

This paper has two principal sections. The first discusses requirements, definitions, valuation methods, and recapture of

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[1] I.R.C. § 2032A. This section was enacted into law by section 2003 of the Estate and Gift Tax Reform Act of 1976. Only estates of decedents dying after December 31, 1976 can elect section 2032A. This section applies also to realty in a closely held corporation but this paper limits its discussion to farm realty. All "sections" referenced in this paper are from the Internal Revenue Code of 1954.

[2] H.R. REP. No. 1380, 94th Cong., 2d Sess. 21 (1976), at 22. This intent was stated in the report as follows:

> [W]here 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. . . .

[3] Keydel, *Explaining the Tax Reform Act of 1976 to Clients*, PRAC. LAW., Mar. 1, 1977 at 11. In actual tax dollars the estate tax will be lowered by $90,000 to $350,000 depending on the tax bracket involved. *Id.* This range of tax savings is derived from the product of the lowest and highest estate tax rates under section 2001(c) and the maximum reduction in the gross estate allowed under section 2032A. The calculations are as follows:

Tax Rate		Maximum Reduction Allowed		Decrease in Tax
18%	of	$500,000	=	$ 90,000
70%	of	$500,000	=	$350,000

The maximum reduction rule is discussed in text accompanying note 32 *infra*.

[4] *Id.*

tax saved by electing the special valuation under section 2032A. The second analyzes the considerations involved to elect section 2032A, the pre-mortem planning necessary to comply with the section, and the post-mortem planning required to avoid forfeiting the benefits of the section.

I. AN INEQUITY OF THE ESTATE TAX LAWS

Under the current law, the property included in a decedent's gross estate is to be reported at its "value."[5] Treasury regulation 20.2032-2(b) defines "value" as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[6] Farm real estate, therefore, has been valued at the "highest and best use" of the property.[7] Consequently, because the farm property's industrial or developmental value was higher than its agricultural value, the farm either had to be sold to pay the high estate tax or converted to a nonagricultural use to increase its income and justify its retention.[8]

Reacting to this inequity, Congress enacted section 2032A to eliminate the "highest and best use" valuation and to introduce "special use" valuation.[9] In enacting the law, Congress evidently felt that a policy of encouraging retention of the "family farm" in the United States outweighed the policy of encouraging industrial development of the land.[10]

II. GENERAL PROVISIONS OF SECTION 2032A

A. *Requirements*

In order to qualify for its benefits, section 2032A prescribes

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[5] I.R.C. § 2031(a).

[6] (1965).

[7] H.R. REP. No. 1380, *supra* note 2, at 21.

[8] *Id.* at 22. *See also,* Kelley, *Estate Tax Reform and Agriculture,* 7 U. TOL. L. REV. 897 (1976); Smith & Scrow, *The Estate and Gift Reform Act of 1976: A Look at Two of the Major Provisions,* UTAH B.J., Winter, 1976, at 42. The former article provides an excellent discussion of the methods of valuation before enactment of section 2032A and of the resulting hardship for the heirs of the farmer's estate. It cites one study which noted that more than 60% of all farm estates in Iowa became legally or economically fragmented following the death of the owner.

[9] H.R. REP. No. 1380, *supra* note 2, at 22.

[10] *Cf.* Taylor, *Public Policy and the Shaping of Rural Society,* 20 S.D.L.R. 475 (1975) (for the opinion that family operated farms are the most efficient and socially desirable method of farming).

a number of specific criteria. The section applies only if the decedent was a citizen or resident of the United States and if the property is "qualified real property."[11] To be "qualified real property" an eight-point test must be met:

1. The property must be real property located within the United States;[12]
2. the property must be used at the time of the decedent's death in a "qualified use;"[13]
3. the property, along with the personal property used with such real property, must pass from the decedent to a "qualified heir;"[14]
4. the property, along with personal property used with it, must comprise at least 50 percent of the adjusted gross estate;[15]
5. the property, valued by itself at its "highest and best" use, must comprise at least 25 percent of the adjusted gross estate;[16]
6. the property must have been owned by the decedent or a "member of his family" during five of the eight years immediately preceding the decedent's death;[17]
7. there must have been "material participation" by the decedent or a "member of his family" in the operation of the property in its "qualified use" during five of the eight years immediately preceding the decedent's death;[18] and
8. the executor or other estate representative must file an election with the estate tax return which designates the realty and agrees that the recapture rules of the section will apply with respect to that property.[19]

B. *Definitions*

To understand the stated requirements of section 2032A, certain phrases defined by that section must be examined.

"Qualified real property" qualifying for "special use" valuation includes the farmhouse, or other residential buildings, and related improvements located on the farm.[20] However, such build-

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[11] I.R.C. §§ 2032A(a), (b)(1).

[12] *Id.* § 2032A(b)(1).

[13] *Id.* § 2032A(b)(1)(A)(i).

[14] *Id.* § 2032A(b)(1)(A)(ii).

[15] *Id.* § 2032A(b)(1)(A). For the purposes of this test, the value of the property, real and personal, and the adjusted gross estate are determined without regard to section 2023A and are reduced by any mortgages or indebtedness on the property. *Id.* § 2032A(b)(3). *See also* section 2053(a)(4).

[16] *Id.* § 2032A(b)(1)(B).

[17] *Id.* § 2032A(b)(1)(C)(i).

[18] *Id.* § 2032A(b)(1)(C)(ii).

[19] *Id.* §§ 2032A(b)(1)(D), (d).

[20] H.R. REP. No. 1380, *supra* note 2, at 23.

ings must be occupied on a regular basis by the owner or lessee of the real property for the purpose of operating the farm.[21] "Qualified real property" also includes roads, buildings, and other structures and improvements functionally related to the "qualified use."[22] To the contrary, elements of value which are not related to the farm use, e.g., mineral rights in the form of a coal or natural gas lease, are not eligible for "special use" valuation.[23]

A "qualified use" is use as a "farm" for "farming purposes."[24] The definition of a farm is quite broad: it includes dairy, poultry, and truck farms, plantations, ranches, nurseries, ranges, greenhouses, orchards and woodlands.[25]

A "qualified heir" is defined as any member of the decedent's family to whom the real property passes.[26] "Member of the family" is defined as the decedent's spouse, ancestor, lineal descendant, or a lineal descendant of the decedent's grandparent, or the spouse of any such descendant.[27] Therefore, along with his brother and sister, the decedent's aunts, uncles, nephews, great nephews, great nieces, and cousins and their spouses, would be included as "members of the family."[28] Adopted children, also, are included as members of the decedent's family.[29]

"Material participation" is determined in a manner similar to that used for purposes of computing net earnings from self-employment under section 1402(a).[30] Although the party carrying

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[21] *Id.* at 24.

[22] *Id.*

[23] *Id. See also* Kirby, *How to Plan for New Special Rules of Valuing Farm and Close Corporation Real Estate,* EST. PLAN. Jan., 1977, at 95.

[24] I.R.C. § 2032A(b)(2)(A). See section 2032A(e)(5) for a definition of farming purposes.

[25] *Id.* § 2032A(e)(4).

[26] *Id.* § 2032A(e)(1).

[27] *Id.* § 2032A(e)(2).

[28] Case & Phillips, *Death and Taxes—The 1976 Estate and Gift Tax Changes,* 1976 ARIZ. ST. L. J. 321, 361. Under the Uniform Probate Code, which has been adopted in Colorado, every class of heir to which property could pass by intestate succession would meet the definition of a "member of the family" under section 2032A(e)(2). *Id.; See also* COLO. REV. STAT. § 15-11-103. Remarkably, section 2032A(e)(2) deviates from the Uniform Probate Code by allowing the spouses of "qualified heirs" to be members of the decedent's family.

[29] I.R.C. § 2032A(e)(2); *Cf.* COLO. REV. STAT. § 15-11-109(a) (1973) which states that for intestacy purposes an adopted person is the child of the adopting parent.

[30] I.R.C. § 2032A(e)(6). Section 1402(a) reads as follows: "The term 'net earnings from self-employment' means the gross income derived by an individual from any trade or

on the business need not be the decedent or a "member of his family," the decedent or a "member of his family" must materially participate in the business.[31]

C. *Valuation Methods*

The special valuation method provided by section 2032A, if elected, can reduce the value of the "qualified real property" by a maximum of $500,000.[32] Therefore, the personal representative must value the property at both its "highest and best use" and its actual agricultural use to determine if the difference between the two values exceeds $500,000.[33]

Section 2032A provides for one primary method of valuation, the income capitalization method. It is based on a formula of cash rentals, real estate taxes, and effective interest rates.[34] Because the elements of the formula are easily determinable, the method has three advantages: 1) "it should reduce subjectivity, and therefore controversy, in farm valuation;" 2) "it should eliminate from valuation any values attributable to the potential for conversion to nonagricultural use;" and 3) it should eliminate from valuation any values attributable to speculative factors.[35] Each element of the formula requires an average based on the five most recent calendar years ending before the date of the decedent's death.[36] The "qualified real property's" value is determined by dividing the difference between the average gross cash rental for comparable land used for farming purposes (and located in the locality of such "qualified real property") and the average state and local real estate taxes for such comparable land, by the average annual effective interest rate for all new Federal Bank loans.[37]

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business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business."

[31] H.R. REP. No. 1380, *supra* note 2, at 23.

[32] I.R.C. § 2032A(a)(2).

[33] RESEARCH INSTITUTE OF AMERICA, THE RIA COMPLETE ANALYSIS OF THE '76 TAX REFORM LAW, at 35 [hereinafter cited as RESEARCH INSTITUTE].

[34] I.R.C. § 2032A(e)(7)(A).

[35] H.R. REP. No. 1380, *supra* note 2, at 24-25.

[36] I.R.C. § 2032A(e)(7)(A).

[37] *Id.* The statute does not specify whether the interest rate for all new Federal Bank loans is to be determined from a national average or regional average. The United States is divided into twelve regions and each region's interest rate presumably would reflect the interest rate the farmer would pay to obtain the loan.

D. *Recapture of the Estate Tax*

Congress feared that unless for an extended period of time after the decedent's death the "qualified real property" is retained as a farm for farming purposes, the "qualified heirs" might obtain a "windfall" by electing actual use valuation and then proceeding to sell the property at its "highest and best use."[38] Therefore, section 2032A prescribes that a *disposition of the property* or a *cessation of the qualified use of the property* within fifteen years of the decedent's death, results in a recoupment of the estate tax originally saved by election of the special valuation method.[39]

1. Disposition of the Qualified Real Property

The report of the House Ways and Means Committee describes those dispositive acts for "qualified real property" which will subject the "qualified heirs" to the recapture provision. In general, the recapture provision is applicable to "qualified real property" that is disposed of in any way to nonfamily members.[40]

Conversely, section 2032A also provides that there is no recapture if the interest in "qualified real property" is transferred, by sale or gift, to a member of the "qualified heir's family."[41] However, this member is now deemed to be the "qualified heir" with respect to such interest even though he may have paid full value for the interest.[42] Consequently, a subsequent disposition of the interest by this deemed "qualified heir" to a nonfamily member within the fifteen year period, will trigger recapture of the estate tax from which the original "qualified heir" already had benefitted and, in addition, will impose liability for the recaptured amount on the deemed "qualified heir."

2. Cessation of Qualified Use

Cessation of qualified use occurs when the farm realty is converted to a nonagricultural endeavor. For example, farmland leased for the purpose of a shopping center would constitute a cessation of use.[43] Cessation also occurs if "[d]uring any period

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[38] H.R. REP. No. 1380, *supra* note 2, at 22.
[39] I.R.C. § 2032A(c)(1).
[40] *Id.*
[41] I.R.C. § 2032A(c)(1)(A).
[42] *Id.* § 2032A(e)(1); H.R. REP. No. 1380, *supra* note 2, at 27.
[43] I.R.C. § 2032A(c)(1)(B).

of eight years ending after the date of the decedent's death and before the death of the qualified heir, there have been periods aggregating three years or more during which there was no material participation by the qualified heir or a member of his family in the operation of the farm or other business."[44] Thus, the concept of "material participation" is an important factor here, as well as in initially qualifying the decedent's estate.

The death of a "qualified heir" does not constitute a cessation of use with respect to that heir's interest.[45] However, if there is more than one "qualified heir" who has an interest in the farm realty, upon the death of one, the potential liability for recapture ceases only as to the proportionate interest of the deceased "qualified heir."[46] In addition, if "qualified real property" was left to two or more "qualified heirs" with *successive* interests in the property, the potential liability for recapture remains undiminished upon the first "qualified heir's death."[47]

3. Computation of the Recapture Tax

The maximum that can ever be recaptured is the tax savings that resulted from the application of section 2032A.[48]

The amount of estate tax benefit potentially subject to recapture with respect to any interest is the lesser of the following: 1) The excess of the estate tax liability, which would have been incurred had the special use valuation provision not been elected, over the actual estate tax liability for that interest based on the "special use" valuation;[49] 2) the amount realized on a sale or exchange of the interest over the "special use" value of the property;[50] and 3) the "highest and best use" value at the time of the recapture event over the "special use" value if that interest triggered recapture due to a cessation of a "qualified use."[51]

Only the first amount noted requires clarification. This amount is referred to in subparagraph 2032A(c)(2) as the

[44] H.R. REP. No. 1380, *supra* note 2, at 26.
[45] *Id.*
[46] *Id.*
[47] *Id.*
[48] Case & Phillips, *supra* note 28, at 371.
[49] I.R.C. § 2032A(c)(2)(A)(i).
[50] *Id.* § 2032A(c)(2)(A)(ii).
[51] *Id.*

"adjusted tax difference attributable to such interest." It can be expressed by the following formula:

$$\frac{(X) \text{ times } (Y)}{(Z)}$$

where:

> X is the total tax the estate deferred due to the "special use" valuation;[52]
> Y is the excess of the interest's "highest and best use" value over the "special use" value;
> Z is the excess of the "highest and best use" value over the "special use" value of all the "qualified real property."

Congress created three devices to ensure payment of the recaptured tax. First, the statute of limitations for the tax does not begin until the Internal Revenue Service is notified of the recapture-triggering event.[53] Second, section 6324B, enacted into law with section 2032A, provides that a lien in favor of the United States attaches to the "qualified real property" for the duration of the recapture period.[54] Third, the agreement that is filed with the estate tax return must contain the consent of each of the parties to the recapture tax provisions.[55] This consent imposes personal liability for any recapture tax due with respect to the "qualified heir's" interest in the "qualified real property."[56]

III. ESTATE TAX PLANNING

A. *Pre-mortem Planning*

Estate tax planning for the farmer should be initiated well in advance of death. If election of section 2032A is contemplated, measures should be taken to ensure the estate's qualification. Also, the best methods to hold and channel the farm assets to members of the decedent's family who will fulfill the section's requirements, must be chosen. Finally, the decision whether to elect section 2032A or section 6166 is faced by the estate with liquidity problems.

[52] This amount is also known as the "adjusted tax difference with respect to the estate." *Id.* § 2032A(c)(2)(C).
[53] I.R.C. § 2032A(f)(1).
[54] *Id.* § 2032A(g).
[55] H.R. REP. No. 1380, *supra* note 2, at 27.
[56] *Id.*

1. General Considerations

The crucial decision is whether the estate should elect section 2032A. A farm located in a completely rural area already should be valued at its current actual use as farmland; the estate would only be hindered by section 2032A.[57] In contrast, since the value of a farm located near residential or industrial property is affected by nonagricultural factors, the valuations based on "highest and best use" and "special use" would be quite disparate. In this latter situation, however, election of section 2032A is not automatic. Consideration must be given to the costs of overseeing,[58] and to the restraint of disposing the "qualified real property" during the fifteen year recapture period.[59] The suggested test is whether the value of the "qualified real property" at its "highest and best use," or the amount of income it could produce if utilized in a nonagricultural manner, is greater than the net monetary return yielded under section 2032A.[60]

For two reasons, the decision whether to elect section 2032A should be made several years prior to the decedent's death. First, if the estate will have a problem meeting the 50 percent and 25 percent test, the decedent should make inter vivos gifts of the nonqualified property.[61] Thus, the percentage of qualifying property in the estate will rise.[62] As an added incentive for holding

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[57] Case & Phillips, *supra* note 28, at 372.
[58] Keydel, *supra* note 3, at 11.
[59] Smith & Scrow, *supra* note 8, at 46.
[60] *Id.*
[61] Case & Phillips, *supra* note 28, at 372.
[62] To illustrate, a farmer owns the following assets:

	Value	Percentage
Two apartment buildings	$ 700,000	70%
Dairy farm	300,000	30%
	$1,000,000	100%

If the farmer makes an inter vivos gift of one apartment building worth $400,000, the estate's value would be $600,000. Consequently, the percentages of the farm assets would rise as follows:

		Percentages		
	Value	Required	Before Gift	After Gift
Total Farm Assets	$300,000	50	30	50
Farmland	$200,000	25	20	33⅓

"qualified real property" until death, the "special use" valuation rule does not apply for gift tax purposes.[63] Therefore, if a donor makes a lifetime transfer of his farm, the property is valued for gift tax purposes at its "highest and best use."[64] Second, to ensure "material participation" in the last eight years of the decedent's life, the members of his family should be encouraged to participate in the farming or ranching operation.[65]

2. Methods of Insuring Continuity of the Farming Operation

Choosing the proper method of holding the farm assets for the purposes of section 2032A is critical. Whether a corporation, partnership, or trust entity is selected,[66] the primary concern must be the continuation of the farm's operation for those children who elect farming for their livelihoods.[67] The corporate entity offers a distinct advantage; ownership is represented by shares of stock. Since only shares of stock are given, transfer of the operating farm to the children is facilitated.[68] While the partnership form has the advantage of ease of formation, its main drawback is that it dissolves upon the death of either partner.[69] Thus, objectives of continuity of operation and smooth intergenerational transfer would be lost.[70] In contrast, the revocable

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[63] RESEARCH INSTITUTE, *supra* note 33, at 34.

[64] *Id.*

[65] Case & Phillips, *supra* note 28, at 372.

[66] Congress indicated that a decedent's estate generally should be able to utilize the benefits of "special use" valuation where it holds the "qualifying real property" indirectly through its interest in a partnership, corporation, or trust. However, two requirements must be met: 1) The business in which such property is used constitutes a closely held business as defined in section 6166; and 2) the real property would qualify for "special use" valuation if it were held directly by the decedent. H.R. REP. NO. 1380, *supra* note 2, at 24. Section 6166(b)(1) defines "interest in a closely held business." A partnership interest is an "interest in a closely held business" if 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or if such partnership had 15 or fewer partners. Stock in a corporation is an "interest in a closely held business" if 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or if such corporation had 15 or fewer shareholders. Note that a trust would qualify if its corpus consisted of a partnership or corporate interest that also qualifies as an "interest in a closely held business."

[67] This is the underlying objective of section 2032A. *See* text accompanying note 2 *supra.*

[68] Kirby, *Choosing the Best Method of Holding Farm Assets Is Integral Part of Premortem Planning*, EST. PLAN., Autumn 1976, at 53.

[69] Treas. Req. § 1.708-(b)(1)(i)(a) (1956).

trust guarantees a smooth inter-generational transfer whenever the decedent's wife does not elect her statutory forced share of the estate.[71]

Once the method of holding the farm assets has been chosen, planning should ensure that recapture of the tax is a remote possibility. Through the farmer's will, the "qualified real property" should be channeled to those members of the decedent's family who will fulfill the requirements of section 2032A.[72]

One foreseeable problem is the possibility that the decedent's spouse will elect against the will for her statutory share of the estate and later sell the "qualified real property" to a nonfamily member.[73] Therefore, the sale would trigger recapture, and the benefits of section 2032A would be forfeited.[74] A plausible solution would be the irrevocable trust since it cannot be defeated by the surviving spouse. However, the effectiveness of this device is illusory: Section 2032A does not apply to what is essentially a gift.[75] Fortunately, two devices may provide a solution to this problem. One is a waiver from the farmer's spouse specifying that she is waiving her right of election.[76] The other is a will contract specifying that she will only sell the "qualified real property" to members of her family.[77] However, since both devices are contractual arrangement, two disadvantages exist: 1) The spouse may or may not agree to the contract; and 2) the court may or may not grant specific performance as a remedy for breach. Regardless, the members of the surviving spouse's family, who wish to continue

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[70] Kirby, *supra* note 68, at 55.

[71] U.P.C. 2-201. The decedent's spouse can defeat the revocable trust because it constitutes a "transfer to the extent that the decedent retained at the time of death a power, either alone or in conjunction with any other person, to revoke or to consume, invade or dispose of the principal for his own benefit." *Id.* 2-202(1)(ii).

[72] Smith & Scrow, *supra* note 8, at 56.

[73] *See* U.P.C. 2-201. The corresponding Colorado provision allows a one-half elective share. COLO. REV. STAT. § 15-11-201 (1973).

[74] *See* text accompanying note 40 *supra*.

[75] *See* Treas. Reg. 25.2512-1 and text accompanying notes 63 and 64 *supra*.

[76] U.P.C. 2-204: "The rights of election of a surviving spouse . . . may be waived, wholly or partially, before or after marriage, by a written contract, agreement, or waiver signed by the party waiving after fair disclosure."

[77] *Id.* 2-701:

> A contract to make a will or devise, or not to revoke a will or devise, or to die intestate . . . can be established only by (1) provisions of a will stating material provisions of the contract; (2) an express reference in a will to a contract and extrinsic evidence proving the terms of the contract; or (3) a writing signed by the decedent evidencing the contract. . . .

the farming operation and to avoid recapture, should attempt to purchase or lease the "qualified real property" from the surviving spouse.[78]

3. The Estate with Liquidity Problems

Another crucial factor in the decision to elect section 2032A involves its interaction with section 6166. In conjunction with section 2032A, section 6166 was enacted to ameliorate the estate tax problems of farmers and ranchers. Both sections can be elected simultaneously.[79] Section 6166 permits the executor to elect to pay by installments the estate tax over a fifteen year period.[80] The first installment may be deferred for five years; during this period only interest on the unpaid tax is due.[81] In addition, a special interest rate of four percent is charged on the first $345,800 in deferred estate tax, reduced by the unified credit allowable under section 2010(a).[82] However, the value of the farm assets must exceed 65 percent of the value of the adjusted gross estate before section 6166 can be elected.[83]

If the "special use" value is elected under section 2032A, the estate may forfeit the beneficial provisions of section 6166.[84] Section 6166(b)(4) provides that the value used to determine the federal estate tax, whether it be "highest and best use" or "special use" value, is the value used for purpose of the sixty-five percent requirement. Consequently, if the special use value of the farm realty significantly reduces the value of the total farm assets, the farm's value may not exceed sixty-five percent of the value of the adjusted gross estate.[85] Such failure to satisfy the sixty-five percent requirement forces a difficult decision since election of one of these code sections precludes the election of the

[78] *See* I.R.C. § 2032A(c)(1)(A).

[79] RESEARCH INSTITUTE, *supra* note 33, at 49.

[80] I.R.C. § 6166(a)(3).

[81] *Id.* §§ 6166(a)(3), (f)(1).

[82] *Id.* § 6601(j). The figure $345,800 represents the liability of a taxable estate of $1,000,000 pursuant to the tax rate schedule in section 2001(c). The interest rate of 4 percent is quite a bargain. Section 6621(a) specifies the general interest rate of 9 percent per annum, or a rate based on 90 percent of the average prime rate quoted by commercial banks to large business.

[83] *Id.* § 6166(a)(1).

[84] Rosen, *New Tax Savings Opportunities in Post-mortem Planning Provided by Tax Reform Act of 1976,* 18 TAX. FOR ACCOUNTANTS 86, 88.

[85] *Id.*

other. The basic test, therefore, is whether the estate's liquidity problems mitigated under section 6166 outweighs the tax avoided under section 2032A.

B. *Post-mortem Planning*

To avert recapture of the estate tax, the estate's personal representative and his counsel must periodically supervise the administration of the "qualified heir's" interest in the farm realty. This supervision, necessarily, must continue throughout the entire fifteen year recapture period. Not only do they have a duty to inform each "qualified heir" of his potential recapture tax liability,[86] but also a duty to discourage premature disposition of the "qualified heir's" interest. Therefore, the severe tax consequences of a premature disposition cannot be overemphasized. Moreover, the estate's counsel should anticipate, with effective tax planning, IRS audits; negligent planning may result in recapture.

1. Effects of Premature Disposition or Cessation

The tax consequences of a premature disposition of a "qualified heir's" interest or cessation of a "qualified use" of the "qualified property" can be disastrous. Section 2032A(c)(5) states that the recapture tax is due and payable on the day ending six months after the disposition or cessation. Interest is charged on the recaptured tax only on the period beginning six months after the day of disposition or cessation and ending on the day of the tax payment.[87] However, the recapture tax is not payable in installments. Section 6166(h)(1), the general installment payment provision, does allow installment payment for deficiencies in tax imposed by section 2001, the general estate tax imposition provision. However, the recapture tax is not imposed by section 2001, but by section 2032A(e)(1).[88] Therefore, the recapture tax is not payable in installments.

Another unfavorable consequence of premature disposition involves the election of section 6166 by an estate with liquidity problems. If the "qualified heirs" dispose of one third or more of the farm interest, then the extension of time for payment of estate

[86] Kirby, *supra* note 23, at 100.
[87] *See* I.R.C. §§ 6601(a), 2032A(c)(5).
[88] The new section states "there is hereby imposed an additional estate tax."

tax ceases to apply.[89] Any unpaid portion of estate tax payable in installments must be paid upon notice and demand from the Internal Revenue Service.[90]

Also, there will be a capital gains tax on any disposition of a "qualified heir's" interest.[91] This capital gain is the difference between the amount realized from a sale and the "qualified heir's" basis in the "qualified property."[92] Consequently, the "qualified heir" must decide how to report this gain. Under section 61(a)(3) the entire gain must be reported in the year of sale. Under section 453(b) only a portion of the gain is reported in any tax year, based on the installment payments actually received in that year.[93]

If the installment method under section 453 is elected, then the payments received from the purchaser cannot exceed thirty percent of the sale price in the year of disposition.[94] Due to this limitation, the payments received in the year of sale probably will be insufficient to pay the recaptured tax caused by the disposition.[95] If the capital gain is reported pursuant to section 61, then the purchase payments can be arranged to cover the recaptured tax liability. However, because the entire gain is reported in one

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[89] I.R.C. § 6166(g)(1)(A).

[90] *Id.*

[91] *See* I.R.C. § 61(a)(3).

[92] Basis will be determined by section 1023, enacted into the Internal Revenue Code under the 1976 Tax Reform Act. The section provides that the basis of the property in the hands of the "qualified heir" is the same as the decedent's basis, increased by certain adjustments. The fact that the transferee *may* have to pay the tax due to recapture does not increase the transferee's basis because of the tax's contingent nature. *See Columbus & Greenville R.R. Co.*, 42 T.C. 834, 848 (1964). Presumably, an increase would be allowed where the transferee actually pays the tax subject to recapture. *See* Case & Phillips, *supra* note 28, at 371.

[93] A person "may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price." I.R.C. § 453(a).

[94] I.R.C. § 453(b)(2)(B).

[95] For example, assume the following:

Sales Price of Interest	$500,000
Basis	200,000
Gain	$300,000

To elect section 453, the purchase payments cannot exceed 30 percent of $500,000, or $150,000, in the year of sale. Therefore, the "qualified heir" will be forced to finance any recapture tax in excess of $150,000.

tax year and thus is subject to higher tax brackets, additional income tax liability is incurred.

2. IRS Audits and Determinations

An IRS audit of an estate electing section 2032A will focus primarily on the section's valuation and recapture provisions. Effective planning is impossible for the former but not for the latter. Due to its subjectivity, valuation is always subject to an IRS attack. However, probable areas of IRS challenge warrant mentioning. First, because the "special use" value cannot decrease the "highest and best use" value by more than $500,000,[96] the agent can create additional estate tax liability. The gross estate will be increased to the extent either the "highest and best use" value is increased or the "special use" value is decreased.[97] Second, the agent could contend that the value of the farm asset fails to satisfy the fifty percent and twenty-five percent tests.[98] Such a determination would have the same effect as a recapture of the estate tax saved.[99]

Effective planning can preclude IRS determinations that result in recapture of the estate tax avoided pursuant to section 2032A. A determination either that "material participation" is lacking or the farming activity is primarily a "hobby" will result in recapture. The germane issue common to both determinations is whether the "qualified heir" is engaged in a "trade or business."

Section 2032A(c)(7)(B) provides that cessation of a "qualified use" occurs if there is no "material participation" by a "qualified heir" or "member of his family" in the operation of the farm.[100] The lack of "material participation" must involve periods aggregating three years or more during any eight-year period within fifteen years of the decedent's death.[101] As noted, "material participation" is determined by section 1402 which re-

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[96] *See* text accompanying note 33 *supra*.

[97] However, additional estate tax liability would occur only when the two values are adjusted after the maximum of $500,000 had already been reached.

[98] *See* text accompanying notes 15 and 16 *supra*.

[99] However, interest would accrue from the date the estate tax was due rather than when the recapture tax was due. *See* I.R.C. §§ 6601(a), 6151(a), 6075(a), and text accompanying note 87 *supra*.

[100] *See* text accompanying note 44 *supra*.

[101] *Id.*

lates to net earnings from self-employment.[102] The issue of whether the "qualified heir" materially participates usually arises when he leases the farm to a nonfamily member.[103] The committee report states unequivocably that mere passive rental of the farm does not constitute "material participation."[104] This statement is true because of the following general rule: income and expenses attributable to rent from real estate are not considered in determining net earnings from self-employment.[105] Therefore, the requisite "trade or business" involvement by the "qualified heir" is lacking.[106]

However, the "qualified heir" may still lease the farm and meet the "material participation" requirement under certain circumstances. The rental arrangement[107] must provide that the "qualified heir" shall materially participate in the "production"[108] or "management of production"[109] of the farm products. Fortunately, the IRS has delineated four objective tests of "material participation." The "qualified heir" or "member of his family" is deemed to materially participate in the "trade or business" of farming if:

> 1. he does any three of the following: a) pay for at least half of the direct costs of producing the crop; b) provides at least one half the equipment and livestock used in producing the crop; c) advises and consults with the tenant periodically; or d) inspects the production activities periodically;[110]
> 2. he takes a substantial part in management decisions that affect the success of the farm activity;[111]
> 3. he works 100 hours or more over a period of 5 weeks or more in activities associated with crop production;[112] or
> 4. he does things, when considered in the aggregate, which demonstrate a material or substantial involvement in the production of the farm goods.[113]

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[102] *See* text accompanying note 30 *supra*.
[103] FARMER'S TAX GUIDE, PUB. 225 (1977), at 54 [hereinafter cited as GUIDE].
[104] H.R. REP. NO. 1380, *supra* note 2, at 23.
[105] GUIDE, *supra* note 103, at 54.
[106] *See* note 30 *supra*.
[107] Treas. Reg. § 1.1402(a)-4(b)(3)(i) (1976).
[108] *Id.* § 1.1402(a)-4(b)(3)(ii) (1976).
[109] *Id.* § 1.1402(a)-4(b)(3)(iii) (1976).
[110] GUIDE, *supra* note 103, at 54. *See* Rev. Rul. 57-58, 1957-1 CB 270, 271. Treas. Reg. § 1.1402(a)-4(b)(3), (4) is the primary source for the Farmer's Tax Guide's Information on "material participation."
[111] GUIDE, *supra* note 103, at 54.
[112] *Id.* at 55.
[113] *Id.*

Using these guidelines, the estate's personal representative or his counsel can convert *passive* rental arrangements into *active* participation in the "trade or business" of farming. In borderline situations, however, they should timely document all facts indicating "material participation" in anticipation of an IRS challenge.

There exists another method by which the IRS may force recapture through the "trade or business" concept. The farm operation must be a "trade or business" before it is considered a "qualified use" of a farm.[114] Section 183(a) states that if any "activity is not engaged in for profit," then no deductions in excess of that activity's income is allowed. Section 183(c) defines an "activity not engaged in for profit" as one other than those activities under section 162 which permits a deduction incurred in carrying on a "trade or business." Therefore, if the IRS agent determines that the farming operation is not engaged in for profit by the "qualified heir," e.g., it is a hobby, the requisite "trade or business" of farming for a "qualified use" ceases. Consequently, the agent would disallow the farm's losses under section 183(a) and impose the recapture tax under section 2032A(c)(1)(B).

Careful tax planning avoids such a result. Section 183(d) provides a rebuttable presumption that the activity is engaged in for profit if in two years out of any five year period the activity produces a net profit. With an accountant's advice, the "qualified heir" can produce "accounting" net profits. If the "qualified heir" computes income under the cash method of accounting, these net profits are accomplished by postponing deductions and accelerating income items in a particular tax year.[115] Furthermore, Treasury regulations identify objective factors for determining the "qualified heir's" subjective intent to make a profit.[116]

[114] I.R.C. § 2032A(b)(2).

[115] *See* I.R.C. §§ 451, 461.

[116] Treas. Reg. 1.183-2(b)(1)-(9) (1972). These factors are:

1. the taxpayer's history of income or losses with respect to the activity;
2. the amount of occasional profits, if any, which are earned;
3. the cause of the losses;
4. the success of the taxpayer in carrying on other similar or dissimilar activities;
5. the financial status of the taxpayer;
6. the time and effort expended by the taxpayer in carrying on the activity;
7. the expertise of the taxpayer or his advisors;
8. the manner in which the taxpayer carries on the activity;

Many of these objective factors can be manipulated to remove any doubt as to the heir's bona fide profit intent. For example, one factor is the manner in which the "qualified heir" carries on the activity.[117] Therefore, the "qualified heir" should conduct the farm operation in a businesslike manner and maintain complete and accurate books and records; a profit intent is thus indicated.

CONCLUSION

For those who qualify and are willing to hold the farm property for fifteen years after the decedent's death, the new law offers substantial estate tax savings. More importantly, section 2032A ensures the continuation of the American family farm in two ways. First, farm assets need not be sold to pay the estate tax. Second, family members are encouraged to participate in farming before and after the decedent's death. Valuable farming knowledge is thereby passed from one generation to the next. In essence, Congress has drafted legislation aimed primarily at social engineering rather than revenue raising.

For the personal representative and his counsel, the new law does not offer a specious challenge. Certainly, the law is complex with myriad references to other Code sections. However, the law's true challenge arises from the exacting decisions required. The crucial decision is whether section 2032A should be elected. Once committed, the personal representative must cope with both the farm family and the Internal Revenue Service for fifteen years to avoid the spectre of recapture.

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9. expectation of profit by the taxpayer;

10. expectation that assets used in the activity may appreciate in value; and

11. elements of personal pleasure or recreation.

[117] *See* note 116, *supra*.