SECTION 2032A: DID WE SAVE THE FAMILY FARM?*

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On October 4, 1976, President Ford signed into law the Tax Reform Act of 1976.[1] The Act introduced fundamental changes in the system of federal estate and gift taxation,[2] including the unification of the estate and gift taxes, an increase in the marital deduction and the imposition of a new tax on generation skipping transfers.[3] One of the most significant changes, however, was made in the valuation area: Section 2003 of the Act[4] permits real property used for "farming purposes"[5] or closely held business uses to be

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1. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

2. J. McCord, 1976 Estate and Gift Tax Reform: Analysis, Explanation and Commentary 2 (1977).

3. For a detailed explanation of the provisions of the Tax Reform Act of 1976, *see generally* Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976 (1976) [hereinafter cited as General Explanation]. For an excellent discussion of the background of and problems raised by the Tax Reform Act of 1976, *see* J. McCord, *supra* note 2. *See also* J. Casner and R. Stein, Estate Planning Under the Tax Reform Act of 1976 (1977); Tax Research Inst. of America, The RIA Complete Analysis of the '76 Tax Reform Law (1976). On the tax on generation skipping transfers, see R. Covey, Generation Skipping Transfers in Trust, (3d ed. 1978).

4. Incorporated in the Internal Revenue Code as § 2032A.

5. "Farming purposes" and "farm" are defined in § 2003(a) of the Tax Reform Act of

valued for estate tax purposes on the basis of its use as a farm or business rather than on some speculative use.[6] However, because of the language of the statute, the matters included and the situations not provided for, the legislation permitting actual use valuation raises significant interpretive problems.[7] This Article will approach these problems from the standpoint of some fairly typical estate planning situations. Following an examination of the provisions of the statute and the difficulties encountered in ascertaining its meaning, an attempt will be made to determine in which of these situations the provisions of the statute will be most useful, and in which situations the statute hinders an estate planner's use of tools he has previously employed to distribute his client's proerty.[8]

I. BACKGROUND OF SECTION 2032A

A. *Farmers and the Federal Estate Tax*

The impetus for reform of the federal estate and gift tax system was primarily provided by three major studies instituted in the late 1960's and early 1970's.[9] These studies gave serious consideration to the problems of

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1976, incorporated into I.R.C. § 2032A(e) (4)-(5). *See* note 76 *infra*.

6. Prior to the enactment of the Tax Reform Act of 1976, the value of each item of property includable in a decedent's gross estate under I.R.C. §§ 2033-2044 was determined under Treasury Regulations adopted by the IRS as its fair market value at the time of the decedent's death, unless the executor elected the alternate valuation method under I.R.C. § 2032. Treas. Reg. § 20.2031-1. The fair market value is defined 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 to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(b).

7. A bill dealing solely with estate and gift tax reform (H.R. 14844) was introduced near the end of the first session of the 94th Congress and was taken up by the House Ways and Means Committee in the second session of the 94th Congress separately from another bill (H.R. 10612) which was primarily concerned with income tax changes. In the Senate, the estate and gift tax bill was not considered until the summer of 1976 and these proposed changes were never really discussed in detail. This procedure provided no time for discussion and consideration of the complexity and interrelationships among the provisions of H.R. 14844. J. MCCORD, *supra* note 2, at 1. Moreover, the changes recommended in H.R. 14844 were so complex and numerous that many commentators believe that even in the House there was too little time to develop and consider the impact of the provisions of H.R. 14844. *See, e.g., id.* at 1-2; S. SURREY, W. WARREN, P. MCDANIEL & H. GUTMAN, FEDERAL WEALTH TRANSFER TAXATION (1977) at 9-10.

8. During the Hearings before the Ways and Means Committee, Representative Steiger of Wisconsin remarked, "[w]e don't want to pass an accountants and lawyers relief act." *Federal Estate and Gift Taxes: Public Hearings and Panel Discussions Before the House Comm. on Ways and Means*, 94th Cong., 2d Sess. 875 (1976) [hereinafter cited as *House Hearings]*. Due to the complexity of the Tax Reform Act of 1976, Congress may have enacted exactly that.

9. D. KAHN & L. WAGGONER, FEDERAL TAXATION OF GIFTS, TRUSTS AND ESTATES 8 (1978). The studies were done by the American Law Institute (American Law Inst., *Federal Estate and Gift Taxation: Recommendations and Reporters' Studies* (1969), *reprinted in* STAFF OF HOUSE COMM. ON WAYS & MEANS, 94TH CONG., 2d SESS., BACKGROUND MATERIALS ON FEDERAL ESTATE AND GIFT TAXATION (Comm. Print 1976) [hereinafter cited as BACKGROUND MATERIALS], the

the preservation of the family farm for future generations and the prevention of the sale of farmland to pay federal estate taxes. This was one of the most discussed areas of estate tax reform.[10]

The farmer's dilemma was a result of several factors. First, and perhaps most significant, was the great increase in the value of land.[11] Iowa Representative Tom Harkin testified before the House Ways and Means Committee that the average value of farmland in Iowa was eighty-four dollars per acre in 1942 and $1,000 per acre in 1976.[12] Most of this increase has occurred recently. For example, the average value per acre of farmland in Iowa increased from $392 in 1970 to $801 in 1975.[13]

Second, the size necessary for a farm to be viable has been steadily increasing. In 1942, the average farm nationally was 182 acres.[14] In 1975, the average farm had doubled to 385 acres and in many farm states the average was higher.[15] This combination of increasing land values and increasing size of farms has vastly increased the value of the family farm's gross estate for federal estate tax purposes.[16]

Third, assets invested in agriculture traditionally have a very low rate of return.[17]

Treasury Department (U.S. Treasury Dep't, Tax Reform Studies and Proposals (Joint Pub., House Comm. on Ways & Means and Senate Comm. on Finance, 91st Cong., 1st Sess.) (Comm. Print 1969) [hereinafter cited as Treasury Proposals], *excerpts reprinted in* Background Materials, *supra), and the American Bankers Association (American Bankers Ass'n, Discussion Draft of Transfer Tax Statute and Explanatory Comments, reprinted in House Hearings, supra* note 8, at 63 [hereinafter cited as ABA Draft]).

10. This was recognized in the congressional debates on estate tax reform. Senator Gaylord Nelson said on the Senate floor "family farms and small commercial enterprises present the greatest difficulties in the estate tax area . . . ." 122 Cong. Rec. 25942 (1976) (remarks of Sen. Nelson).

11. *See, e.g., House Hearings, supra* note 8, at 419 (statement of Sen. Nelson). Senator Nelson stated: "In rural areas many farmers bought their land 30 or 40 years ago for $100 per acre. Now, productive farm land sells for over a thousand dollars an acre in 6 states and is approaching that level in 4 others." *Id.*

12. *House Hearings, supra* note 8, at 890 (statement of Rep. Harkin).

13. A table prepared by the Economic Research Service of the U.S. Dep't of Agriculture. *House Hearings, supra* note 8, at 422 (annexed to the statement of Sen. Nelson). *See also* American Bankers Ass'n, *Commentary on Proposed Tax Reform Affecting Estates and Trusts,* 8 *reprinted in House Hearings, supra* note 8, at 287 [hereinafter cited as ABA Commentary]. This trend has continued. The average value of an acre of Iowa farmland on November 1, 1978 was $1,644, an increase of 13% in one year. Des Moines Register, Dec. 15, 1978 at 1A, col. 4. In Scott County, Iowa, the average price of farmland on November 1, 1978 was $2,558 per acre. *Id.* Moreover, sales of Iowa farmland can bring a price greatly in excess of the average. A sale of 153 acres near Spencer, Clay County, Iowa in 1978 brought $3,225 an acre. Des Moines Register, Sept. 2, 1978, at 7S, col. 4.

14. *House Hearings, supra* note 8, at 11.

15. *Id.;* 122 Cong. Rec. 30855 (1976) (remarks of Rep. Bedell).

16. *See Contemporary Studies Project: Large Farm Estate Planning and Probate in Iowa,* 59 Iowa L. Rev. 794, 984 app. I (1974).

17. *See* Kelley, *The Farm Corporation as an Estate Planning Device,* 54 Neb. L. Rev.

Finally, the method by which real property is valued for the federal estate tax added to the problem. As previously stated, real property is valued for federal estate tax purposes at its fair market value.[18] However, the fair market value of real property is not based on its actual use on the date of a decedent's death, but rather on its "highest and best use." Simply stated, farmland is not always valued as a farm, with a possible reduction in value compensating for the low rate of return on farmland. The Internal Revenue Service will value the land based on what its investigation reveals to be the highest and best use, based on its opinion as to the short-term development of the area.[19] Land adjacent to municipalities may often be valued on potential development as residential or commercial property.[20] This problem is illustrated by the position of the Internal Revenue Service in *Estate of Ethel C. Dooly*.[21] Ethel Dooly died in 1964 owning stock in two closely held corporations, Dooly Corporation and Island Ranching Company. Dooly Corporation's assets included over half the outstanding shares of Island Ranching. The dispute centered on the valuation of the shares of Island Ranching, which actively conducted a ranching business in Utah, Wyoming and Idaho. Antelope Island, the headquarters of Island Ranching, is located in the Great Salt Lake, west of Salt Lake City, Utah. In 1964 most of the population growth in this area was eastward from Salt Lake City.[22] The area of Wasatch Mountains, east of Salt Lake City, had been developed for summer homes, hunting, fishing and ski resorts. Only industry was expanding to the west of Salt Lake City, and private recreation centers which had operated in that area had generally failed.[23] The only connection by road to the island at the time of Ethel Dooly's death was a three-mile-long

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217, 218 (1975). Kelley states that the average rate of return on such assets is "scarcely" three percent. *But see House Hearings, supra* note 8, at 356-57 (statement of Robert M. Brandon, Public Citizen Tax Reform Research Group).

18. *See* note 6 *supra*.

19. Internal Revenue Service, Audit Technique Handbook for Estate Tax Examiners, § 520(2) *reprinted in* II INTERNAL REVENUE MANUAL (CCH) § 4350 at 7625-29.

> Inherent in this definition [of fair market value] is the requirement that the highest and best use of the property be considered. Thus, use of the land for farming purposes might not be its highest and best use if it were located within a good business area or within a substantial residential development area. Highest and best use of the property is the use which prudence dictates will, over a reasonably foreseeable period of time, produce the highest net return or benefits.

20. *House Hearings, supra* note 8, at 7 (statement of L.C. Carpenter, Midcontinent Farmers Assoc.). Moreover, speculators may increase the price of land beyond its productive value based on future development or tax loss considerations. *See also House Hearings, supra* note 8, at 356 (statement of Robert M. Brandon). "According to USDA surveys, the average value of all farmland in the United States reached $370 per acre by March, 1975, but land transferred to industrial uses brought $1,872 per acre, subdivision land brought $1,574 and land conveyed to rural residential $974." *Id.*

21. 31 T.C.M. (CCH) 814 (1972).

22. *Id.* at 815.

23. *Id.*

causeway maintained by Island Ranching. Sewage dumped in the lake caused insect problems and an unpleasant odor. The island was unusually susceptible to electrical storms and there were no sewage facilities on the island.[24] Efforts to turn the island into a national park had been unsuccessful, and Island Ranching had never been approached by private developers.[25]

The estate valued its block of Island Ranching stock at $4.00 per share. The IRS valued the estate's block of Island Ranching at $14.00 per share (later amended to $20.14), and the block of Island Ranching owned by Dooly Corporation at $20.14 per share (later amended to $22.67).[26] The major reason for the high valuation by the Internal Revenue Service was that the IRS contended that recreation, rather than ranching, was the highest and best use of Antelope Island,[27] despite the significant evidence to the contrary. The court rejected the contention of the IRS, stating that to find recreation as the highest and best use of Antelope Island in 1964 would be "to engage in mere speculation and conjecture."[28] The important point is not that the court found against the IRS, but that, given the compelling arguments for treating the island as a ranch, the IRS forced the estate to go to court by maintaining its untenable view. It is not difficult to imagine that many estates, for economic or other reasons, have not challenged the IRS valuations in court, and as a result had property overvalued based on the same speculative developmental approach advocated by the IRS in *Estate of Ethel C. Dooly*.[29]

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24. *Id.* at 815-16.

25. *Id.* at 819.

26. *Id.* at 816-17. Thus the difference between the valuations of the Island Ranching stock was as follows:

	Estate	IRS
Estate's 9,690 shares	$38,760	$195,157
Dooly Corp.'s 50,010 shares	$200,040	$1,133,727
	$238,800	$1,328,884

It is not possible from the opinion to determine exactly the valuation of the stock asserted by the estate. The estate's expert witness valued the smaller block at $3.50 per share and the larger block at $5.25 per share, and it is possible that the estate also valued the larger block at a higher value than the $4.00 value used on its estate tax return. The table above utilizes the $4.00 per share rate.

27. *Id.* at 818.

28. *Id.* The court reviewed the facts and concluded that there was "no reasonable probability that a private party would purchase the island for a recreation area in 1964," *id.* at 819, and that the island's highest and best use in 1964 was as a ranch.

29. *See also House Hearings*, *supra* note 8, at 593 (statement of Nat'l Livestock Tax Comm., *et al.)*. This gives five examples, allegedly taken from actual case histories, of valuation practices used by the IRS resulting in unfair valuations. However, it is unclear whether the

B. *The Liquidity Problem*

In the 1940's, the value of farm land was so low that the owner of a family farm rarely paid an estate tax.[30] Since then, the estate tax exemption had remained constant,[31] but the combined effects of inflation, the rise in land values and the increase in the size of farms has increased the gross estate of most farmers far above the exemption limit,[32] resulting in the necessity of raising money to pay the estate tax due on the owner's death.[33] The low earnings-to-asset ratio prevents a farmer from accumulating liquid assets during his lifetime to pay the taxes.[34] In addition, a much larger percentage of a farmer's assets are in land and machinery than is true for a non-farmer.[35] The alternatives available were well-summarized in testimony before the House Ways and Means Committee:

> What are the sources which can be used to pay these [federal estate] taxes?
>
> The first is from farm earnings. As we know from looking at farm earnings, the production costs in the industry now are frequently higher than the income from those assets. So farm earnings cannot be counted on to supply the funds.
>
> The second is from nonfarm assets, but most farms and ranches do not have sufficient nonfarm assets to pay the Federal estate tax.
>
> The third place farmers and ranchers look to pay Federal estate tax is by borrowing the money, but farm and ranch indebtedness is already at record levels. Many farms and ranches are mortgaged to the hilt and

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results in these examples were caused by IRS decisions that the highest and best use of the land was other than farming and ranching or by other factors.

30. *See House Hearings, supra* note 8, at 419-20 (statement of Sen. Nelson); *id.* at 7 (statement of L. C. Carpenter).

31. Until the passage of the Tax Reform Act of 1976, the exemption was $60,000. Section 2001(a)(2) of the Tax Reform Act of 1976 added § 2010(a) and (b) to the Internal Revenue Code providing for a phased-in credit as follows:

For decedents dying in	Credit
1977	$30,000
1978	$34,000
1979	$38,000
1980	$42,500
1981	$47,000

The credits are equivalent to exemptions of approximately $120,667, $134,000, $147,333, $161,563 and $175,625, respectively.

32. *Contemporary Studies Project, supra* note 16, at 928-29.

33. *See Tax Reform, 1969: Hearings on Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess. pt. 11, 4031 (1969) (statement of Rep. Price) [hereinafter cited as *Tax Reform Hearings]*.

34. *See Contemporary Studies Project, supra* note 16, at 928-29; *Tax Reform Hearings, supra* note 33, at 4028-29 (statement of Stephen H. Hart on behalf of the Nat'l Livestock Tax Comm.).

35. *House Hearings, supra* note 8, at 356 (statement of Robert M. Brandon).

> cannot borrow enough money to pay the tax.
>
> That leaves the fourth alternative. That is to sell part or all of the farm or ranchland to pay Federal estate taxes. This is what has caused the problem.[36]

The number of farms has decreased greatly since World War II and is expected to continue to decrease,[37] and there is at least some statistical evidence supporting the allegation that a significant portion of this decrease in the number of farms is attributable to sales to pay federal estate taxes.[38] In addition, some farms have undoubtedly been sold to pay federal estate taxes in cases where the buyer was also a farmer, thus not resulting in a decrease in the number of farms.

C. *The Jeffersonian Ideal in Modern Times*

Despite some statistical evidence indicating the liquidity problem could and should be solved by other means,[39] the farmers' lack of liquidity was

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36. *House Hearings, supra* note 8, at 588-89 (statement of Samuel P. Guyton).

37. Note, *Material Participation and the Valuation of Farm Land for Estate Tax Purposes Under the Tax Reform Act of 1976,* 66 Ky. L.J. 848, 850-51 (1977-78) [hereinafter cited as Note, *Material Participation]*. The author states that since World War II the number of farms in the U.S. decreased by over 2,000,000 and that the prognosis is that an additional 200,000 farms will be lost in the next 20 years. *See also* 122 Cong. Rec. 30855 (1976) (remarks of Rep. McCollister).

38. ABA Commentary, *supra* note 13, at 8-9, *reprinted* in *House Hearings, supra* note 8, at 285-86. The ABA comments state in part: "Our member banks in farm areas have confirmed the fact that a substantial number of farm sales are made by estates and that the number has been increasing in recent years. The primary reason is that the value of farm land has been increasing rapidly." *See House Hearings, supra* note 8, at 592 (statement of National Livestock Tax Comm., *et al.)*, quoting a Department of Agriculture report which stated that one-fourth of all farm real estate transfers are for the purpose of estate settlement. The same report was quoted by Senator Bentsen in the debate on the bill on the Senate floor. 122 Cong. Rec. 25955 (1976). *See also House Hearings, supra* note 8, at 419-20, where Senator Nelson stated that in 1975 the Senate Small Business Committee heard testimony that almost a third of the farms in the Northwest are being sold to pay estate and inheritance taxes. In testimony before the House Ways and Means Committee, Rep. Charles E. Grassley stated:

> In 1957 a survey of 76 Iowa farm landowners revealed that if each of the landowners were to die on the day of the survey, 91 percent would not have sufficient liquid assets to pay the estate taxes.
>
> In 1963 Brown University published the results of a study of farms that were sold or merged from 1955 to 1959. It concluded that estate taxes were responsible in 60 percent of the cases. A 1974 study of Iowa farm estates generated a similar conclusion.

House Hearings, supra note 8, at 677. However, the Iowa study cited by Rep. Grassley did not conclude that farmers truly had a liquidity problem. *See* note 39 *infra*.

39. The Iowa study cited by Rep. Grassley came to the following conclusion:

> Many authorities have commented on the liquidity problems commonly thought to be associated with farm estates. According to the hypothesis, while the level of liquid assets in most estates remains relatively constant, rising land values and fixed death tax exemptions, coupled with estate tax rates which have either remained constant or

persuasive to Congress.[40] It was persuasive because it raised two emotional

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> increased, all combine to cause a widening gap between probate taxes and costs on the one hand and the pool of liquid assets available for their payment on the other.
>
> The findings of this study fail to bear out the existence of the liquidity problem postulated by these authorities — at least among the 64 *probate* estates which were examined. There was a *potential* liquidity problem among *living farmers*, however. But rather than indicating any pervasive dissimilarity between the two groups, the difference in liquidity appears to show merely that farm operators generally acquire greater amounts of liquid assets between retirement and death.

Contemporary Studies Project, *supra* note 16, at 928-29 (emphasis in original).

Two widely respected authorities in estate planning, Professor Stanley S. Surrey and former Internal Revenue Commissioner Jerome Kurtz, also question the existence of a liquidity problem in most farm estates, arguing that the problem, if it exists, is not as great as it appears and could be corrected by liberalizing the provisions of the Code providing for extensions of time for the payment of the estate tax. Kurtz & Surrey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, The Criticisms, and a Rebuttal*, 70 COLUM. L. REV. 1365, 1396-1400 (1965). Kurtz and Surrey cite the testimony of an attorney with a small to medium size practice at earlier hearings before the House Ways and Means Committee, stating that it was his experience that when an owner sells a closely held business, he does it for non-tax reasons, either because his children have no interest in running the business and he is too old or for other reasons. If the owner truly desires to pass the business on to the next generation, a way to solve the estate tax problem is always found. In his view, the liquidity argument in most cases is only window-dressing. *Id.* at 1399 *citing Tax Reform, 1969: Hearings Before The House Comm. on Ways and Means*, 91st Cong., 1st Sess. pt. 13, at 4865-69 (statement of Donald C. Lubick).

The Treasury Department felt that the problem was one of failure to use existing methods already authorized by existing statutes and lack of careful estate planning:

> Estates which contain farms or closely held family businesses sometimes encounter difficulty in finding the cash needed to pay the Federal taxes which become due shortly after death. This problem can arise as a result of improper estate planning, rapid appreciation in the value of an asset, or reluctance to sell an asset for sentimental or business reasons. The inability to pay death taxes in a timely fashion is here referred to as the "liquidity problem".
>
> Careful business and estate planning can help to eliminate the liquidity problem. Moreover, the Internal Revenue Code already provides installment payment privileges for use in situations in which an estate contains a farm or other closely held business.

TREASURY PROPOSALS, *supra* note 9, at 401, BACKGROUND MATERIALS, *supra* note 9, at 301. However, there is evidence that very few estates ever request relief under the installment payment privilege of § 6166, mainly because the executor remains personally liable for the 10 year installments. According to one Internal Revenue Service District Officer in Omaha, only about five percent of farm estates ever request relief under § 6166. *House Hearings*, *supra* note 8, at 355-56 (statement of Robert M. Brandon).

In the Tax Reform Act of 1976, the standard for obtaining an extension of time to pay taxes on deficiencies under §§ 6161(a)(2), (b)(2) & 6163(b) was changed from "undue harship" to "reasonable cause". The Act also renumbered former § 6166 as § 6166A and added a new § 6166, providing for a deferral of principal payments of tax for up to five years after the normal due date and payment of the principal in at least two but not more than ten annual installments after the deferral period. New § 6166 is available to defer that portion of the tax attributable to the inclusion in the gross estate of the value of a closely held business (including farms). For a discussion of these new rules see J. MCCORD, *supra* note 2, at 361-77; Hjorth, *Special Estate Tax Valuation of Farmland and the Emergence of a Landholding Elite Class,* issues. First, most senators and congressmen intuitively felt that it was never the purpose of the federal estate and gift tax system to cause the break-up of small family farms. The decrease in the number of farms raised the spectre of a large portion of the farms in America coming under the control of large corporate farming operations.[41] Second, the farm liquidity problem permitted its proponents to appeal to the tradition of the patriotic, democratic, hard-working farmer. This provided an opportunity few legislators could resist to praise the independent small farmer. Perhaps the best of these orations was given by Senator Gaylord Nelson:

> On a strictly economic level, family farms and businesses have proven to be the most efficient producers of food, shelter, and many other basic and convenience goods and services that can be found anywhere in the world.
>
> The bonus to our society is that what these successful entrepreneurs do for the towns and cities that prospered them.
>
> For 200 years in this country we have had a system where farms and businesses could be passed along from one generation to another. These enterprises put down roots in their communities. Their owners come to care about their employees, their customers, their churches, schools, and hospitals. They work in local charities and clubs and are the cement of community life.
>
> Thomas Jefferson perceived this two centuries ago at the time of the Revolution when he wrote about the value of the independent freeholder with a stake in society. In this our Bicentennial Year, death levies are threatening to destroy this system by taxing it out of existence.
>
> . . . .
>
> In my view, there is as much hard economic value as there is social

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53 Wash. L. Rev. 609, 631-39 (1978). For an analysis of the possible effects of new § 6166 on estate planning for farmers, see Hjorth, *id.* at 658-62. It is too early to determine if the changes in these provisions will encourage their greater use by farm estates.

40. *See* 122 Cong. Rec. 25955 (1976) (remarks of Sen. Bentsen).

41. *Id.* Senator Bentsen stated in part:

> In some cases, heirs are forced to sell part or all of a family farm or business in order to pay the heavy estate tax burden. This obviously hurts the family that loses its farm or business. It also hurts the community that loses the support and concern that local ownership brings. And it hurts our National economy. When family farms and ranches are taken over by huge corporate farming operations; and when independent and innovative small businesses are taken over by large outside corporations; the healthy competition our economy needs to provide stable non-inflationary growth is undermined.
>
> . . .
>
> The Federal estate tax was never intended to break up small family farms and ranches. After working hard all their lives, after struggling with the uncertainties of the elements, farmers and ranchers deserve better than to have their heirs forced to sell their land for taxes. And as consumers who count on continued high agriculture production, all other Americans deserve better, too.

See also 122 Cong. Rec. 30855 (1976) (remarks of Rep. Bedell).

> merit in preserving the building blocks of our free enterprise system . . . .
>
> There are further benefits to our political democracy in keeping power decentralized among smaller economic units and in bolstering self-reliance and independence among our citizens.
>
> In my view, the preservation of small family enterprises, which embody so many of the basic traditional values of this country, is an adequate reason for distinguishing in the estate tax laws between our most productive citizens and those whom the law might allow, even encourage, to be completely unproductive.[42]

When a system poses a threat to a group which can generate such an emotional appeal, the system is usually changed to remove the threat.

II. Structure of Section 2032A

A. *The Congressional Purpose*

The congressional response to the farm liquidity problem was the addition of Section 2032A to the Internal Revenue Code in the Tax Reform Act of 1976.[43] The Report of the House Ways and Means Committee described the reasons for the change:

> 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.
>
> However, your committee recognizes that it would be a windfall to the beneficiaries of an estate to allow real property used for farming or closely held business purposes to be valued for estate tax purposes at its farm or business value unless the beneficiaries continue to use the property for farm and business purposes, at least for a reasonable period of time after the decedent's death. Also, your committee believes that it

42. 122 Cong. Rec. 25944 (1976).
43. Tax Reform Act, *supra* note 1, § 2003.

> would be inequitable to discount speculative values if the heirs of the decedent realize these speculative values by selling the property within a short time after the decedent's death.
>
> For these reasons, your committee has provided for special use valuation in situations involving real property used in farming or in certain other trades or businesses, but has further provided for recapture of the estate tax benefit where the land is prematurely sold or is converted to nonqualifying uses.[44]

The *House Report* shows the tension felt in Congress between the practical and political necessity of providing relief for family farms and businesses and the need (based on revenue and equitable considerations) to limit the relief granted. The congressional purpose was twofold: to provide relief for a class of estates in which a significant portion face severe liquidity problems, and to minimize the possibility that real property, particularly farmland, will be removed from agricultural production, and more particularly, from family ownership.[45]

B. *Methods of Valuation under Section 2032A*

If the provisions of section 2032A are met, the value of the "qualified real property" is, for estate tax purposes, its value for use as a farm for farming purposes or its use in a trade or business other than farming as the case may be.[46] The statutory method for valuing qualified real property shows that the primary concern of the statute was farms. Section 2032A(e)(7) provides a method of valuation available only to farms. The section provides that the value of a farm for farming purposes is obtained by dividing:

> (i) the excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm over the average annual State and local real estate taxes for such comparable land, by
>
> (ii) the average annual effective interest rate for all new Federal Land Bank loans.[47]

However, the above formula may not be used where it is established that there is no comparable land from which the average gross cash rental may be determined or where the executor elects to have the value deter-

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44. H.R. Rep. No. 94-1380, 94th Cong., 2d Sess. 21-22 (1976), *reprinted in* [1976] U.S. Code Cong. & Ad. News 3356, 3375-76 [hereinafter cited as House Report]. *See also* General Explanation, *supra* note 3, at 537.

45. *See* J. McCord, *supra* note 2, at 309; Note, *Material Participation*, *supra* note 37, at 873.

46. I.R.C. §§ 2032A(a)(1) & (b)(2).

47. The section further provides that each average annual computation shall be made on the basis of the five most recent calendar years ending before the date of decedent's death.

mined under the alternate formula.[48]

In all cases where the "farm method" of section 2032A(e)(7) is not or may not be used, the so-called "multiple factor" method of section 2032A(e)(8) must be used.[49] The multiple factor method is no more certain in enabling the executor to determine how to compute the value or what data to use than is the previous "highest and best use" method of valuing farms.[50] Since it is unclear how each of the five factors are to be weighed[51] or combined into a single value, many of the same problems in valuing farms before the enactment of section 2032A will be present if the "multiple factor" formula is elected or must be used.[52] The inclusion of section 2032A(e)(8)(e) ("any other factor which fairly values the farm or closely held business value of the property"), could permit consideration of many of the same arguments employed by the Internal Revenue Service under the "highest and best use" standard.

C. *Obstacles to the Use of Section 2032A(e)(7) — What is Comparable Land?*

It is expected that most executors will elect the "farm method" under section 2032A(e)(7) to value qualifying real property.[53] It can easily be

48. I.R.C. § 2032A(e)(7)(B).

49. I.R.C. § 2032A(e)(8). The factors 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 business,

(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.

50. M. Boehlje & N. Harl, "Use" Valuation Under the 1976 Tax Reform Act: Problems and Implications 9-10 (Iowa State University, Dep't of Economics, Staff Paper No. 72, 1978).

51. *Id.*

52. Among these problems are which sales are "comparable," the reliability of appraisers, their knowledge and expertise (both generally and of local conditions), and possible development of the surrounding area. *See, e.g.*, Estate of Chloe A. Nail, 59 T.C. 187 (1972); Estate of Ethel C. Dooly, 31 T.C.M. (CCH) 814 (1972); Estate of C. Glen Vinson, 22 T.C.M. (CCH) 280 (1963). *See generally* Kelley, *Estate Tax Reform and Agriculture*, 7 U. Tol. L. Rev. 897 (1976) [hereinafter cited as Kelley, *Tax Reform]*, and especially Appendix A thereto.

53. Bock & McCord, *Estate Tax Valuation of Farmland Under Section 2032A of the Internal Revenue Code: An Analysis of the Recently Proposed Treasury Regulations*, 1978 S. Ill. U.L. J. 145, 148.

shown that use of the farm method can result in great savings in estate taxes.[54] However, the statute creates certain obstacles to the use of the farm method. Several of these will be briefly discussed.

The purpose of providing this method is explained in the *House Report:*

> The special farm valuation method is provided to permit the executor, in many situations, to achieve a substantial amount of certainty in arriving at use valuation for farmland as well as to eliminate nonfarm factors in valuing farmland. Since this method involves a mathematical computation in which the amount of the annual rental may in many cases be determinable with reasonable certainty and the capitalization rate is determinable, this method should offer three advantages. First, it should reduce subjectivity, and thus controversy, in farm valuation. Second, it should eliminate from valuation any values attributable to the potential for conversion to nonagricultural use. Third, it should also eliminate as a valuation factor any amount by which land is bid up by speculators in situations where nonagricultural use is not a factor in inflated farmland values.[55]

The average annual effective rates on Federal Land Bank loans in the various districts are easily determinable and have been determined for estates of decedents dying in 1977 and 1978.[56] However, the statute requires the use of "the average annual gross cash rental" for comparable land used for farming purposes and "located in the locality of such farm."[57] There is no definition in the statute of "locality." Furthermore, in the midwest, many farm leases are in the form of crop sharing or percentage of crop arrangements, rather than cash rent.[58] Lastly, and perhaps most significantly, there is the problem of identifying "comparable" farmland. The last problem is probably the most important, since in the absence of comparable land, the farm method cannot be used by the executor.[59]

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54. One author has performed the computation for a hypothetical farm in Winnebago County, Illinois. In that county, the average annual gross cash rental value during the past five years of the average farm with a fair market value of $2,000 per acre is approximately $75 per acre. The average real estate taxes are about $9 per acre. Using 8 ¾ % as the average effective Federal Land Bank loan rate, he computed a value of $754 per acre. On a 400-acre qualifying farm, this results in a reduction of the value of the taxable estate by nearly $500,000. Kinley, *Some Thoughts on Section 2032A,* 1978 U. Ill. L. F. 409, 410 (1978). It should be noted that an attempt is being made to determine the factors relevant to determine the 2032A(e)(7) valuation of qualifying real property in Iowa. *See* M. Boehlje & N. Harl, *supra* note 50, at 26-44.

55. House Report, *supra* note 44, at 24-25. *See also* General Explanation, *supra* note 3, at 540.

56. The rate for decedents dying in 1977 range from 8.21% (St. Paul District) to 8.70% (Omaha District). The rates for decedents dying in 1978 range from 8.47% (St. Paul District) to 8.92% (Omaha District). Rev. Rul. 78-363, 1978-2 C.B. 232. For 1979 rates, *see* Rev. Rul. 79-189, I.R.B. 1979-25, 7.

57. I.R.C. § 2032A(e)(7)(A)(i).

58. J. McCord, *supra* note 2, at 333.

59. I.R.C. § 2032A(e)(7)(B)(i). It should be noted that this subsection does not specifically

The Internal Revenue Service has issued proposed regulations explaining section 2032A(e)(7) which clarify these questions to some extent.[60] The proposed regulations define gross cash rental rather narrowly by requiring that the rentals result from an arm's length transaction and by excluding rents paid wholly in kind *(e.g.,* crop share), the cash portion of rents paid partially in kind, and rentals under leases if the lessor participates in the management or operation of the farm to the extent that would qualify as material participation.[61] Also, lands leased from the federal government or any state government which are leased for less than the amount which would be demanded by a private individual for profit, and leases between family members not providing a return commensurate to that under leases between unrelated parties in the locality are not "arm's length transactions" and cannot be used.[62]

The proposed regulation also defines comparable real property.[63] Unfor-

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require that the "comparable land" be in the locality of the farm owned by the decedent, as does § 2032A(e)(7)(A)(i). However, § 2032A(e)(7)(B) provides that the "farm method" shall not be used where there is no comparable land from which the average annual gross cash rental may be determined. This appears to be a clear cross-reference to § 2032A(e)(7)(A)(i).

60. Proposed Treas. Reg. § 20.2032A-4, 43 Fed. Reg. 31,042 (1978). Proposed Treas. Reg. § 20.20 32A-4(b) was withdrawn and a new regulation proposed on September 10, 1979, 44 Fed. Reg. 52697 (1979).

61. Proposed Treas. Reg. § 20.2032A-4(b), 44 Fed. Reg. 52697 (1979). The earlier version of this proposed regulation would have permitted the use of crop share leases to determine cash rental value under two conditions: first, no farm real property in the same locality was both comparable and leased on a cash basis and, second, the products or crops received must be disposed of for cash or in an arm's length transaction occurring in the normal course of business under local farming pracctices. The former proposed regulation represented a reasonable interpretation of the staute by the Internal Revenue Service. The new proposed regulation is unnecessarily restrictive and conforms to neither the statutory language nor the congressional purpose. Its promulgation is further proof of the evident desire of the IRS to severely restrict the use of the "farm method" of valuation. See text accompanying notes 64-68 *infra.*

As to material participation, see Sections III and IV *infra.*

62. Proposed Treas. Reg. § 20.2032A-4(b)(2)(ii), 44 Fed. Reg. 52697 (1979).

63. Proposed Treas. Reg. § 20.2032A-4(d), 43 Fed. Reg. 31043 (1978). The proposed regulation provides as follows:

> (d) *Comparable real property defined.* Comparable real property must be situated in the same locality as the specially valued property. This requirement is not to be viewed in terms of mileage or political divisions alone, but rather is to be judged according to generally accepted real property valuation rules. The determination of properties which are comparable is a factual one and must be based on numerous factors, no one of which is determinative. It will, therefore, frequently be necessary to value farm property in segments where there are different uses or land characteristics included in the specially valued farm. In such a case, actual comparable property for each segment must be used, and the rentals and taxes from all such properties combined for use in the valuation formula given in this section. However, any premium or discount resulting from the presence of multiple uses or other characteristics in one farm is also to be reflected. *All factors generally considered in real estate valuation are to be considered in determining comparability under section 2032A.* While not intended as an exclusive list, the following factors are among those to be considered

tunately, the definition makes a mockery of the statute's avowed purpose to "permit the executor, in many situations, to achieve a substantial amount of certainty in arriving at use valuation of farmland"[64] and to "reduce subjectivity, and thus controversy, in farm valuation."[65] The key sentence in the proposed regulation is "[a]ll factors generally considered in real estate valuation are to be considered in determining comparability under section 2032A."[66] For years the Internal Revenue Service has been contesting this same issue under the rubric of determining fair market value by the techniques of comparable sales.[67] The Service in a given case may always argue there are no comparable sales in the locality based on its appraiser's finding of a difference in one or more of the factors listed in the proposed regulation or any other factor it finds significant, or it can argue that only land rented at a very high cash rental is comparable. If history is any guide, the Service will take the same posture in determining what is "comparable real property" as it did and does in determining what is "highest and best use" and in determining what is a "comparable sale" to determine what is fair market value.[68] If this assumption is correct, aided by the rule that a determination made by the Internal Revenue Service is presumed correct,[69] the proposed regulation will encourage, rather than discourage, litigation. If this proves to be the case, section 2032A will have failed in one of its primary purposes.

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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 conditions 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; and

(10) Availability of, and type of, transportation facilities in terms of costs and of proximity of the properties to local markets. (emphasis added).

64. House Report, *supra* note 44, at 24.

65. *Id.*

66. Proposed Treas. Reg. § 20.2032A-4(d), 43 Fed. Reg. 31,043 (1978).

67. *See, e.g.,* Estate of J.S.A. Spicer, 33 T.C.M. (CCH) 45 (1974); Estate of Ethel C. Dooly, 31 T.C.M. (CCH) 814 (1972); Estate of S. Glen Vinson, 22 T.C.M. (CCH) 280 (1963). *See generally* Kelley, *Tax Reform, supra* note 52; Kelley, *Farmland Values for Estate Tax Purposes*, 22 Prac. Lawyer 71 (Jan. 1976).

68. *See* notes 19, 66 *supra.*

69. *See* Wells Fargo Bank & Union Trust Co. v. McLaughlin, 79 F.2d 934 (9th Cir.), *cert. denied*, 296 U.S. 638 (1935); Germantown Trust Co. v. Lederer, 263 F. 672 (3d Cir. 1920).

D. *Section 2032A Requirements*

For the special use valuation to be allowed, the following criteria must be met:

1. The decedent was a United States citizen or resident at the time of his death;[70]
2. The executor must elect to have the section applied[71] and file a written agreement signed by each person who has an interest in the property valued under section 2032A[72] consenting to the recapture provisions;[73]
3. The real property must be located in the United States;[74]
4. The property must have been used on the date of the decedent's death for a qualified use[75] (defined as use as a farm for farming purposes[76] or use in a trade or business other than farming[77]);
5. Fifty percent or more of the adjusted value of the gross estate must consist of the adjusted value of real or personal property which, at the decedent's death, was used for a qualified use.[78] (Adjusted value of the gross estate is the value of the gross estate, determined without regard to 2032A, reduced by the amount of any deduction allowed under section 2053(a)(4).[79]

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70. I.R.C. § 2032A(a)(1)(A).

71. I.R.C. §§ 2032A(a)(1)(B), (d)(1).

72. I.R.C. §§ 2032A(a)(1)(B), (d)(2).

73. *See* I.R.C. § 2032A(c). *See also* Section V *infra*.

74. I.R.C. § 2032A(b)(1).

75. *Id.*

76. I.R.C. § 2032A(b)(2). "Farm" is broadly defined to include "stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands." I.R.C. § 2032A(e)(4). "Farming purposes" is also broadly defined as meaning:

> (A) cultivating the soil or raising or harvesting any agricultural or hotricultural commodity (including the raising, shearing, feeding, caring for, training and management of animals) on a farm;
>
> (B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural 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; and
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> (C) (i) the planting, cultivating, caring for, or cutting of trees, or
> (ii) the preparation (other than milling) of trees for market.

I.R.C. § 2032A(e)(5). The broad definitions were intentional. The House Ways and Means Committee and the Conference Committee intended the activities engaged in on the real property would be determinative of whether real property is used as a farm for farming purposes. *See* House Report, *supra* note 44, at 23; General Explanation *supra* note 3, at 538.

77. I.R.C. § 2032A(b)(2)(B).

78. I.R.C. § 2032A(b)(1)(A).

79. I.R.C. § 2032A(b)(3)(A). Section 2053(a)(4) allows a deduction from the gross estate for the amount of "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" if such deduction is allowable by the law of the jurisdiction under which the estate is being administered.

For real or personal property, it is the value of the property, determined without regard to 2032A, reduced by the amount of any 2053(a)(4) deduction as to such property.[80]);

6. Twenty-five percent or more of the adjusted value of the gross estate must consist of the adjusted value of real property which was being used for a qualified use on the date of decedent's death;[81]

7. The "qualified real property" (any property eligible for special use valuation) must be acquired from or passed from the decedent to a qualified heir;[82] and

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80. I.R.C. § 2032A(b)(3)(B).

81. I.R.C. § 2032A(b)(1)(B).

82. I.R.C. § 2032A(b)(1)(A)(ii) and (b)(1)(B). The wording of the statute makes it clear that the first two requirements of I.R.C. § 2032A(b)(1) can be combined as follows: 50% or more of the adjusted value of the gross estate must consist of the value of real or personal property, must have been used for a qualified use on the date of the decedent's death and must also pass to a qualified heir from the decedent, and 25% or more of the adjusted value of the gross estate must consist of the adjusted value of real property meeting the same two requirements. 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." I.R.C. § 2032A(e)(1). Member of the family means as to any individual, such person's ancestor or lineal descendant, any lineal descendant of a grandparent of such individual, such person's spouse or the spouse of such descendant. I.R.C. § 2032A(e)(2). A legally adopted child of a person is treated as a blood child of such person for the purposes of the definition of "member of the family." *Id.* In light of the problems and differing results of statutes and court interpretations regarding the effect of adoptions, it is unclear if the IRS will permit an adopted person to qualify as a "member of the family" when such person is adopted by a collateral relative or a descendant of decedent. This may be particularly relevant in trust situations. *See* L. SIMES, HANDBOOK OF THE LAW OF FUTURE INTERESTS 218,220 (2d ed. 1966). There is no indication in the Committee Reports that Congress considered this problem when developing § 2032A.

It should also be noted that § 702(d)(1) of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (1978), which incorporated portions of the Technical Corrections Bill (H.R. 6715), amended § 2032A(b)(1) of the Internal Revenue Code to read:

> For the 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 . . . (emphasis indicates language added by the Revenue Act of 1978).

The Senate Committee Report states that the amendment was made because under the Tax Reform Act of 1976 it was not clear whether, if the estate otherwise qualified under the percentage tests, property used for a qualifying use but passing to persons who were not qualified heirs could be valued under § 2032A, and that the intent of Congress was that only property passing to a qualified heir was eligible for special valuation. SENATE COMM. ON FINANCE, TECHNICAL CORRECTIONS ACT OF 1978, S. REP. No. 95-745, 95th Cong., 2d Sess. 82 (1978).

The Revenue Act of 1978 also, in § 702(d)(2), added a new subsection to 2032A(e) to make it clear that distribution of qualified property by an estate or trust in satisfaction of a pecuniary bequest will not bar special use valuation by providing that such real property shall be deemed to have passed from the decedent. New § 2032A(e)(9) provides:

> (a) PROPERTY ACQUIRED FROM DECEDENT—Property shall be considered to have been acquired from or to have passed from the decedent if—
> (A) such property is so considered under section 1014(b) (relating to basis of prop-

8. For five years or more during the eight-year period ending on the date of decedent's death (a) the real property must have been owned by the decedent or a member of is family and used for a qualified use, and (b) the decedent or a member of this family must have materially participated in the operation of the farm or other business.[83]

Most of these requirements will be treated shortly.[84] Before doing this it should be noted that the section 2032A valuation of qualified real property cannot reduce the value of qualified real property (and thus cannot reduce a decedent's gross estate) more than $500,000.[85] It should also be noted that the Tax Reform Act of 1976 provided for recapture of all or a portion of the tax saved on certain dispositions of qualified real property within fifteen years of the decedent's death[86] and for a special lien for additional estate tax which may come due.[87] These matters will also be examined subsequently.

E. *Preliminary Problems of the Statute*

Certain of the requirements discussed in the preceding subsection create problems in achieving the goals of the statute. These goals were to provide relief for family farms and businesses from liquidity problems allegedly caused by the federal estate taxes, to prevent forced sales of family farms and to permit certainty in the use valuation of farmland.[88] One goal of the statute was presumably to avoid the frequent disputes between executors and the Internal Revenue Service over the fair market value of property.[89] It has been previously shown that the proposed regulations provide a great deal of opportunity for continued dispute over the elements making up both

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erty acquired from a decedent),

(B) such property is acquired by any person from the estate in satisfaction of the right of such person to a pecuniary bequest, or

(C) such property is acquired by any person from a trust in satisfaction of a right (which such person has by reason of the death of the decedent) to receive from the trust a specific dollar amount which is the equivalent of a pecuniary bequest.

To complete congressional treatment of pecuniary bequests, § 702(d)(3) of the Revenue Act of 1978 added the words "determined without regard to section 2032A" at the end of § 1040(a). This amendment was necessary to make clear that only the appreciation occurring after the date of death will be recognized as gain and that the amount of appreciation would be determined without regard to the special valuation rules.

83. I.R.C. § 2032A(b)(1)(C). For a discussion of the material participation requirement, *see* Section IV *infra.*

84. The requirements of decedent's United States citizenship or residence and the location of the real property in the United States need no elaboration. Material participation will be treated separately in Section IV *infra.*

85. I.R.C. § 2032A(a)(2).

86. I.R.C. § 2032A(c).

87. I.R.C. § 6324B.

88. House Report, *supra* note 44, at 21-22, 24. *See* text accompanying note 45 *supra.*

89. *See* text accompanying notes 19-29 *supra.*

the farm method and the multiple factor method under 2032A.[90] But the problem with appraisals is more extensive. Several provisions of section 2032A in practice require that two appraisals be made, one to determine the 2032A valuation and another to ascertain the fair market value of the property so that a determination whether the property qualifies for 2032A valuation can be made.[91] Sections 2032A(b)(1)(A) and (b)(1)(B) provide that fifty percent or more of the adjusted value of the gross estate consist of qualified real or personal property used for a qualified use and passing from the decedent to a qualified heir and that twenty-five percent or more of the adjusted value of the gross estate consist of qualified real property. Adjusted value is determined without regard to 2032A,[92] therefore, it must be determined at fair market value.[93] Moreover, the requirement that the special use valuation cannot decrease the value of the qualified real property by more than $500,000[94] requires a valuation at fair market value. There is nothing in the statute prohibiting the IRS from contesting any of these valuations. This could cause a change in the tactics of the IRS: instead of arguing a higher fair market value it could argue that the fair market value is low enough so that the estate will not meet the fifty percent or twenty-five percent tests. Alternatively, the IRS in many cases may continue to argue for a higher fair market value of the qualified property. If the court agrees, the amount of aid offered by 2032A will be reduced by the limit of 2032A(a)(2). For example, suppose the executor submits a fair market value appraisal of qualified real property of $1,000,000 and a use valuation of $500,000. The IRS argues that the fair market value of the qualified real property is $2,000,000. If the IRS is successful, the property will be valued in the estate at $1,500,000.[95] One effect of the statute is to give the IRS a choice of appraisals to attack and a number of possible strategies for increasing the estate tax on estates electing 2032A.[96] Of course, the increased cost and administrative burden on

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90. I.R.C. §§ 2032A(e)(7)-(8). *See* text accompanying notes 63-69 *supra*.

91. It is possible in a given case that four appraisals will be required to enable the executor to determine the optimal election under § 2032A since appraisals determining the value on the alternate valuation date must be considered in addition to date of death value. J. McCord, *supra* note 2, at 313.

92. I.R.C. § 2032A(b)(3).

93. Treas. Reg. § 20.2031-1(b). *See also* J. McCord, *supra* note 2, at 322.

94. I.R.C. § 2032A(a)(2).

95. If the past practices of the IRS are any guide, many cases of this sort will be litigated. *See* text accompanying notes 19-29 *supra*. When the liquidity problem of farmer's estates is discussed, the costs of challenging the IRS (including attorneys fees) cannot be ignored. Though these costs are presumably an estate tax deduction (I.R.C. § 2053(a)(2); Treas. Reg. §§ 20.2053-3(a), (c)(2)), the deduction will only "reimburse" the estate to the extent of the estate's tax bracket. If the attorneys fees become significant, they could provide the difference between being able to pass on the farm to the family member to whom it is bequeathed and a forced sale.

96. It appears clear that the basic purpose of the 50% requirement was to assure that the farm property constitutes a substantial portion of decedent's gross estate. The 25% require-

the estate, together with the possibilities of a greater number and variety of challenges to the appraisals, defeat both the certainty in valuation hoped for by Congress and one of the primary goals in all tax revision, simplicity. Moreover, they hinder the congressional goal of preserving family farms.[97]

At least one authority has alleged that it is unclear from the statute what specific use is to be referred to for the special valuation.[98] That is, suppose, on the date of death, the land is being used for one agricultural activity *(e.g.,* a corn farm) but could be used for a more profitable agricultural activity *(e.g.,* a wheat farm or for cattle or hog raising). Which use is "the use under which it qualifies, under subsection (b), as qualified real property"?[99] The legislative hearings[100] appear to clearly indicate that the current, actual use is the one referred to. The purpose of the statute, to prevent the illiquidity in farm estates from causing forced sales to pay estate taxes, could be heavily compromised if a "highest and best agricultural use" standard is adopted. In the *House Report,* the "reasons for change" section includes the revealing statement: "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 business."[101] The *House Report* also refers to valuation at actual use.[102] Though this matter should be clarified by regulations,[103] the preferred and logical reading of the

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ment was inserted to insure that the qualified real property constitues a substantial capital component of the farm or business. J. McCord, *supra* note 2, at 322. It appears that both requirements may be aimed at restricting the use valuation to the family farm.

97. *See* Section I *supra*. In an article submitted to the Committee, Donald Kelley stated that the enactment of 2032A was a national farm policy decision, not a tax decision. *House Hearings, supra* note 8, at 1688.

98. J. McCord, *supra* note 2, at 315.

99. I.R.C. § 2032A(a)(1).

100. For discussion of these hearings, *see* Section I *supra.*

101. House Report, *supra* note 44, at 22.

102. *Id.* The Conference Report states that if certain conditions are met, "the executor may elect to value qualified real property included in decedent's gross estate on the basis of such property's value in its *current* use rather than on the basis of its highest and best use." H. Conf. Rep. No. 94-1515, 94th Cong., 2d Sess. 610, *reprinted in* [1976] U.S. Code Cong. & Ad. News 1222, 1353 (emphasis added). *See also* General Explanation *supra* note 3, at 537.

103. The proposed regulations do not clarify the problem. Proposed Treas. Reg. § 20.2032A-3 states:

> If this election is made, the property will be valued on the basis of value for *its qualified* use in farming or the other trade or business rather than its fair market value determined on the basis of highest and best use (if other than the use in farming or other business).

Proposed Treas. Reg. § 20.2032A-3(a). 43 Fed. Reg. 31,040 (1978). This is the only reference to the problem in the regulations so far proposed under I.R.C. § 2032A.

See also IR-2160 (Sept. 10, 1979), 3 Fed. Est. & Gift Tax Rep. (CCH) ¶ 12,307, stating that an executor is not required to show that property has a different or higher use other than statute is that the land will be valued at its actual, current agricultural use.[104]

It should also be noted that, for the purpose of meeting the fifty percent and twenty-five percent requirements, the gross estate is reduced only by secured debts for which the decedent was personably liable.[105] It is not clear why the reduction is limited to secured debts, rather than the more usual debts and expenses. For example, in computing the marital deduction, the deduction is limited to the greater of $250,000 or fifty percent of the value of the adjusted gross estate.[106] The adjusted gross estate is computed by subtracting from the value of the gross estate the aggregate amount of the deductions allowed under sections 2053 and 2054.[107] In fact, the section may well have been drafted in a manner inconsistent with congressional intent.[108] This could prevent use of 2032A in a number of estates.[109]

A possible trap for attorneys is contained in Section 2032A(b)(1)(A), which requires that fifty percent or more of the adjusted value of the gross estate consist of the adjusted value of real or personal property which was being used for a qualified use. The statute states that any personal property used to meet the fifty percent requirement *must* pass to a qualified heir.[110] There seems to be no logical reason for requiring that the personal property pass to the qualified heir. The personal property will be valued at fair mar-

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farming in order to elect special use valuation.

104. For a fuller discussion of this problem, see J. McCord, *supra* note 2, at 316-17.

105. This results from the definition of adjusted value in I.R.C. § 2032A(b)(3).

106. I.R.C. § 2056(c)(1)(A).

107. I.R.C. § 2056(c)(2).

108. The House Report states that the value of the farm must be 50% of the decedent's gross estate reduced by "debts and expenses." House Report, *supra* note 44, at 22. The Joint Committee on Taxation agrees, using the same language. General Explanation, *supra* note 3, at 538.

109. *See* J. McCord, *supra* note 2, at 322-23. McCord gives the example of a gross estate of $1,000,000 consisting of farm land valued at $600,000 which is subject to a $300,000 mortgage. McCord states that the qualified real property would not meet the 50% test of § 2032A(b)(1)(A) since the adjusted value of the gross estate is $700,000 ($1,000,000 less $300,000) and the adjusted value of the qualifying property is $300,000 ($600,000 less $300,000). He argues that if a $200,000 unsecured production loan is outstanding when decedent died, the net value of the farm land ($300,000) represents 60% of the actual net worth of the estate ($500,000), but special use valuation could not be used because of the limitation on deductions of only secured debts. *Id.* In the case posited by McCord, it is at least arguable that the statute is reasonable because the production loan would have to be paid or taken into account before the net value of the farm land could be determined. On the other hand, it is arguable that the loan should be viewed as payable from the crop rather than as reducing the value of the land. A better example might be if the $200,000 were composed of administrative expenses (attorneys fees, commissions, etc.) and other unsecured debts or debts for which the decedent was not personally liable. In such a case it is difficult to justify not subtracting the amount of the debt or expense from the "adjusted value" of the gross estate. The qualified real property clearly represents a significant enough portion of the estate in such a case to be within the class of estates Congress intended to benefit.

110. *See* J. McCord, *supra* note 2, at 324-25.

ket value in any case, since only real property is eligible to be valued at special use value.

The purpose of the fifty percent and twenty-five percent requirements appears to be to restrict the use of section 2032A to the estate of decedent's who have a significant proportion of their taxable estate composed of real and personal property devoted to farm uses. This is related to the primary purpose of section 2032A, to encourage the continued use of property for farming and other small business purposes and to prevent forced sales of family farms.[111] There seems to be no particular relationship between giving the personal property to a qualified heir and achieving these purposes. In fact the *House Report* speaks only of the real property passing to a qualified heir.[112] Moreover, it should be noted that technically the statute does not prevent bequeathing the real property to one qualified heir and the personal property to another.[113] Despite these arguments, the statute is clear and the Revenue Act of 1978 did nothing to clarify this problem.[114] To avoid the trap, the estate planner should insure that if the use of personal property is or may be necessary to meet the fifty percent requirement, that property is bequeathed to a qualified heir.[115] In view of the possible ambiguity of the statute, it might be wise to bequeath any personal property which is or may be used to meet the fifty percent requirement in the same manner as the qualified real property.

III. Material Participation

As previously stated, in enacting Section 2032A, the primary concern of Congress was to benefit the family farm. Congress wished to prevent the farming industry from being concentrated in the hands of "corporate

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111. House Report, *supra* note 44, at 22.

112. *Id.*

113. I.R.C. § 2032A(b)(1)(A)(ii) states only that 50% or more of the adjusted value of the gross estate must consist of the adjusted value of real or personal property which "was acquired from or passed from the decedent to *a qualified heir* of the decedent." (emphasis added). This does not necessarily have to be interpreted to mean one qualified heir. In fact, equality among children in a farm family could be made difficult or impossible to achieve if the above quoted phrase was interpreted to mean that qualified real property and personal property equaling 50% or more of the adjusted value of the gross estate must be left to one qualified heir. Neither the Committee Reports nor the Staff Explanation shed any light on this problem. However, it is doubtful that Congress intended to imply such a requirement in view of the detailed wording of the statute.

114. The Revenue Act of 1978 did amend § 2032A(b)(1), but only to insure that the special valuation applies only to interests passing to qualified heirs. Revenue Act of 1978, *supra* note 82, § 702(d)(1).

115. Of course, in the usual situation, the personal property used in the farm operation (and thus used in meeting the 50% requirement) will be disposed of in the same manner as the qualified real property. However, though this may explain the statutory wording, it does not justify the requirement of the personal property passing to the qualified heir.

agribusiness,"[116] and encourage the continuation of family operated farms.[117] The major method Congress chose to attain this objective was to permit special use valuation only where there was material participation in the operation of the farm or closely held business by the decedent or a member of his family.[118] The material participation requirement has probably generated more comment than any other provision of section 2032A.[119]

A. *Material Participation: Section 1402(a)(1)*

Material participation is not directly defined in section 2032A; rather, section 2032A(e)(6) provides: "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)."[120] Section 1402(a)(1) defines net earnings from self-employment for the purposes of computing the tax on self-employment income. The section includes in the definition of net earnings from self employment, income derived by an owner of land if there exists an arrangement between the owner and the tenant providing for the producing of agricultural commodities by the tenant and material participation by the owner in the production or the management of production of such commodity and the material participation actually occurs.[121] The regulations under section 1402 of the Internal Revenue Code

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116. 122 CONG. REC. 25,955 (1976) (remarks of Sen. Bentsen).

117. *See, e.g., id.* at 25,948 (remarks of Sen. Nelson); *id.* at 30,851 (remarks of Rep. Keys); *id.* at 30,855 (remarks of Rep. Broomfield).

118. I.R.C. § 2032A(b)(1)(c)(ii). Actually the material participation requirement is two fold. First, in order for real property to be accorded special use valuation, the property must be "qualified real property." I.R.C. § 2032A(a)(1). In order to be qualified, "during the 8-year period ending on the date of the decedent's death there must have been periods aggregating 5 years or more during which . . . there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business." I.R.C. § 2032A(b)(1)(C)(ii). Second, if during any period of eight years ending after the date of the decedent's death and before the death of the qualified heir, or fifteen years after the death of the decedent (whichever occurs first), there are periods aggregating three years or more, during which there was no material participation by the decedent or any member of his family, or by the qualified heir or a member of his family, all or a portion of the tax saved by the special use valuation will be recaptured. I.R.C. § 2032A(c). On the recapture of the estate tax saved, see Section V *infra.*

119. Two particularly good discussions are Hjorth, *supra* note 39, and Note, *Material Participation, supra* note 37. *See also* Bock & McCord, *supra* note 53, at 159-67; Matthews & Stock, *Section 2032A: Use Valuation of Farmland for Estate Tax Purposes,* 14 IDAHO L. REV. 341, 350-356 (1978); Normand, *Special Use Valuation of Farmland for Estate Tax Purposes: Arrangements for Material Participation,* 30 BAYLOR L. REV. 245 (1978).

120. *See* HOUSE REPORT, *supra* note 44, at 23, n.1. *See also* GENERAL EXPLANATION, *supra* note 3, at 538, n.1.

121. The above is a simplification. Section 1402(a)(1) provides that in computing net earnings from self-employment:

> there shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the

further develop the material participation requirement.[122] Both an arrangement for material participation and actual material participation are required,[123] and both must be in the production or management of production of the agricultural commodity.[124] Thus, the test of material participation will focus on the meaning of production and management of the production.

1. *Production*

Production is composed of two main elements: physical work and financial resources furnished.[125] Though the undertaking to furnish machinery, implements, livestock, etc. is said to not in itself be sufficient, it can become important in cases where the amount of physical work is not material.[126] The regulations provide that if under the arrangement the owner is to engage in physical work, but the degree of such work is not material, and the owner in addition undertakes to furnish a substantial portion of the materials or to furnish funds or assume financial responsibility for a sub-

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> deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity.

I.R.C. § 1402(a)(1).

122. Treas. Reg. § 1.1402(a) (1956).

123. I.R.C. § 1402(a)(1).

124. Treas. Reg. §§ 1.1402(a)-(4)(b)(1)(i) — 1.1402(b)-1(b)(3) (1956). The arrangement may be either written or oral and must impose on the owner or tenant the obligation to produce one or more agricultural or horticultural commodities on the land of the owner or tenant. Treas. Reg. § 1.1402(a)-4(b)(3)(i) (1956).

125.
> The term "production", wherever used in this paragraph, refers to the physical work performed and the expenses incurred in producing a commodity. It includes such activity as the actual work of planting, cultivating and harvesting crops, and the furnishing of machinery, implements, seed, and livestock. An arrangement will be treated as contemplating that the owner or tenant will materially participate in the "production" of the commodities required to be produced by the other person under the arrangement if under the arrangement it is understood that the owner or tenant is to engage to a material degree in the physical work related to the production of such commodities . . . .

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

126. *Id.* However, the statement in the regulations that there cannot be material participation solely through the furnishing of financial resources has been rejected in dictum. Henderson v. Flemming, 283 F.2d 882, 889 (5th Cir. 1960).

stantial portion of the expenses involved, the arrangement will be treated as contemplating material participation of the owner in the production of the commodity.[127]

2. *Management of Production*

Management of the production of a commodity is a term used primarily to refer to the making of the managerial decisions relating to the production.[128] The regulation lists a number of decisions which will be taken into account in determining whether a person is engaged in a material degree in the management of the production of the commodity.[129] The regulations single out making inspection of the production activities and advising and consulting with the actual producer as to the production of commodities as especially significant in the decision on whether material participation exists.[130] Such activities alone produce "a strong inference" that the arrangement contemplates participation in the management of production.[131] On the other hand, the decisions on selecting the crops or livestock, and the decisions on the types of machinery or crop rotation are downplayed.[132]

3. *The Farmer's Tax Guide*

The tests in the regulations offer some guidance on material participation and some evidence of the importance assigned to each factor. However, the most often used tests are those in the *Farmer's Tax Guide*, an Internal Revenue Service publication.[133] The tests stated there are:

> You are materially participating if you have an arrangement for your participation and you meet the requirements in one of four tests. Test No. 1. You do any three of the following: (1) advance, pay, or stand good

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

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

129. *Id.* The decisions referred to are when to plant, cultivate, dust, spray or harvest the crop (including advising and consulting, and making inspections), rotation of crops, the kind of crops to be grown, the type of livestock to be raised and the type of machinery and implements to be furnished.

130. *Id.*

131. *Id.* Presumably, if the inspection and consultations are significant, the participation would be material. Though it is somewhat unlikely that an owner would engage in inspections and consultations without decision making, the regulations appear to imply that such activity would constitute material participation. One case has, in effect, adopted this rationale, although an alternate rationale exists for the decision. Celebrezze v. Wifstad, 314 F.2d 208, 218 (8th Cir. 1963).

132. The regulations state none of these decisions alone (or, by implication, together) are of themselves sufficient. Treas. Reg. § 1.1402-4(b)(3)(iii) (1963). However, they may be significant in the overall determination of material participation, particularly when accompanied by periodic advice, consultation and inspection. *Id.*

133. U.S. Dep't of the Treasury, Internal Revenue Service, Pub. No. 225, Farmer's Tax Guide (1979 ed.) [hereinafter cited as Farmer's Tax Guide].

> 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.[134]

The four tests are not intended to be the only methods to qualify for material participation; they are rather "safe harbor" tests that will, if met, automatically insure qualification.[135] Even so, it should be noted that only Test No. 3, which contains a definite number of hours and a definite period, provides a truly quantifiable and certain test to ensure qualification.[136] Test No. 1 provides some definitiveness in terms of furnishing equipment and costs of production, but is vague as to advice and consultation, which are stated in the regulations to be the most important criteria in determining material particiation. The remaining two tests are general and provide no more certain guidelines than do the regulations.

B. *Material Participation: Social Security Act Section 211(a)(1)*

The regulations previously discussed are designed to determine what earnings are included in the tax base used to finance the federal Old Age and Survivor Insurance Trust Fund, which was created to provide income primarily to the aged and disabled and their survivors.[137] In order to receive benefits from the fund, the recipient (or, in the case of survivors benefits, the deceased) must have made contributions to the fund (either through wage deductions (FICA) or the tax on self-employed income). Though there is very little informative case law on what constitutes material participation under section 1402(a)(1) of the Internal Revenue Code, the Social Security Act (which provides for the distribution of the benefits financed by FICA deductions and the tax on net earnings from self-employment) contains provisions almost exactly corresponding to section 1402(a)(1). Section 211(a)(1) of the Social Security Act[138] basically tracks the language of section

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134. *Id.* at 52.

135. Normand, *supra* note 119, at 253. The treasury regulations define material participation through the use of a series of examples. *See* Treas. Reg. § 1.1402(a)-4(b)(6) (1963) and Proposed Treas. Reg. § 1.1402(a)-(4)(b)(6), 43 Fed. Reg. 31,040 (1978).

136. Normand, *supra* note 119, at 253.

137. 42 U.S.C. § 401 (1976).

138. 42 U.S.C. § 411(a)(1) (1976).

1402(a)(1) of the Code in terms of including in the term "net earnings from self-employment" any income derived from an arrangement contemplating material participation by the owner of land in the production or management of the production of agricultural or horticultural commodities, if such material participation actually occurs. Moreover, the regulations issued under the Social Security Act[139] are similar as to material participation in all respects to the Treasury Regulations issued under section 1402(a)(1). A number of cases have been decided under section 211(a)(1) of the Social Security Act providing some guidelines as to what constitutes material participation under the statute.

C. *Material Participation: The Case Law*

Whether there is material participation "is a factual determination that can only be made on a case-to-case consideration."[140] Moreover, the Social Security Act is to be given a liberal interpretation.[141] "Material" is to be given "its common and well-understood meaning" of "solid or weighty character; substantial; of consequence; not to be dispensed with; important."[142] Under section 1402(a)(1) of the Code and section 211(a)(1) of the Social Security Act, production can be material with respect to:

1. Production of the commodity; or
2. Management of the production of the comodity; or
3. Both production and management of the production, considered together.[143]

1. *Production: Furnishing Expenses and Risk Incurred*

Not many cases have concerned themselves solely with what qualifies as material participation in the production of the commodity. The regulations imply that some physical work is necessary to qualify under this test.[144] This position was rejected in dicta in *Henderson v. Flemming*.[145] The court said:

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139. 20 C.F.R. § 404.1053 (1979), especially subsections (c)(3) and (4).

140. Hoffman v. Ribicoff, 305 F.2d 1, 9 (8th Cir. 1962).

141. Foster v. Celebrezze, 313 F.2d 604, 607 (8th Cir. 1963); Harper v. Flemming, 288 F.2d 61, 64 (4th Cir. 1961); Henderson v. Flemming, 283 F.2d 882, 887 (5th Cir. 1960).

142. Foster v. Celebrezze, 313 F.2d 604, 607 (8th Cir. 1963).

143. Treas. Reg. §§ 1.1402(a)-4(b)(3)(i), 1402(a)-4(b)(4) (19639; 20 C.F.R. §§ 404.1053(c)(3)(i), 404.1053(c)(4) (1979).

144. Treas. Reg. § 1.1402(a)-4(b)(3)(ii) (1963) states that production refers to "the physical work performed and the expenses incurred in producing a commodity" but states that the mere undertaking to furnish machinery, implements and livestock and to incur expenses is not in itself sufficient, thus giving rise to the implication that physical work is required.

145. 283 F.2d 882 (5th Cir. 1960). In *Henderson*, the actual holding of the court was that the owner, a 91-year-old invalid who was physically incapable of overseeing farming operations during the years in question, materially participated through an agent (her son) on a contract basis. The physical work required by the arrangement was breaking ground and planting the

> [W]e know at least today that agriculture is or may be big business. It takes more than land and a willing hand. It takes working capital, frequently in considerable amounts. An owner of land who is required to (and does) furnish substantial amounts of cash, credit or supplies toward this mutual undertaking which are reasonably needed in the production of the agricultural commodity and from the success of which he must look for actual recoupment likewise makes a "material participation."[146]

Two other cases indicate that other courts agree with the dicta in *Henderson v. Flemming* that no physical work is necessary to qualify for material participation as to production. In *Bridie v. Ribicoff,*[147] plaintiff owned a 203-acre farm which he leased on a crop share or stock share basis. The farm was basically a livestock operation. Under the lease the owner was required to pay one-half of the cost of the threshing and combining of soybeans, twine and bailing wire, corn shelling and seed (except that the owner would pay for all grass seed and the tenant for all potato seed), veterinary expense for stock and trucking incident to farm operations. The owner in fact advanced all the money necessary to buy the feeder cattle or sows purchased and was not reimbursed until the animals were sold. The court cited *Henderson v. Flemming* with approval for the proposition that a substantial amount of capital reasonably necessary for the farming operation is in itself sufficient to qualify for material participation,[148] but stated that a decision as to whether to adopt this rationale was not necessary to the case in light of the fact that the owner periodically advised and consulted with the tenant, inspected the livestock and made management decisions.[149] However, the emphasis of the court's opinion and its reasoning indicate that if presented with a pure case of advancement of capital alone, the court would find it sufficient for material participation.[150]

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crop. There is nothing in the court's opinion indicating whether this physical work was material in itself or whether it had to be combined with the furnishing of resources to be material. The arrangement required the owner to furnish the planting seed and to pay one-half of the cost of insecticide. Also, the economics of the arrangement involved the owner's financing the cost of fertilizer (which was substantial), which was repaid by the tenants when the crop was sold. Concerning the holding of the court, both I.R.C. § 1402(a)(1) and 42 U.S.C. § 411 (a)(1) were amended for taxable years beginning after December 31, 1973, by providing that material participation shall be determined without regard to any activities of an agent. *See also* Bravenec & Olsen, *How to Reap Estate Tax Benefits Through Use of the Alternate Valuation of Farmland,* 48 J. TAX. 140, 143 (1978).

146. Henderson v. Flemming, 283 F.2d 882, 888 (5th Cir. 1960).

147. 194 F. Supp. 809 (N.D. Iowa 1961).

148. *Id.* at 815.

149. *Id.* at 815-16.

150. The testimony recited by the court as to management decisions made by the owner is equivocal. It does not appear that the arrangement contemplated that plaintiff would make the final decisions; in fact, decisions were made jointly by the owner and tenant. There is substantial evidence of inspection and consultation with regard to the livestock and it is possible that the decision rested on the fact that the plaintiff materially participated in the manage-

In *Celebrezze v. Miller*,[151] Miller was 82 years old. He employed two tenants who cultivated the cotton, corn and sweet potatoes grown on the farm. Miller received one-third of the crop and was required to pay one-third of the costs of fertilizer, poisons and labor hired, and to absorb one-third of any loss. Miller was also required to inspect the crops three or four times a month and, during his visits, consult with and advise the tenants regarding the application of fertilizer and poisons and the time and place to plant. The tenants furnished the seed, tilled the crops, hired labor when required and conducted the farm operations. Miller spoke no English. In a short opinion, the court held that Miller's activities qualified as material participation. Though not emphasized, the fact that Miller spoke no English emerges as one of the significant factors in the decision. Reading the case with this knowledge, it is difficult to believe that Miller's advice and consultation in the farming operation were significant.[152] Thus, the furnishing of one-third of the cost emerges as the key indicia of material participation in this case.

Since the courts have been somewhat unwilling to develop guidelines as to what percentage of costs furnished by the owner will qualify as material participation, a number of the opinions in this area have emphasized another factor in their analysis: the risk taken by the owner. This is most often apparent in crop share arrangements; in return for his furnishing the seed, fertilizer, implements, etc., the owner receives a portion of the crop or a portion of the proceeds. He also necessarily assumes the risk of low production or low prices, since his share is payable in crops or the proceeds from the sale of crops. Several cases have focused on this factor as evidence of material participation. The origin of this analysis was in *Henderson v. Flemming*,[153] which involved a 91-year-old widow, Mrs. Poole, who for the years in question was an invalid in a wheel chair. The arrangement with her tenants required her to "break ground" and plant the crop, which she did through her son on a contract basis. The court held that physical labor could be accomplished through an agent or employee, but in this case the

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ment of production or in the production and management of production. *See* 20 C.F.R. § 404.1053(c)(3)(iii) (1979), which states:

> [I]f under the arrangement it is understood that the owner or tenant is to advise or consult periodically with the other person as to the production of the commodities required to be produced by such person under the arrangement and to inspect periodically the production activities on the land, a strong inference will be drawn that the arrangement contemplates participation by the owner or tenant in the management of the production of such commodities.

151. 333 F.2d 29 (5th Cir. 1964).

152. It is of course possible that Miller used a translator to convey his advice to the tenants, or that Miller and the tenants spoke a common language. However, there is nothing in the opinion so indicating. If this were the case, it is highly likely that the court would have referred to it.

153. 283 F.2d 882 (5th Cir. 1960).

physical work was apparently not substantial enough to constitute material participation.[154] The agreement also required Mrs. Poole to furnish the planting seed and bear one-half of the cost of insecticide. Also, since she was required to "break ground" and plant, she was responsible for the expense of fuel to operate the farm machinery and the depreciation on the machinery. These expenses, together with the physical labor of her son, could have been enough for material participation in the production of the commodity.[155] However, the court, rather than basing its decision on the expense assumed by Mrs. Poole, emphasized the risk she took:

> Under the sharecropping arrangements effected in her behalf by [her son], Mrs. Poole, of course, furnished the land. But there was much more. She was equired to bear a considerable financial risk and contribution . . . . The sharecropping tenants, on the other hand, were required to bear . . . the entire cost of fertilizer . . . . Actually, of course, Mrs. Poole had to finance the cost of fertilizer which would run several thousands of dollars and her reimbursement would come as a back-charge against the tenants' share when and as the cotton was harvested, ginned and sold. After deducting back charges due by the sharecropper tenants, the proceeds of the cotton were split 50/50.[156]

The effect of this risk was stated by the court as follows:

> In the same approach, we know at least today that agriculture is or may be big business. It takes more than land and a willing hand. It takes working capital, frequently in considerable amounts. An owner of land who is required to (and does) furnish substantial amounts of cash, credit or supplies toward this mutual undertaking which are reasonably needed in the production of the agricultural commodity and from the success of which he must look for actual recoupment likewise makes a "material participation." One is hardly a mere landlord in the traditional sense if he must risk considerable funds in addition to the land in the success of the venture. And what he gets — or hopes to get — is more than rent. It is profit from the operation of a business, a business fraught with financial risks — the business of producing agricultural commodities.[157]

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154. *Id.* at 887-888.

155. *See* 20 C.F.R. § 404.1053(c)(3)(ii) (1979):

For example, if under the arrangement it is understood that the owner or tenant is to engage periodically in physical work to a degree which is not material in and of itself and, in addition, to furnish a substantial portion of the machinery, implements, and livestock to be used in the production of the commodities or to furnish or advance funds or assume financial responsibility for a substantial part of the expense involved in the production of the commodities, the arrangement is treated as contemplating material participation of the owner or tenant in the production of such commodities.

156. 283 F.2d at 885-86.

157. *Id.* at 888.

2. *Management of Production: Decision Making*

As discussed above, despite the Service's emphasis on physical work, the courts have focused on the furnishing of expenses and the risk incurred by the owner in determining whether an owner materially participated in the production of a commodity. A similar process has occurred in determining whether an owner materially participated in the management of the production of the commodity. The regulations[158] specify that two factors, the making of managerial decisions relating to the production, and advising, consulting and making inspections as to such matters, are to be considered in the determination. But the regulations clearly indicate that advice, consultation and inspection are to be more heavily weighted than actual decision making.[159] The decided cases however, have on the whole taken the more logical position that the focus should be on the question of who makes the final decisions and that inspections, consultation and advice are only a factor to be considered in making this determination.

A leading case in this area is *Foster v. Celebrezze.*[160] In that case, the lease provided that "the Tenants agree . . . to put in such crops in such manner as the Landlord may direct . . . ."[161] The court stated that the provision gave the owner "broad managerial powers" including the right to "direct and supervise the method of preparing the seed bed, the time and method of planting the seed, the amount of seed to be planted per acre, and related matters, which would appear to be substantial managerial functions which would have a material bearing upon production."[162] The court also noted that other provisions of the lease gave the owner the right to approve the seed to be planted, to designate fields on which manure was to be used

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158. Treas. Reg. § 1.1402(a)-4(b)(3)(iii) (1963) and 20 C.F.R. § 404.1053(c)(3)(iii) (1979).

159. Thus, 20 C.F.R. § 404.1053(c)(3)(iii) (1979) and Treas. Reg. § 1.1402(a)-4(b)(3)(iii) (1963) both provide:

> The services which are considered of particular importance in making such management decisions are those services performed in making inspections of the production activities and in advising and consulting with such person [the actual producer of the commodities] as to the production of the commodities. Thus, if under the arrangement it is understood that the owner or tenant is to advise or consult periodically with the other person as to the production of the commodities required to be produced by such person under the arrangement and to inspect periodically the production activities on the land, a strong inference will be drawn that the arrangement contemplates participation by the owner or tenant in the management of the production of such commodities. The mere undertaking to select the crops or livestock to be produced or the type of machinery and implements to be furnished or to make decisions as to the rotation of crops generally is not, in and of itself, sufficient. Such factors may be significant, however, in making the over-all determination of whether the arrangement contemplates that the owner or tenant is to materially participate in the management of the production of the commodities.

160. 313 F.2d 604 (8th Cir. 1963).

161. *Id.* at 608.

162. *Id.*

as fertilizer, to determine whether meadows or pastures were to be plowed, to direct the clipping of clover and cutting of weeds and to decide whether to participate in government farm programs.[163] The court held that "material" should be given its common and well understood meaning: "Of solid or weighty character; substantial; of consequence; not to be dispensed with; important,"[164] and decided that the managerial powers given under the lease are items which "materially affect the production of agricultural commodities."[165] The court briefly mentioned that the exercise of the rights granted the owner, Mrs. Foster, in the lease would require periodic inspections and consultations, but its decision is clearly bottomed on the decision making power granted the owner.

A recent case illustrating material participation in the management of production is *McCormick v. Richardson.*[166] McCormick (ironically, a former employee of the IRS) on his retirement became actively involved in the management of a 160-acre farm in Illinois. He hired a person to clear a woodland area of the farm, to plow and to put the soil in condition for planting in 1965. He and the tenant on the farm (who had farmed under an oral arrangement with McCormick for the previous seven years) agreed that modern farm machinery was needed. The tenant purchased the machinery. McCormick paid various expenses of the farm, including maintenance of a drainage ditch, the furnishing and spreading of lime and rock phosphate, all real estate taxes and insurance, the cost of clover seed, repair of buildings and fences and of applying weed killer, and forty percent of the cost of the fertilizer, nitrogen, poison and weed killer. McCormick also determined when soil tests should be made and had them done. The court, however, focused on the modern methods used by McCormick, including the use of aerial photographs, which together with careful inspections of the land and records of the quantity of each product produced, aided in McCormick's preparation of a careful plan of crop rotation and resting of fields. The court also noted that after February 1965, McCormick retained the right to insist that his views be followed in case of disagreement with the tenant. McCormick always decided whether a government crop plan should be entered into. The court further noted that McCormick devised several innovative methods to deal with problems on the farm, such as a rotation plan of alternating corn and wheat and the use of a new chemical after the wheat was harvested to eliminate Johnson grass. The court ruled that McCormick made a very helpful contribution to the management of production, which was sufficient to prove material participation. The court emphasized his decisions to modernize the farm machinery, to construct new buildings and the careful planning which resulted in a very substantial increase in the crops

163. *Id.*
164. *Id.* at 607, *quoting* Webster's New International Dictionary (2d ed.).
165. 313 F.2d at 608.
166. 460 F.2d 783 (10th Cir. 1972).

produced.[167] The court was clear in its emphasis on decision-making:

> The phrase, "the management of the production of such agricultural . . . commodities" means, we hold, the determination of what shall be done or carried out which will affect production and how and by whom it shall be done or carried out. And it does not mean the physical exertion by which the actual doing or carrying out of the operation is accomplished. Hence, physical participation is not required.[168]

The two cases most clearly illustrating the courts' focus on the power to make financial decisions in determining material participation, however, are *Hoffman v. Gardner*[169] and *Colegate v. Gardner*.[170] In *Hoffman*, the claimant was a resident of Missouri who owned farms in Iowa. His brother-in-law, a farmer who lived near the farms Hoffman owned in Iowa, acted as intermediary by keeping in touch with tenants who actually farmed the land and kept the claimant advised. In the year at issue claimant entered into written leases with two tenants for the farming of the farms in Iowa. The leases gave Hoffman complete managerial control. The tenants were only permitted to make suggestions.[171] He designated when and where crops were to be planted and when they were to be cultivated, harvested, and sprayed.[172] He directed the manner of tending the crops. He kept charts showing crop information and each year sent the tenants a map showing where to fertilize, the type of fertilizer, terracing and other matters.[173] The only evidence of advice, consultation and inspection was that Hoffman consulted periodically with his brother-in-law and directly with the tenants by telephone and letter and in these consultations advised and instructed them about the crops.[174] In addition, claimant and his daughter spent a week on the farms.[175] All other inspections were by Hoffman's brother-in-law.[176] In reversing the District Court's finding that claimant had not materially participated in either the production or the management of production, the court stated:

> From the findings of fact, it clearly appears that claimant not only materially participated in the production of the crops but also in the management of the production of the crops. He admittedly made important decisions concerning production of the crops, improved the money

167. *Id.* at 787-88.

168. *Id.* at 787. Other cases illustrating the emphasis on final decision making in deciding whether an owner has materially participated in the management of production include Celebrezze v. Benson, 314 F.2d 219 (8th Cir. 1963); Celebrezze v. Wifstad. 314 F.2d 208 (8th Cir. 1963); and Bridie v. Ribicoff, 194 F. Supp. 809 (N.D. Iowa 1961).

169. 369 F.2d 837 (8th Cir. 1966).

170. 265 F. Supp. 987 (S.D. Ohio 1967).

171. 369 F.2d at 839.

172. *Id.*

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

crops, and materially participated in the financing . . . .[177]

In *Colegate,* claimant lived on and owned a 65-acre farm. In 1963, she entered into an arrangement with a neighbor to farm fifty acres of her farm. Claimant decided what she wanted planted, which was apparently subject to a difference of opinion between claimant and her neighbor.[178] At planting time, claimant made two inspections of the area, each lasting approximately fifteen minutes. During the growing period she made no regular inspections, but went "around the outside of the crops."[179] When the crop was to be harvested and marketed, claimant insured that her share of the crops were put in the proper place. The Secretary of HEW argued that claimant's participation was not material because the two inspections lasted only fifteen minutes each and that the consultations and management decisions took place only several times a year.[180] The court made short work of this argument:

> It is further the view of this Court that the evidence establishes without a shadow of a doubt that the inspections and consultations were important and material. The basic decision to farm this sixty acres was made by the petitioner. The basic decision to grain farm it was made by the petitioner. The basic decision involving the question of what acreage was to be devoted to soy beans in what year was made by the petitioner. The record establishes the same fact with respect to where to plant hay, or wheat, or corn. She superintended and directed the storage of her part

177. *Id.* at 840. The court went on to state:

> The findings of fact seem to be conclusive that the claimant here made important decisions concerning the production activities on the farms, some of which resulted in increased production and greater profits. He improved the money crops and his experimentation with new types of fertilizer resulted in a large increase in the corn crop. His conservation projects also improved the crops in the bottom land. In fact, if this claimant did not materially participate within the meaning of the statute, it is difficult to conceive how a nonresident owner could possibly materially participate in the production or management of production of the commodities grown on a farm. It is true that claimant here did not actually visit the farms except for a week during the growing season, but one could hardly expect a person of his age to traipse between his home in Missouri and his farms in Iowa, a round trip distance of some eight hundred miles, when he could acccomplish the same thing by letter and telephonic communication with his tenants and the employment of a farmer brother-in-law who lived nearby and who actually visited the farms from two to four times a month during the growing season . . . . Claimant's farms were a constant topic of conversation in his household. He maintained charts on them and studied farm techniques, soil conditions and kept abreast of the weather conditions and completely directed the farming operations. About the only things he did not do were to personally set foot on the farms at frequent intervals and engage in the physical farming activities, neither of which is a requirement of the statute.

Id. at 841-42.

178. 265 F. Supp. at 989.

179. *Id.*

180. *Id.* at 991.

> of the crops and also decided where to market those crops. Her participation was therefore material . . . .[181]

Though there is language in the opinion mentioning inspections, advice and consultation and furnishing of capital, the court's primary emphasis on decision making is clear.

IV. Material Participation Under Section 2032A

A. *The Proposed Regulations*

Regarding material participation, section 2032A states only that it "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)."[182] This requirement was apparently imposed to avoid a windfall to beneficiaries, in furtherance of the purpose of the statute to preserve the family farm.[183] The Internal Revenue Service has issued proposed regulations[184] designed to clarify and define the activities which will qualify as material participation under 2032A.[185] Despite certain differences from the regulations under section 1402 and the Social Security Act, it is doubtful that the regulations contemplate major deviations from the tests for material participation developed by the courts under these statutes.[186]

It should first be noted that the proposed regulations provide that activities of an agent or employee other than a family member will not be attributed to the owner.[187] It is, however, unclear whether the addition of

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181. *Id.*

182. I.R.C. § 2032A(e)(6).

183. The House Report provides:

> However, your committee recognizes that it would be a windfall to the beneficiaries of an estate to allow real property used for farming or closely held business purposes to be valued for estate tax purposes at its farm or business value unless the beneficiaries continue to use the property for farm or business purposes, at least for a reasonable period of time after the decedent's death.

House Report, *supra* note 44, at 22.

184. Proposed Treas. Reg. § 20.2032A-3, 43 Fed. Reg. 31,040-42 (1978).

185. The proposed regulations also contain certain provisions regarding material participation when the property was held by the decedent or is bequeathed to the qualified heir in the form of a corporation, partnership or trust. Proposed Treas. Reg. § 2032A-3(e), 43 Fed. Reg. 31,041 (1978). These will be discussed in Section VI, F and G *infra*.

186. This is so despite the statement in the proposed regulations that:

> [i]n the absence of this direct involvement [actual employment to the extent necessary personally to fully manage the farm] in the farm or other business, the activities of either the decedent or family members must meet the standards prescribed in this paragraph and those prescribed in the regulations issued under section 1402(a)(1) of the Code. The regulations under section 1402(a)(1) are applicable for purposes of this section to the extent they are not inconsistent with its express requirements.

Proposed Treas. Reg. § 2032A-3(d)(1), 43 Fed. Reg. 31,041 (1978).

187. *Id.* This agrees with the amendment of I.R.C. § 1402(a)(1) made in 1974 providing that material participation shall be determined without regard to the activities of an agent.

the word "employee" was intended to further restrict the type of arrangement qualifying for special use valuation.[188]

The first test is that "[a]ctual employment on a substantially full-time basis (35 hours a week or more) or to any lesser extent necessary personally to manage fully the farm or business in which the real property to be valued under section 2032A is used constitutes material participation."[189] This should present no problem and has never been a significant factor in the cases dealing with material participation. Though more specific than the income tax regulations[190] or the *Farmer's Tax Guide*,[191] this standard was designed to meet the non-controversial case where the decedent and the qualified heir (or a member of the family of the decedent and the qualified heir) actually farm the land and produce the commodity. It is unlikely that much controversy will result from this provision.

If the activities are not on a full-time basis, the activities "must be pur-

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188. It is clear from the proposed regulations that the addition of "employee" was not intended to disqualify all tenancy arrangements. The probable purpose was to prevent the owner from avoiding the statutory requirements by drafting a formal employment contract with a non-family member to operate the farm and make the management decisions, yet have the activities of the employee attributed to the owner because he was an employee and not an agent. There may also have been an intent to exclude qualification of real property owned by a person owning a large amount of property who hires managers to operate the farms. Though it is doubtful that the addition of "employee" will be significant, court decisions will have to be awaited to determine its significance.

189. Proposed Treas. Reg. § 2032A-3(d)(1), 43 Fed. Reg. 31,041 (1978).

190. Treas. Reg. § 1.1402(a)-4(b)(3)(ii) (1963) provides: "The term 'production,' wherever used in this paragraph, refers to the physical work performed and the expenses incurred in producing a commodity. It includes such activities as the actual work of planting, cultivating, and harvesting crops . . . ."

191. Test No. 3 of the *Farmer's Tax Guide* provides that a farmer materially participates if "[He] work[s] 100 hours or more spread over a period of 5 weeks or more in activities connected with producing the crop." FARMER'S TAX GUIDE, *supra* note 133, at 49. However, the standards stated in the *Farmer's Tax Guide* and the proposed regulations are directed at different situations. Section 1402(a) defines earnings from self-employment for the purpose of taxing those earnings to finance the Federal Old Age and Survivors Insurance Trust Fund (OASI). OASI provides income to persons whose income is reduced through old age and disability. To receive OASI benefits, a person must have made contributions to OASI, either through deductions from wages or taxes on self-employment income. Income from rents is excluded from self-employment income, because it does not diminish from age or disability and therefore does not need to be replaced by OASI benefits. However, income received (whether referred to as rent or something else) by persons materially participating in production on agricultural land is taxed under § 1402(a) because it depends on the work of the owner. *See* Note, *Material Participation*, *supra* note 37, at 863. Since the purpose of § 2032A has nothing to do with replacing income lost through age or disability, the 35 hour-a-week standard of full-time employment is justified. Moreover, this is not the only way to qualify under § 2032A. Due to the fact that almost all the cases dealing with material participation have concerned persons claiming OASI benefits and have involved the question of whether material participation existed in an earlier year (thus providing the contribution from self-employment income necessary to collect benefits), the cases decided under the Social Security Act are not made irrelevant by the "full-time basis" provisions of the proposed regulations.

suant to an arrangement providing for actual participation in the production or management of production where the land is used by any nonfamily member, or any trust or business entity, in farming or another business."[192] The heart of the proposed regulations, however, is section 20.2032A-3(d)(2), enumerating the factors considered in determining material participation. The section provides:

> No single factor is determinative of the presence of material participation, but physical work[193] and participation in management decisions[194] are the principal factors to be considered. As a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business.[195] While they need not make all final management decisions alone, the decedent and family members must participate in making a substantial number of these decisions.[196] Additionally, production activities on the land should be inspected regularly by the family participant,[197] and funds must be advanced or financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used.[198] In the case of a farm, a substantial

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192. Proposed Treas. Reg. § 2032A-3(d)(1), 43 Fed. Reg. 31,041 (1978). The corresponding income tax regulation is Treas. Reg. § 1.1402(a)-4(b)(1)(i) (1963).

193. Treas. Reg. § 1.1402(a)-4(b)(3)(ii) (1963) states that physical work is a major ingredient in the "production" of the commodity. The regulation also states:

> An arrangement will be treated as contemplating that the owner or tenant will materially participate in the 'production' of the commodities required to be produced by the other person under the arrangement if under the arrangement it is understood that the owner or tenant is to engage to a material degree in the physical work related to the production of such commodities.

Id.

194. This is one part of the meaning of "management of the production" of the commodies. Treas. Reg. § 1.1402.(a)-(4)(b)(3)(iii) (1963). As above noted, the income tax regulations emphasize advice and consultation, but the cases clearly hold that the key to material participation under this standard is the making of a substantial number of key management decisions. *See* text accompanying notes 161-181, *supra*. The statement that participation in management decisions is a principal factor to be considered in determining material participation appears to be a belated recognition by the IRS of the holdings of these cases.

195. Advice and consultation is the second key factor in the meaning of "management of the production" under the income tax regulations. Treas. Reg. § 1.1402(a)-4(b)(3)(iii) (1963).

196. This is clearly a recognition of the cases holding that "material" is to be interpreted as meaning important, and that, if the owner makes or participates to a material degree in making a substantial number of important managerial decisions, he materially participates. *See, e.g.*, Celebrezze v. Miller, 333 F.2d 29 (5th Cir. 1964); Foster v. Celebrezze, 313 F.2d 604 (8th Cir. 1963); Conley v. Ribicoff, 294 F.2d 190 (9th Cir. 1961); Miller v. Flemming, 215 F. Supp. 691 (W.D. La. 1963).

197. This is emphasized in Treas. Reg. § 1.1402(a)-4(b)(3)(iii) (1963) as part of the decision making activities involved in "management of the production." In fact, making inspections, together with advice and consulation, are the services which are considered of "particular importance" in that decision. *Id.*

198. This is one factor in "production." Treas. Reg. § 1.1402(a)-4(b)(3)(ii) (1963). The assumption of financial responsibility has been a crucial factor in many of the cases involving

> portion of the machinery, implements, and livestock used in the production activities should also be furnished by the family members.[199] With farms, hotels, or apartment buildings, the operation of which qualifies as a trade or business, the decedent or heir's maintaining his or her principal place of residence on the premises is a factor to consider in determining whether the overall participation is material.[200]

Thus, none of the factors to be considered in determining whether material participation exists under the regulations proposed by the IRS is new. All the factors are contained in the regulations under section 1402 of the Code or have been recognized by case law. The only difference appears to be that although, like the regulations under the Social Security Act and section 1402(a), the proposed section 2032A regulations require material participation in either the production or the management of the production (or both) and give separate factors to be considered for each, the proposed regulations under 2032A (unlike the regulations under section 1402(a) and the Social Security Act) appear to contemplate involvement in several of the enumerated activities. The unstated requirement is that even if, for example, the decedent and the qualified heir (or members of their families) made most final management decisions, this would not be enough. They would also have to regularly advise, consult and inspect the production activities, or assume financial responsibility for a substantial portion of the risk, or maintain a principal place of residence on the farm. However, it is highly unlikely that the courts will require anything in addition to activities found sufficient from material participation in previous cases for several reasons. First, the proposed regulations clearly state: "If the involvement is less than full-time, it must be pursuant to an arrangement providing for *actual participation in the production or management of production* where the land is used by any nonfamily member, or any trust or business entity, in farming or another business."[201] The key words "production or management of production" are the same criteria given in the income tax regulations. More importantly, they are stated in the alternative, indicating that material participation in *either* the production or the management of production will satisfy the statute. Lastly, the income tax regulations state several factors in defining pro-

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material participation. *See, e.g.*, Celebrezze v. Miller, 333 F.2d 29 (5th Cir. 1964); Celebrezze v. Wifstad, 314 F.2d 208 (8th Cir. 1963); Foster v. Celebrezze, 313 F.2d 604 (8th Cir. 1963); Henderson v. Flemming, 283 F.2d 882 (5th Cir. 1960); Miller v. Flemming, 215 F. Supp. 691 (W.D. La. 1963).

199. This is specifically stated as one factor relevant to the determination of whether an owner has materially participated in the production of a commodity. Treas. Reg. § 1.1402(a)-4(b)(3)(ii) (1963).

200. While this factor is not specified in the income tax regulations, it was an important factor in the finding of material participation in Colegate v. Gardner, 265 F. Supp. 987 (S.D. Ohio 1967).

201. Proposed Treas. Reg. § 20.2032A-3(d)(1), 43 Fed. Reg. 31,041 (1978) (emphasis added).

duction and several others in defining management of production.[202] In many cases the government has contended that the presence of all factors in some degree are necessary to satisfy the standard.[203] The courts have unanimously rejected this position.[204]

In light of the similarity between the income tax regulations and the proposed regulations under 2032A, together with the statutory reference to section 1402 of the Code and the stated congressional intent, it is highly likely that what will qualify as material participation for income tax purposes and social security benefit purposes will also qualify for special valuation under 2032A. Still to be explored, however, is whether this material participation standard serves the congressional purpose in enacting 2032A.

B. *Material Participation and the Congressional Purpose*

1. *Material Participation, the Family Farm and the Absentee Landlord*

The major purpose behind the enactment of section 2032A was to prevent the forced sale of family farms due to the necessity of raising money to pay estate taxes.[205] The comments of congressmen during the hearings and debates clearly reflect the values the congressman wished to preserve. They wished to preserve the ideal of the family farmer. Senator Nelson expressed it as follows:

> For 100 years in this country, we have had a system where farms and businesses could be passed along from one generation to another. These enterprises put down roots in their communities. Their owners come to care about their employees, their customers, their churches, schools and hospitals. They work in the local charities and clubs and are the cement of community life.[206]

Senator Nelson and other congressmen justified the special provision for farmers by referring to the ideal of the family farmer, who toiled endlessly in his field for little return to produce food for the rest of the nation. The farmer was seen as a main building block of the American economic system and the bulwark of the political system.[207] Regardless of the idealistic rheto-

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

203. Most often the government has contended that physical labor in addition to the furnishing of equipment is necessary for material participation in production, and that inspection, advice and consultation in addition to decision making is necessary for material participation in management of production.

204. *See, e.g.*, McCormick v. Richardson, 460 F.2d 783 (10th Cir. 1972); Celebrezze v. Benson, 314 F.2d 219 (8th Cir. 1963); Henderson v. Flemming, 283 F.2d 882 (5th Cir. 1960); Bridie v. Ribicoff, 194 F. Supp. 809 (N.D. Iowa 1961).

205. *See* Section I *supra* for the background of the statute.

206. 122 Cong. Rec. 25948-49 (1976) (remarks of Sen. Nelson).

207. One commentator has stated that the basic purposes of § 2032A (and the other provisions of the Tax Reform Act of 1976 affecting farmers) were "to (1) preserve family farming operations, (2) keep land in agricultural production rather than subject it to the designs of

ric used, the type of farm Congress wished to benefit is not in doubt. It was the person who lived on and worked his own land with the help of his family and who expected his children to work the land after he died. Moreover, Congress intended to benefit those families having children or grandchildren desiring to work the land. However, the material participation standard is, in certain cases, not well-suited to accomplish this objective. The problem with the standard is that a person can materially participate in the management of the production of a commodity without living on the qualifying real property or without even visiting the property very often.[208] This is even easier under section 2032A than it is under the Social Security Act regulations, since under 2032A the material participation can be accomplished by a member of decedent's family or qualified heir's family.[209] "Member of the family" means an individual's ancestor, lineal descendant, a lineal descendant of a grandparent of such individual, the spouse of the individual and the spouse of any such descendant.[210] This allows many people to take advantage of 2032A who certainly do not conform to the congressional ideal of a family farm. For example, a doctor practicing medicine in Florida could own a farm in Iowa. Suppose he has a first cousin twice removed[211] living in Des Moines whose wife[212] was raised on a farm. The doctor makes an arrangement with the wife of his first cousin twice removed (whom he may barely know) to manage the farm, presumably for some consideration. He also finds a tenant to farm the land and makes the required arrangement with the tenant reserving all managerial decisions to him or to the wife of his cousin.[213] The arrangement may also provide for the doctor to pay for a portion or all of the expenses of the farm. There is no doubt, under the cases previously discussed, that the farmer would be materially participating in the management of the production if he made the management decisions. However, under 2032A, the doctor need know nothing about farming since the wife of his cousin can make all the decisions. Thus, a possible product of the operation of section 2032A would give the benefit of the special use valu-

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speculators, (3) keep land from the hands of corporate agriculture, and (4) preserve basic social and economic values associated with the family farm." Note, *Material Participation, supra* note 37 at 857. This formulation is basically sound. The concern is with the social and economic factors Congress wished to preserve, and whether material participation is a workable tool to preserve these values.

208. *See* discussions of Hoffman v. Gardner, 369 F.2d 837 (8th Cir. 1966) and Colgate v. Gardner, 265 F. Supp. 987 (S.D. Ohio 1967) in text accompanying notes 169-181 *supra*.

209. I.R.C. §§ 2032A(b)(1)(C)(ii) and 2032A(c)(7)(B)(ii), (c).

210. I.R.C. § 2032A(e)(2).

211. The first cousin twice removed is a great great grandson of the doctor's grandparents, thus qualifying as a "member of the family." *Id.*

212. The wife of the second cousin also qualifies as a member of the family as a "spouse of any such descendant." *Id.*

213. The nature of the arrangement necessary to qualify for material participation will be briefly discussed in subsection C of this Section *infra*.

ation to a person who neither lives on the land nor knows anything at all about farming — your basic absentee landlord. Moreover, assuming the doctor could bequeath the property to his children, who also know nothing about farming and did not wish to farm the land, they could continue the arrangement begun by their father without destroying the material participation.[214] This is hardly the "family farmer" envisioned by Congress when section 2032A was enacted.[215] This suggests the possibility that, despite the foregoing analysis, Congress intended that a stricter standard govern material participation under 2032A than the standard under 1402(a) (and, by analogy, the standard under the Social Security Act[216]). This determination requires an analysis of the policies underlying each statute.

2. *The Purposes of the Three Statutes*

The first point is that section 1402(a)(1) of the Code and Section 211(a)(1) the Social Security Act (42 U.S.C. § 411(a)(1)) are inextricably linked. Section 1402(a) defines net earnings from self-employment income. Section 1401 of the Code imposes a tax on such earnings. 42 U.S.C. § 411(a) defines net earnings from self-employment income in the same manner as section 1402(a) of the Code, but for the purpose of determining the amount of old age, survivor and death benefits to which a person is entitled.[217] Stated in another way, the tax collected on self-employment income (as well as on wages and other forms of income) provides the fund to pay the benefits provided for in the Social Security Act. To be eligible to receive benefits under the Social Security Act, one must have contributed (through wages, taxes on self-employment earnings, etc.), to the fund. The rationale behind the benefits is that persons whose income is reduced due to inability to work because of age or disability should have at least a portion of their lost income replaced. Contributions to the fund are made during years of productive work when earnings are greatest. However, income (rents, for example) which is not generally subject to reduction based on age or disability is excluded from the definitions of net earnings from self-employment;[218] only income from a trade or business which depends to some extent on the activ-

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214. However, the children would have to find another relative to take over the management duties, since the wife of the first cousin twice removed would be a descendant of their great grandparents, which would apparently not be sufficient under § 2032A(e)(2). However, if the doctor had originally delegated the management of the farm to his nephew or niece, or the spouse of one of his nephews or nieces, the children could continue the arrangement and be within § 2032A.

215. *See also* Dyer, *Estate Tax Savings and the Family Farm: A Critical Analysis of Section 2032A of the Internal Revenue Code,* 11 U. Cal. D. L. Rev. 81, 96 (1978).

216. 42 U.S.C. § 411(a)(1) (1976).

217. *See* 42 U.S.C. §§ 402, 403 (1976).

218. I.R.C. § 1402(a)(1); 42 U.S.C. § 411(a)(1) (1976).

ity of the worker or owner is included.[219]

Thus, the purpose of the Social Security Act is to provide benefits to persons who, by virtue of age or disability, suffer a reduction in income due to a reduction of activity. The material participation standard regarding income from farming was enacted by the Social Security Amendments of 1956.[220] The purpose of the Act was clearly stated in the Report of the Senate Committee on Finance:

> The bill thus would extend coverage under old-age and survivors insurance to certain farmers who, though not covered under the present law, have income from work and therefore are exposed to the type of income loss against which the program is designed to afford protection.[221]

The Senate Finance Committee, in discussing the amendment to 42 U.S.C. 411 which included farmers who materially participate in the production or the management of production, also formulated the basis for a liberal interpretation of material participation: "Your Committee has consistently held the view that the coverage of the program should be as nearly universal as practicable."[222] Thus, coverage under the Social Security Act was broadened under the 1956 amendments. If material participation is given a broad definition, farmers who materially participate are subject to taxation on the income earned from farming in cases in which such income results at least in part from their activity and, in turn, collect social security benefits when they are no longer able to engage in farming to a substantial degree and their income is (presumably) diminished. A liberal interpretation of material participation clearly enhances the function of Code § 1402(a) and the Social Security Act to tax self-employment income earned during periods of significant farming activity and pay social security benefits during periods of decreased activity and lower income.[223] This analysis is strengthened by view-

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219. I.R.C. § 1402(a); 42 U.S.C. § 411(a) (1976).

220. Act of Aug. 1, 1956, ch. 836, tit. I, § 104(c)(2), 70 Stat. 824-25. Section 1402(a)(1) of the Internal Revenue Code was similarly amended by Act of Aug. 1, 1956, ch. 836, tit. II, § 201(e)(2), 70 Stat. 840.

221. S. Rep. No. 2133, 84th Cong., 2d Sess. 8, *reprinted in* [1956] U.S. Code Cong. & Ad. News 3877, 3884, *quoted in* Colegate v. Gardner, 265 F. Supp. 987, 990 (S.D. Ohio 1967).

222. *Id.* at 1, U.S. Code Cong. & Ad. News at 3878, *quoted in* Colegate v. Gardner, 265 F. Supp. 987, 990 (S.D. Ohio 1967); Henderson v. Flemming, 283 F.2d 882, 887-88 n.7 (5th Cir. 1960).

223. At least one case, Henderson v. Flemming, 283 F.2d 882 (5th Cir. 1960), impliedly recognized this rationale when it said:

> When it comes to interpreting the phrase 'materially participates' in the production or management of production of agricultural commodities, we think that Congress likewise used these words in a sense consistent with the broadening of coverage. Mere ownership of property let out to another on some basis by which the amount payable for use (rent) might come from crops produced was not an activity which Congress regarded as an employment or as generating income from employment. The 1956 Amendment did not touch this. But the variables of our complex rural economy, well

ing the social security benefits as, in a sense, an inexact "repayment" of the self-employment taxes the beneficiaries have been paying through their active years.

It is much more difficult to view section 2032A in these terms. Section 2032A is an exception to the normal estate tax rule of valuing property at fair market value and highest and best use.[224] Moreover, a large number of tests must be met in order to take advantage of section 2032A.[225] Exceptions to tax statutes are to be strictly construed.[226] Unlike benefits under social security, the goal of which is universal coverage as far as practicable, section 2032A was enacted as a solution to a relatively narrowly defined problem — the farm family who was forced to sell the farm to pay estate taxes (and perhaps other costs of estate administration).[227] Absent from the policies precipitating the enactment of 2032A are two important factors present in the policies behind the Social Security Act and section 1402 of the Code — a stated broad scope of coverage and a "return of past payments" — both of which strongly militate in favor of a liberal construction of "material participation" under the Social Security Act and section 1402.

Moreover, the inclusion of the material participation standard in section 2032A quite likely had an additional purpose, also related to the overall congressional policy of preserving the family farm.[228] Congress did not wish to benefit corporate agribusiness. It wished to keep as much farmland as possible in the ownership of small farmers and to prevent large agribusiness firms from purchasing the land of small farmers whose families are forced to sell the land to pay estate taxes following the farmer's death.[229] By requiring

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> known to Congress, presented other situations in which the owner of land did much more than furnish the land (and for which he would recieve his rental). He might, under the arrangement, determine the crops to be planted, the areas to be cultivated, the time of planting, the fertilization program, and the manner and time of harvesting. If these activities were of a material, *i.e.*, substantial importance from a practical point of view, then the Amendment was to make such activities self-employment by the owner and the proceeds income from self-employment. Although Congress did not undertake to phrase it in any such legal catagories, this was a recognition that under some arrangements, the two, the onwer of the land and the so-called tenant, are engaged in a joint venture. The result would be that the owner of the land, as well as the tenant, would, in this way, be engaged in the business of farming.

Id., at 888.

224. I.R.C. § 2031; Reg. § 20.2031-1(b). *See* notes 5 and 19A *supra*.

225. *See* Section II D *supra*.

226. Universal Oil Products Co. v. Campbell, 181 F.2d 451, 457 (7th Cir.), *cert. denied*, 340 U.S. 850 (1950); Commissioner v. Sweat, 155 F.2d 513, 517 (4th Cir. 1946), *cert. denied*, 329 U.S. 801 (1947); United States v. Stiles, 56 F. Supp. 881, 883 (W.D. Ark. 1944); Wallace v. United States, 50 F. Supp. 178, 179 (W.D.N.Y. 1943), *rev'd on other grounds*, 142 F.2d 240 (2d Cir. 1944), *cert. denied*, 323 U.S. 712 (1941). *See also* United States v. Stewart, 311 U.S. 60, 71 (1940).

227. *See* Section I *supra*.

228. House Report, *supra* note 44, at 5.

229. *See* text accompanying notes 206-7 *supra*.

material participation, which, by the time the hearings on what became the Tax Reform Act of 1976 were held, had a relatively well-defined meaning, Congress ensured that one farm owned by a large landowner who owned many farms would not qualify, nor would farmland owned by a large corporation.[230] The material participation requirement, particularly in its focus on decision-making, effectively eliminates the farm corporation from qualification. However, must "material participation" be given the broad reading the courts have employed under 411(a)(1) of the Social Security Act in order to exclude corporate agribusiness? Quite obviously the answer is no. In fact, the opposite is true. The narrower the reading of "material participation" given by the courts under section 2032A, the fewer the number of estates that will qualify for the special use valuation. In short, rather than being designed to include more persons, the material participation requirement under section 2032A is designed more to *exclude* many farmers from gaining the benefit of special use valuation. A strict interpretation of material participation under section 2032A will restrict those qualifying to a class much closer to the congressional ideal of the family farmer.[231]

The foregoing discussion permits the proposed Treasury Regulations under 2032A to be viewed in a different light. Perhaps implicitly recognizing the strength of the foregoing argument, the Internal Revenue Service deliberately worded the factors to be considered in determining material participation cumulatively, rather than in the alternative.[232] It is possible that the intent of the regulations is that simply making or participating in a substantial number of final management decisions should not be enough to constitute material participation under section 2032A. Perhaps, in addition to decision making, advice and consultation and the assumption of financial responsibility will be required. The idea may be to make enough activity required so that relatives of most "absentee owners" will not undertake to fulfill the requirements of material participation unless they either participate directly (at least to some extent) in the operation of the farm or are fairly certain that the farm will be bequeathed to them when the owner dies. This interpretation would narrow the class able to elect special use valuation to a class much closer to the one envisioned by Congress. Moreover, requiring several activities in order to materially participate may well encourage a person wishing to take advantage of the special use valuation to participate in the farming operation either himself or through members of his immediate family rather than through distant relatives. In this connection, the

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230. As previously stated, section 1402(a) of the Code was amended in 1974 to exclude vicarious material participation solely through an agent. Pub. L. No. 93-368, § 10(b), 88 Stat. 420 (1974). It is unlikely that any one officer of a large corporation would be involved in sufficient activity as to any farm to materially participate under the case law.

231. *See* text accompanying note 206 *supra*. *See also* Section I *supra;* Note, *Material Participation*, *supra* note 37 at 850-57.

232. Proposed Treas. Reg. § 20.2032A-3(d)(2), 43 Fed. Reg. 31,041 (1978).

statement in the proposed regulation that "[w]ith farms . . . the decedent or heir's maintaining his or her principal place of residence on the premises is a factor to consider in determining whether the overall participation is material"[233] takes on an added significance. Living on the farm comes closest to the congressional ideal of the family farmer. It is to be expected that the Internal Revenue Service will emphasize this element in cases litigated under section 2032A.

In summary, the courts will be faced with a choice of how to interpret material participation under section 2032A. The statute can be literally interpreted and material participation given the same broad meaning it has been given under the Social Security Act. This can be justified on the ground that when words are used in several places in the same statute, they should be given the same meaning unless the context clearly requires otherwise, buttressed by the express terms of the statute.[234] Uniformity of meaning is highly desirable. Moreover, Congress is presumed to be aware of the interpretation of the statute which has been given by the courts.[235] Alternatively, the courts may decide to attempt to interpret the words so as to reflect the policy of Congress as closely as possible. It is impossible to predict at this time which way the courts will decide this crucial issue.

C. *Planning for Material Participation*

In order to qualify for special use valuation, two material participation requirements must be satisfied:

1. The decedent or a member of his family must materially participate for periods aggregating five years or more during the eight-year period ending on the date of decedent's death;[236] and
2. During any eight-year period ending *after* the date of the decedent's death, there has been no period of three years or more during which there was no material participation by the decedent or a member of his family (before death) or the qualified heir or a member of his family (after the decedent's death).[237]

The statute creates a trap for the unwary. Suppose Farmer Gray, who owns a farm, becomes severely ill in 1985 and for one year neither he nor any member of his family materially participates in the operation of a farm. By 1986 Farmer Gray has recovered and materially participates in the farm until his death in 1988. He bequeaths the farm to his son, Dorian. During 1989, while the estate is in administration, neither Dorian nor any of his

233. *Id.*

234. I.R.C. § 2032A(e)(6).

235. *See, e.g.*, Cannon v. Univ. of Chicago, _ U.S. _, _; 99 S. Ct. 1946, 1956-58 (1979).

236. I.R.C. § 2032A(b)(1)(C)(ii).

237. I.R.C. § 2032A(c)(7)(B). Technically, failure to meet this requirement causes recapture. Recapture will be discussed in Section V *infra*.

family materially participates. Dorian materially participates in 1990, but in 1991 his wife's mother becomes ill and he and his wife must spend substantial time in a distant state caring for her. Thus, Dorian does not materially participate during 1991. Though Farmer Gray has satisfied section 2032A(b)(1)(c)(ii), a recapture tax will clearly become payable because section 2032A(c)(7)(B) has been violated.[238] This points out the need for careful pre-death planning of material participation (to insure initial qualification for special use valuation) and, of equal significance, an arrangement insuring prompt commencement of material participation by the qualified heir or a member of his family on the owner's death (to avoid recapture).

A second problem in planning to insure material participation is presented by Proposed Regulation section 20.2032A-3(c)(2). This proposed regulation defines the period for which material participation must last. The proposed regulation states in part:

> In determining whether the required participation has occurred, periods of less than 30 days during which there was no material participation may be disregarded. This is so only if these 30-day periods were both preceded and followed by periods of more than 120 days in which there was uninterrupted material participation.[239]

There is nothing of such specificity in the regulations under section 1402 or the Social Security Act.

This provision can be interpreted in several ways. It may only refer to actual employment on a full-time basis as a method of satisfying material participation.[240] If so, the provision makes some sense in attempting to explain what is meant by "full-time basis." This explanation is unlikely, however, in view of the fact that the provision for actual employment on a substantially full-time basis is in a separate subsection of the proposed regulations and that nothing in the "30 day period disregarded" provisions limits its applicability to the question of whether a person is actually employed on a substantially full-time basis. Moreover, it is common knowledge that farm work has periods of intense activity and slack periods. Should the fact that the owner of a farm does not engage in substantial important activity for forty days (for example, during the winter months) have adverse consequences? A second possible explanation is that this provision was inserted to reinforce the narrow interpretation of material participation suggested above so as to confine the real property qualifying for special use valuation to those farms operated in accordance with the congressional ideal of a fam-

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238. The eight-year period covers from 1984 to 1991 and includes three years (1985, 1989 and 1991) where no material participation took place. *See* Hjorth, *supra* note 39, at 629; Matthews & Stock, *supra* note 119, at 358.

239. Proposed Treas. Reg. § 20.2032A-3(c)(2), 43 Fed. Reg. 31,041 (1978).

240. *See* Proposed Treas. Reg. § 20.2032A-3(d)(1), 43 Fed. Reg. 31,041 (1978).

ily farm.[241] That is, a farmer who lives on the land and whose sole or principal occupation is farming is likely to do something of importance during each thirty-day period (planning for the following year, activities in marketing the crop, reading and considering material about insecticides, attending meetings of various organizations, etc.), whereas an owner who does not live on the land and actively engage in farming as his main activity will not. This explanation, however, makes it difficult to comprehend how an owner of land or a qualified heir can materially participate through a family member, which the statute specifically permits,[242] unless the family member is totally involved on a continuing basis in running the farm. It is unlikely that even a family member who makes the final decisions on farming operations will do something important every 30 days. Moreover, the cases previously discussed[243] indicate that material participation is a cumulative concept. It is the total responsibility for important final decisions, the overall involvement including responsibility for expenses, taking the financial risk of failure, advice, consultations and responsibility for making final decisions which constitute evidence of material participation. The important decisions may be made in several short periods, such as the planting, harvesting and marketing seasons. The provision disregarding periods of no material participation appears to be an attempt to quantify what is inherently unquantifiable.

It is also possible that the proposed regulation is intended to determine material participation in terms of days or months, rather than years. That is, if a person materially participated for 200 days out of a year, but had periods of 30 days or more not preceded and followed by periods of more than 120 days in which there was uninterrupted material participation, the IRS would allow only 200 days for that year and if decedent had not materially participated for 1095 days[244] during an eight-year period, the Service would argue that his estate was not eligible to elect to have his real property valued under 2032A. This explanation seems implausible, since enforcement would be an administrative nightmare. The audit of a federal estate tax return and any litigation could degenerate into an argument over whether the reading of a farm journal on a given day was significant enough to qualify as material participation.[245] It is highly unlikely that Congress intended such a

241. *See* Section IC, *supra*.

242. I.R.C. §§ 2032A(b)(1)(C), 2032A(c)(7)(B).

243. *See* cases discussed in Section III C, *supra*.

244. Query: Would the I.R.S. recognize leap years?

245. An offshoot of this argument is that the Service intends to retain the option of forcing the estate of a decedent (or a qualified heir) to prove that he had materially participated for the required number of days. Again, this is unlikely due to the detailed records which would be required and which most farmers do not presently keep. Moreover, if such records were to be required, it would have been logical for the statute to have specified such a requirement. Whether material participation is to be read broadly or narrowly, § 2032A is still a relief measure for certain groups. It is clear that Congress did not intend that it be denied to otherwise

result.

Lastly, the provision could mean that if, during any year, there were periods of thirty days or more where there was no material participation,[246] a conclusive presumption was to be established that there was no material participation for the entire year. This seems to be an unduly harsh rule. First, given the large number of requirements stated in section 2032A, it is highly probable that if Congress intended such an interpretation, it would have specifically so stated in the statute. Second, the long hearings on the subject gave many members of Congress an understanding of farming methods. Also, Congress contains many members (particularly those from farming areas) intimately familiar with the nature of farming. Congress, or many of its members, presumably knew that important decisions in farming are often concentrated into several relatively short periods of time and that important or substantial activities are not done every day or even every month. It is difficult to impute to Congress an intent to have a year ignored for the purpose of material participation if no significant activity occurs during one thirty-day period.

The wording of proposed regulation section 20.2032A-3(c) raises troubling questions. Both its meaning and purpose are unclear. To a great extent, its period requirements are directly contrary to the entire idea of material participation. Judicial clarification of this provision will be necessary before attorneys are able to plan with regard to it.

It is also clear that for many clients, an arrangement planned for the purpose of meeting the pre-death material participation requirements will be contrary to the client's desires regarding social security benefits. This is because the material participation necessary to insure eligibility for special use valuation may result in the income from the farming operation being classified as net earnings from self-employment under section 1402(a) of the Code.[247] In addition, earned income above the level allowed will reduce social security benefits paid.[248] It has been suggested that one solution to this problem is to have a member of the family undertake the material participation, thus permitting the decedent to collect the maximum social security benefit for which he is eligible.[249]

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qualified estates for lack of incredibly detailed record keeping.

246. If there are periods of less than 30 days with no material participation which are not both followed and preceeded by periods of more than 120 days of uninterrupted material participation, the same result would occur.

247. For 1979, the scheduled tax is 8.1% on the first $22,900 of income. I.R.C. § 1401.

248. However, earned income reduces social security benefits only through age 72 and after 1981 benefits will only be reduced through age 70. 42 U.S.C. §§ 403(f), (h)(1)(A) (1976 & Supp. 1978).

249. *Id.* However, in many cases the landowner (decedent-to-be) will be the only person available to materially participate, or only he will have the skill, knowledge and experience necessary. This is especially true if material participation is interpreted more narrowly for the purposes of § 2032A than for the Social Security Act, as previously suggested.

Remaining is the question of what provisions should be included in a crop share lease to insure material participation if the owner determines to have a tenant operate the land. Michael D. Boehlje and Neil E. Harl, experts on agricultural economics and law, have suggested that the lease require involvement by the landowner in decisions relating to the following:

> (1) cropping patterns and the rotation, if any, to be followed each year,
>
> (2) levels of fertilization and formulae of fertilizer to be applied (NPK),
>
> (3) participation or non-participation in government price/income support programs,
>
> (4) plans for chemical weed and insect control including type of chemical, rate of application and type of application (broadcast or band),
>
> (5) soil and water conservation practices to be followed,
>
> (6) scheduling of repairs to buildings, fences and tile lines,
>
> (7) decisions on use of storage facilities as between landlord and tenant,
>
> (8) changes in basic tillage practices (e.g. shift to minimum tillage),
>
> (9) varieties of seed to be purchased,
>
> (10) marketing strategy for the landlord's share of the crop and coordination of delivery by the tenant, and
>
> (11) for livestock share leases, decisions relative to type of livestock production to be undertaken, level of production planned, nutrition and animal health plans and marketing strategies.[250]

The strategy of Professors Boehlje and Harl, which was formulated prior to the issuance of the proposed regulations under section 2032A,[251] is clearly directed at the "management of the production" aspect of material participation.[252] In light of the possible narrow interpretation of material participation under 2032A suggested above, until court decisions defining material participation under 2032A are made I would recommend that the lease provide for regular advice and consultation by the owner and tenant on farming operations, regular inspection of the land by the owner or a member of his family, and the furnishing of equipment, material and supplies by the owner. If possible, the lease should also provide for residence by the owner in any dwelling house on the land.[253] Professors Boehlje and Harl also suggest that the owner maintain a daily diary or similar record of activities related to participation under the lease.[254] Such a record, in view of the many unsolved questions regarding material participation, is of extreme importance.

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250. M. Boehlje & N. Harl, *supra* note 50, at 16. *See also* Normand, *supra* note 119.

251. The proposed regulations under § 2032A were published in the Federal Register in July 1978.

252. *See* Treas. Reg. § 1402(a)-(4)(b)(3)(iii).

253. *See* Normand, *supra* note 119, at 273 (App. § 6.1).

254. M. Boehlje & N. Harl, *supra* note 50, at 16.

V. Recapture and the Special Lien

A. *The Recapture Tax*

Though Congress believed that it was inappropriate to value land actually used for farming purposes at its potential highest and best use, it recognized that a windfall would result if the land were to be so valued and the beneficiaries did not continue to use the land for farming for a reasonable period of time after the decedent's death.[255] The method chosen to avoid this windfall was to recapture the estate tax benefit granted by section 2032A if the land is sold to a nonfamily member or converted into a nonqualifying use[256] within fifteen years after the decedent's death.

1. *Overview of the Recapture Tax*

Basically, the recapture tax (referred to in the Code as an "additional estate tax") is imposed for the following events:

> If, within 15 years after the decedent's death and before the death of the qualified heir—
>
> (A) the qualified heir disposes of any interest in qualified real property (other than by a disposition to a member of his family), or
>
> (B) the qualified heir ceases to use for the qualified use the qualified real property which was acquired (or passed) from the decedent,
>
> then, there is hereby imposed an additional estate tax.[257]

The first thing to be noticed is that, subject to certain qualifications, death of the qualified heir or the expiration of fifteen years from the date of the decedent's death, whichever occurs first, extinguishes liability for the recapture tax. Moreover, if the disposition of the property or cessation of qualified use occurs more than 120 months (ten years) and less than 180 months (fifteen years) after the decedent's death, the recapture tax is ratably phased out based on the number of full months after the decedent's death in excess of 120 when the recapture event occurs.[258]

Disposition is intended to be a broad term. It includes a sale (or an exchange) of the real property to a nonfamily member (regardless of whether the exchange is taxable or tax-free), an involuntary conversion or similar transaction (under Code sections 1033 or 1034)[259] and a gift to a nonfamily member.[260]

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255. House Report, *supra* note 44, at 22.
256. I.R.C. § 2032A(c); House Report, *supra* note 44, at 22.
257. I.R.C. § 2032A(c)(1).
258. I.R.C. § 2032A(c)(3).
259. House Report, *supra* note 44, at 25.
260. M. Fellows, 1977 Supplement to D. Kahn & E. Colson, Federal Taxation of Es-

Cessation of use means ceasing to use the property as a farm or closely held business[261] or if, during any eight-year period ending after decedent's death and before the death of the qualified heir, there were periods aggregating three years or more where the decedent or a member of his family did not materially participate in the operation of the farm or closely held business (before decedent's death) and the qualified heir or a member of his family did not materially participate in the operation of the farm or other business (after decedent's death).[262]

If a disposition and a cessation of use both occur, only one recapture tax is imposed on any one portion of the property and the tax is assessed after the first recapture event to occur.[263] The additional estate tax is due and payable six months after the date of the recapture event[264] and the qualified heir is personally liable for the tax.[265]

2. *Amount of Recapture Tax*

In general, the amount of recapture tax is the lesser of:

(1) The excess of what the estate tax liability would have been if the property had been valued under section 2031 over the estate tax liability using 2032A[266] (referred to as the "adjusted tax difference"[267]), or

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TATE, GIFTS AND TRUSTS 118 (1977). There are several exceptions to this rule. No recapture will result if the property is disposed of by virtue of an involuntary conversion or condemnation if the proceeds are reinvested in real property which originally qualified for special use valuation. HOUSE REPORT, *supra* note 44, at 25. It is intended that no recapture tax result if the property is disposed of by tax free transfer to a corporation (§ 351) or to a partnership (§ 721) if (1) the qualified heir retains the same equitable interest in the property, (2) the corporation or partnership would, with respect to the qualified heir, be considered a closely held business under § 6166 and (3) if the corporation or partnership consents to be personally liable for the recapture tax if it disposes of the property or ceases to use it for a qualified use during the recapture period. *Id.* at 25, n.3. If involuntary conversion of the qualified real property occurs, no recapture will occur if the qualified real property is replaced by other real property of equal value to be used for the same use. I.R.C. § 2032A(h). For a further discussion, *see* J. MCCORD, *supra* note 2, at 336-38. Of course, by implication, a sale, exchange, gift or other disposition to another qualified heir is not a recapture event. However, the transferee is to be treated as if he had received the property from the decedent and becomes personally liable for the recapture tax. HOUSE REPORT, *supra* note 44, at 26-27. Query, will the death of the transferor or the transferee remove the liability for recapture? The House Report quaintly states that the transferee "steps into the shoes of the first heir," HOUSE REPORT, *supra* note 44, at 26, indicating that perhaps the death of the second qualified heir is the relevant event, but the answer is unclear.

261. I.R.C. § 2032A(c)(7)(A). McCord argues that this may mean the specific use which was being made of the land at decedent's death. J. MCCORD, *supra* note 2, at 338.

262. I.R.C. § 2032A(c)(7)(B). This trap which can cause recapture based on decedent's material participation has already been discussed. *See* text accompanying note 238 *supra*.

263. I.R.C. § 2032A(c)(4); *See also* GENERAL EXPLANATION, *supra* note 3, at 541.

264. I.R.C. § 2032A(c)(5).

265. I.R.C. § 2032A(c)(6).

266. I.R.C. § 2032A(c)(2)(A)(i).

(2) The excess of the amount realized from the disposition (or in any case where the sale or exchange is not at "arm's length," the fair market value) over the special use valuation.[268] Basically, the "adjusted tax difference" is the savings in estate tax resulting from the employment of special use valuation. This, logically enough, is what Congress felt was equitable to collect if the land was removed from the farming or other business status which it wished to benefit and encourage. In cases where the value of the real property has so depreciated in value that the difference between the amount realized from the disposition and the special use value is less than the estate tax savings, the lesser amount is the amount recaptured.[269]

If qualified real property is bequeathed to more than one qualified heir, the statute directs an apportionment of the adjusted tax difference based on the proportion of the reduction in value of the respective interests in the qualifying real property.[270]

3. *Interpretive Problems in the Formula*

A problem occurs when a qualified heir disposes of or ceases to use only a part of the qualified property. Without careful reading of the statute, one might think that the adjusted tax difference attributable to such interest would be only a portion of the adjusted tax difference based on the ratio of the value of the portion disposed of to the value of all the qualified real property, since "interest" as used in 2032A(c) should mean that portion of the qualified property disposed of or no longer used for a qualified use.[271] However, one author has convincingly argued that "interest" actually means the total amount of qualified property received from the decedent and that Congress intended this result.[272] This can cause recapture of the entire es-

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267. I.R.C. § 2032A(c)(2)(C).

268. I.R.C. § 2032A(c)(2)(A)(ii).

269. *Id.*

270. I.R.C. § 2032A(c)(2)(B), (C). In terms of recapture tax liability, the liability of any interest is computed by the following formula:

$$\text{Reduction in estate tax by virtue of use of § 2032A} \times \frac{\text{Reduction in value of interest}}{\text{Reduction in value of all qualified property.}}$$

See Bravenec & Olsen, *supra* note 145, at 142.

271. "Interest" is not defined in § 2032A.

272. M. Fellows, *supra* note 260, at 124-28. The following example, similar to that used by Ms. Fellows, illustrates her argument:

In 1983 A dies leaving 1,000 acres of farmland to his daughter D, having a fair market value at the date of death of $1,500,000 and a special use value of $1,000,000. The executor elects to value the land under § 2032A. The estate tax is $250,000. If the § 2032A election had not been made the estate tax would have been $500,000. In 1987 D sells 500 of the 1,000 acres tate tax saved by the use of section 2032A on a transfer or cessation of use

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to a subdivision developer for $1,000,000. If "interest" means the amount sold by the qualified heir, the additional estate tax of $125,000 is computed as follows:
The lesser of:
1) The adjusted tax difference attributable to the interest:

$$\frac{\$750{,}000 - \$500{,}000}{\$1{,}500{,}000 - \$1{,}000{,}000} \times (\$500{,}000 - \$250{,}000)$$
$$= \$125{,}000$$

or
2) The excess of the amount realized over the § 2032A value of the interest: $1,000,000-$500,000=$500,000.
However, if "interest" means the entire amount of qualified real property received from the decedent, the recapture tax is $250,000 calculated as follows. The lesser of:
(1) The adjusted tax difference attributable to the interest:

$$\frac{\$1{,}000{,}000 - \$500{,}000}{\$1{,}000{,}000 - \$500{,}000} \times (\$500{,}000 - \$250{,}000)$$
$$= \$250{,}000$$

or
(2) The excess of the amount realized over the § 2032A value of the interest: $1,000,000-$500,000 = $500,000. Thus, the entire tax savings is recaptured.

Fellows then offers two arguments supporting the contention that Congress intended that the entire estate tax savings should be recaptured, even though only a portion of the qualified real property was sold. First, § 2032A(c)(2)(D)(i) dealing with partial dispositions, provides that the value to be taken into account when computing the recapture tax on the portion disposed of shall be the pro rata share of the value of the portion *only* in the computation under § 2032A(c)(2)(A)(ii), the computation of the excess of the amount realized over the special use valuation. By so specifying, Congress intended that the adjusted tax difference with respect to the interest should *not* be reduced pro rata in the case of partial dispositions. *Id.* at 126. However, it could be argued that in cases similar to the example, the adjusted tax difference attributable to such interest will *always* be the same as the adjusted tax difference with respect to the estate. This would obviate the need for separate definitions of "adjusted tax difference attributable to interest" (§ 2032A(c)(2)(B)) and "adjusted tax difference with respect to the estate" (§ 2032A(c)(2)(C)) except where qualified real property is given to more than one qualified heir or in the case of successive interests. The question then occurs as to why, since Congress was so particular in prescribing a rule for partial dispositions, it did not preface the definitions in § 2032A(c)(2)(B) and (C) with the qualification that they were only to apply in cases of interests given to more than one qualified heir or of the creation of successive interests. Despite this, Fellows' argument is impressive, especially since she goes on to illustrate that if "interest" means the amount disposed of by the qualified heir, a later transfer of the remaining property would not result in recapture of the remaining tax savings. *Id.* at 126-28. Fellows further buttresses her argument by quoting § 2032A(c)(2)(D)(ii) which states:

> the adjusted tax difference attributable to the interest taken into account with respect to the transaction involving the second or any succeeding portion shall be reduced by the amount of the tax imposed by this subsection with respect to all prior transactions involving portions of such interest.

Id. at 126. She argues that the use of "portions of such interest" is a clear indication that "interest" must refer to the entire property passing from the decedent (or the previous qualified heir) to the qualified heir. Of course, it is possible to argue that the quoted subsection is merely intended to indicate that if a qualified heir receives two or more parcels of qualified real of a portion of the qualified real property. This unclarity in the definition of "interest" should be carefully considered by practitioners in determining whether to elect 2032A.

Problems also exist concerning the imposition of the recapture tax when the decedent creates successive interests in the qualified real property. These will be discussed subsequently.[273]

B. *The Special Lien on Qualified Real Property*

To protect the government's interest in case a recapture tax is imposed, the Tax Reform Act of 1976 also added section 6324B to the Internal Revenue Code.[274] This section creates a lien in favor of the United States on any property in which an interest in qualified real property under section 2032A exists.[275] The lien is in the amount of the adjusted tax difference attributable to the interest.[276] The lien arises at the time a 2032A election is filed and continues until the recapture tax liability under 2032A(c) is satisfied or "has become unenforceable by reason of lapse of time."[277] The lien is not valid against any purchaser, or any holder of a security interest, mechanic's lien or judgment lien, until a notice of the lien has been filed.[278] The lien replaces any lien against the estate under section 6324.[279] The lien is not valid as against a prior mechanic's lien or any security interest under section 6323(c), whether prior or subsequent, except for such interests which came into existence after a notice that payment has been accelerated has been

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property, a reduction of the adjusted tax difference is allowed for the tax imposed on prior transactions involving only that parcel. However, "interest" is not a totally appropriate term in such a context and Ms. Fellows' argument has a great deal of merit. The term "interest" should be clarified by regulations.

273. The two most frequently used examples are life estates and trusts. *See* Section VI G *infra*.

274. Tax Reform Act of 1976, *supra* note 1, § 2003(b), 90 Stat. 1861, (codified at I.R.C. § 6324(B)).

275. I.R.C. § 6324B(a).

276. *Id.*

277. I.R.C. § 6324B(b)(1). Presumably by the reference to the lien becoming unenforceable by lapse of time, Congress intended that the lien lapses on the first to occur of 15 years from the decedent's death or of the death of the qualified heir. *See* House Report, *supra* note 44, at 27. Section 6324B(b)(2) provides that the lien will also end when "it is established to the satisfaction of the Secretary that no further tax liability may arise under § 2032A(c) with respect to such interest." There is no indication in the legislative history as to what circumstances this provision was intended to cover.

278. I.R.C. § 6324B(c) making § 6324A(d)(1) applicable to the special lien. The notice must meet the requirements of § 6323(f); that is, it must be filed in an office designated by state law where the property is situated, or, if the state has not designated such an office, with the clerk of the U.S. district court in the judicial district in which the land is situated. The form of notice shall be prescribed by the Secretary of the Treasury and must be indexed at the district office of the IRS.

279. I.R.C. § 6324B(c), making § 6324A(d)(4) applicable to the special lien.

filed.[280] Regulations are to be issued permitting the furnishing of security as a substitute for the special lien.[281] The biggest problem with the special lien is the impairment of the qualified heir's ability to obtain the financing needed to operate the farm.[282] The first response to this was the issuance of a news release by the IRS.[283] The news release stated that the rule of code section 6324A(d)(3)(c), relating to liens arising from extensions of time to pay tax under section 6166 and 6166A, that the lien is not valid "against financing agreements securing loans for construction or improvement of real property, raising or harvesting of farm crops, or raising livestock or other animals"[284] was also applicable to the special lien arising under section 6324B. Furthermore, the 6324B lien is not valid against such financing agreements, regardless of whether the agreement comes into existence before or after the filing of the tax lien. Apparently not satisfied with this response, in the Revenue Act of 1978 Congress added code section 6325(d)(3)[285] to provide that the Secretary of the Treasury may subordinate any lien imposed by section 6324B if he determines that the United States "will be adequately secured after such subordination."[286] It is not known

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280. I.R.C. § 6324B(c), making § 6324A(d)(3) applicable to the special lien. The security interests under § 6323(c)(3) are those resulting from an agreement to make cash disbursements to finance the construction or improvement of real property, a contract to construct or improve real property, or the raising and harvesting of a farm crop or the raising of livestock or other animals.

281. I.R.C. § 6324B(d).

282. J. McCord, *supra* note 2, at 348. *See also* M. Boehlje & N. Harl, *supra* note 50, where the authors state:

> The tax lien that attaches to real property if "use" valuation is elected has implications concerning credit utilization and credit flows in agriculture. Some lenders have expressed reservations as to advancing funds if the security already has a "use" valuation tax lien attached. If such a lien is attached to real property, it may reduce the possibility of using that property as the collateral for refinancing as commonly occurs during farm expansion and in periods of financial stress. Consequently, if such liens become a common occurrence, those farmers may find it more difficult to use their real estate as a source of security for credit transactions.

Id. at 40-41.

283. I.R.S. News Release 1823 (June 2, 1977), 3 Fed. Est. & Gift Tax Rep. (CCH) ¶ 12,029.

284. *Id.*

285. Revenue Act of 1978, *supra* note 82, § 513.

286. *Id.* The statute authorizes the issuance of a "certificate of subordination." It is hoped that these will be issued liberally to enable farmers to use the qualified real property as security for loans needed for the continued operation and improvement of the farm. It was the intent of Congress that the 6324B lien not operate in such a way as to prevent the farm from continued viable operation. *See* Staff of the Joint Committee of Taxation, 95th Cong., 2d Sess., General Explanation of the Revenue Act of 1978 (1979) [hereinafter cited as General Explanation, 1978]:

> The Congress believes that the subordination of lien provision should be clarified to permit the subordination of the special tax lien in appropriate cases. In this way, the purpose of providing the special estate tax valuation for farm and closely held busi-

how liberal the IRS will be in subordinating liens under section 6324B, but a liberal use of the provision will allay the fears of many farmers concerning the availability of future credit if they elect to use section 2032A.

VI. Estate Planning Under Section 2032A

A. *The Basis Problem*

Insofar as the estate tax is concerned, election of special use valuation appears to be an attractive alternative to farm owners. The worst effect would be a deferment of a portion of the federal estate tax.[287] However, the election has income tax effects which must also be taken into account and which considerably affect the utility of section 2032A.

1. *Basis Determined Under Step-Up Method*

Before the passage of the Tax Reform Act of 1976, the basis of property to the estate of a decedent (and to the beneficiaries) was the fair market value of the property on the date of the decedent's death.[288] The Tax Reform Act of 1976 eliminated the former "stepped-up" basis for property of decedents dying after December 31, 1976 and replaced it with carryover basis.[289] However, in view of the uproar raised by attorneys and corporate fiduciaries, as well as concern expressed during the hearings on the Tax Reform Act of 1976,[290] Congress postponed the effective date of the carryover

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> ness real property will not be frustrated by unduly restricting an heir's ability to obtain working capital and other financing because the lien for such financing would be inferior to the preexisting special tax lien.

Id. at 291.

287. By making an election under section 2032A, the value of the gross estate, and thus the federal estate tax, would be reduced. Even if a recapture event occurs, only the estate tax savings would be recaptured. *See* Section V A *supra*. In the interim, the estate tax saved could help to relieve the cash needs of the farm or could be invested.

288. I.R.C. § 1014(a). The Tax Reform Act of 1976 did not alter section 1014(a), but instead provided that section 1014 did not apply to any property for which section 1023 mandated a carryover basis. I.R.C. § 1014(d).

289. I.R.C. §§ 1014(d) and 1023.

290. *See* General Explanation, 1978, *supra* note 286:

> A number of administrative problems concerning the carryover basis provision have been brought to the attention of Congress. Administrators of estates have testified that compliance with the carryover basis provisions has caused a significant increase in the time required to administer an estate and has resulted in raising the overall cost of administration. Moreover, the Congress believes that it should thoroughly review the basis concept of carryover basis in addition to considering its effect on the administration of estates . . . .

Id. at 294.

There is no question that many Congressmen recognized the potentially disasterous effects of carryover basis on farms. *See* 122 Cong. Rec., 30848 (1976) (statement of Rep. Conable); *id.* at 30849 (statement of Rep. Schneebeli). Apparently, however, it took a year of experience with carryover basis and many protests to make other Congrressmen question the wisdom of carry-basis rule until December 31, 1979.[291] On April 2, 1980, President Carter signed the Crude Oil Windfall Profit Tax Act of 1980[292] which contained a section completely repealing the carryover basis provisions of the Internal Revenue Code[293] and reviving prior law.[294] However, the 1980 Act permits executors of estates of decedents dying after December 31, 1976 and before November 7, 1978 to irrevocably elect to have the basis of all estate property governed by the carryover basis rules.[295] Since some executors must now consider whether to elect to use carryover basis, the effect of section 2032A election on basis will be discussed as to both the "stepped-up" basis and carryover basis.

Under "stepped-up" basis rules the basis of the qualified real property would be "stepped-up" to special use values (presumably lower than fair market value). If it is unlikely that the property will be sold within fifteen years of the decedent's death, a decision of whether or not special use valuation should be selected will depend on a comparison of the estate tax saved against the increased capital gains tax which will be paid on the sale because of the lower basis. Often the capital gains rate will be lower than the estate tax rates, thus suggesting that the use of section 2032A will result in an overall tax savings.[296] However, if there is a possibility (or a likelihood) that the property will be disposed of within fifteen years after the decedent's death, or will cease to be used as a farm, or that material participation will not occur for three years or more during any eight-year period ending after the date of the decedent's death,[297] section 2032A should probably not be elected or, at least, the adverse consequences of election should be seriously considered. In this situation, not only will the estate tax originally saved be recaptured, but the beneficiary will realize a capital gain based on the excess of the amount realized over the special use value.[298] The reason for this is

over basis.

291. Revenue Act of 1978, *supra* note 82, § 515.

292. Pub. L. 96-223.

293. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. 96-223, § 401(a).

294. *Id.* at § 401(b). The Act is effective with respect to decedents dying after Dec. 31, 1976. *Id.* at § 401(e).

295. *Id.* at § 401(d). The election must be made within 120 days following enactment of Pub. L. 96-223 in a manner prescribed by the Secretary of the Treasury or his delegate.

296. Also to be taken into account is the value of deferring taxes by paying less estate tax at decedent's death and more income tax on capital gains at a later date. Lastly, it should not be overlooked that the additional capital gains generated by the lower special use value basis may result in the imposition of a minimum tax (technically an alternative minimum tax for tax years ending after December 31, 1978). *See* I.R.C. §§ 56-58.

297. *See* I.R.C. § 2032A(c)(7)(B).

298. I.R.C. § 1001. Of course, a gift of the property to a non-qualified heir or a mere cessation of qualified use will not, as such, result in the realization of capital gains. *See* Treas. Reg. § 1.1001-1(a) (1957). However, care should be taken so that treatment of the transfer as part sale and part gift is avoided. *See* Treas. Reg. § 1.1001-1(e) (1957). However, even in these cases, on a subsequent sale by the beneficiary the capital gain realized will be the excess of the

that the basis of the qualified real property is not increased on the imposition of the recapture tax.[299] The result is that not only will the full estate tax (that is, the tax which would have been paid had the property been valued at its highest and best use) be paid, but an additional income tax based on a portion of the difference between the fair market value at the date of decedent's death (or alternate valuation) and the special use value on such date will be assessed. Thus the estate and/or the qualified heir will pay more tax by electing special use valuation than would have been the case if an election under section 2032A was not made.[300]

2. *Basis Under Carryover Basis*

When considering the basis consequences under the carryover basis rules,[301] several factors must be considered. Basically, for executors electing carryover basis,[302] the basis of property received by the estate or the beneficiary is its adjusted basis immediately before the death of the decedent.[303]

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amount realized over the special use valuation. Thus the same result is produced, but the capital gains tax is deferred until the sale or other disposition of the property by the qualified heir (in the case of the cessation of use as a farm or a failure to meet the material participation rules) or a sale or other disposition by the donee.

299. This is clear from the wording of I.R.C. § 1014(a), which provides in part:

> [t]he basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be—
>
> . . . .
>
> (3) in the case of an election under section 2032.1 [sic], its value determined under such section.

The only portion of section 2032A which mentions value is § 2032A(a), which provides that the value shall be "its value for the use under which it qualifies, under subsection (b), as qualified real property." Subsection (b), which defines qualified real property, refers to the date of decedent's death. Thus, the basis of the property is its special use value on the date of decedent's death or the alternate valuation date.

300. Of course, it is true that a portion of the estate tax will be deferred by making the § 2032A election. But in the context of an overall increase in tax, it is doubtful that in many cases the deferral will be significant enough to overcome the adverse tax consequences of the election.

301. *See generally,* T. McGrath & J. Blattmachn, Carryover Basis Under 1976 Tax Reform Act (1977); Freilicher, *Problems of Fiduciaries Resulting from Carryover Basis,* 36 N.Y.U. Inst. Fed. Tax. 613 (1978); Barnett, *Carryover Basis at Death Neither Novel, New Nor Necessarily A Nightmare,* 12 U. Miami L. Center Inst. Est. Plan. 19-1 (1978); Covey, *Recent Developments Concerning Estate, Gift and Income Taxation 1977,* 12 U. Miami L. Center Inst. Est. Plan. 1-1 (1978); Covey, *Recent Developments Concerning Estate, Gift and Income Taxation—1976,* 11 U. Miami L. Center Inst. Est. Plan. 1-1 (1977). For a review of the inadequacies of the carryover basis rules, *see* Covey and Hastings, *Cleaning Up Carryover Basis,* 31 Tax Law. 615 (1978). *See also* Conway, *Carryover Basis—An Impossible Dream,* 118 Trs. and Est. 10 (Mar. 1979).

302. Crude Oil Windfall Profit Tax Act, *supra* note 284, § 401(d).

303. I.R.C. § 1023(a). For the purpose of the remainder of this article, adjustments to basis under § 1016 will not be considered.

Section 1023 then prescribes four adjustments which are to be made to this basis: a "fresh start" adjustment,[304] an adjustment for the federal and state estate taxes attributable to the appreciation in the property,[305] a minimum carryover basis[306] and an adjustment for state inheritance taxes paid by the person acquiring carryover basis property.[307] For the purposes of this article, a discussion of only the first two of these adjustments will be necessary.

With respect to qualified real property we start with the cost basis (as adjusted under section 1016). The "fresh start" adjustment is intended to prevent the income taxation of appreciation which occurred before the effective date of the Tax Reform Act.[308] This is done by assuming a uniform basis of appreciation; the excess of the value of such property over the decedent's adjusted basis is determined and multiplied by a fraction equal to the number of days the property was held by decedent prior to January 1, 1977 divided by the total number of days the decedent held the property.[309] The resulting amount (the fresh start adjustment) is added to the decedent's basis.[310] Although not mentioned in the statute, it is clear that for the purposes of the fresh start adjustment, the value of qualified real property is the value determined under section 2032A if special use valuation is elected.[311] Thus if a section 2032A election is made, the total appreciation will be less than if the property is valued at its fair market value. This will result in a lower fresh start adjustment and a lower basis. If the property is later sold, the capital gains will be greater than if no election had been made.

It should be noted that there is nothing in the carryover basis rules allowing a recomputation of the fresh start adjustment if a recapture event occurs and a recapture tax imposed. Although the legislative history does not disclose whether Congress considered the problem, a provision of the Revenue Act of 1978 raises an inference that no recomputation will be allowed. A question had arisen as to whether successive fresh start adjust-

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304. I.R.C. § 1023(b).

305. I.R.C. § 1023(c).

306. I.R.C. § 1023(d).

307. I.R.C. § 1023(e).

308. General Explanation, *supra* note 3, at 553.

309. I.R.C. § 1023(h)(2). The excess of value over the decedent's adjusted basis is first reduced by adjustments for depreciation, amortization and depletion. I.R.C. § 1023(h)(2)(B)(i). After multiplying the result by the applicable fraction, adjustments for depreciation, amortization and depletion attributable to the portion of the holding period occurring prior to January 1, 1977 are added to the basis so computed. I.R.C. § 1023(h)(2)(B)(ii).

310. I.R.C. § 1023(h)(2)(A), (B).

311. For the purposes of this rule [the fresh start adjustment], the fair market value of property on the date of the decedent's death is to be determined under the special valuation rule for farms or other closely held businesses if that rule is elected for estate tax purposes (sec. 2032A), but determined without regard to the alternate valuation rule (sec. 2032).

General Explanation, *supra* note 3, at 556.

ments would be allowed for carryover basis property which was devised, bequeathed or transferred intestate by more than one decedent. Section 702(c)(4) of the Revenue Act of 1978 added section 1023(b)(4) to the Code to state that basis would not be increased because of the death of a decedent if his basis reflects the adjusted basis of the property which was carryover basis property with respect to a prior decedent. The amendment reflects Congress' intention that there should be only one fresh start adjustment.[312] It can be postulated that no new adjustment to basis under the fresh start provision is to be made on the occurrence of a recapture event.

However, this is not the only problem facing an attorney or executor contemplating a 2032A election under carryover basis. A second adjustment to the carryover basis of property is made to reflect the federal and state estate taxes attributable to the appreciation.[313] The purpose of this adjustment is to avoid a double tax on the appreciation. This adjustment is made after the fresh start adjustment has been computed. The carryover basis is increased by an amount which bears the same ratio to the federal estate taxes as the net appreciation in value of the property bears to "the fair market value of all property which is subject to the tax imposed by section 2001 or 2101."[314] The first point of importance is that, as in the fresh start adjustment, the net appreciation in the value of qualified real property will be less if a section 2032A election is made than if the election is not made, thus resulting in a lower increase in basis. However, the most significant question regarding this adjustment is whether the imposition of a recapture tax triggers an increase in basis under section 1023(c) based on the additional estate tax paid. An argument could be made that since the effect of the recapture tax is to treat the qualified real property as if it had been valued originally in the decedent's estate at its fair market value (including the highest and best use standard), the entire 1023(c) adjustment should be recomputed based on the higher appreciation (fair market value on date of death less adjusted basis as opposed to section 2032A value less adjusted basis) and the increased estate tax paid, or, alternatively, that the qualified heir's basis in the qualified real property should be increased by that portion of the recapture tax representing the appreciation in the value of the property to the decedent's date of death. However, the available evidence suggests fairly clearly that no adjustment to basis under section 1023(c) will be made based on the recapture tax. The staff of the Joint Committee on Taxation stated, in regard to the adjustment for federal and state estate taxes:

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312. As stated by the Staff of the Joint Committee on Taxation as "Reasons for Change": "The Congress believes that it should be made clear that the 'fresh start' adjustment is to be made only once." GENERAL EXPLANATION, 1978, *supra* note 286, at 415.

313. I.R.C. § 1023(c).

314. *Id.* A similar adjustment is made with respect to state estate taxes.

> The term "Federal and State estate taxes" includes the tax imposed by section 2001 or 2101 reduced by any credits allowable against such tax. *It does not include any additional estate tax imposed because of a disposition of property which qualified for the special farm or closely held business valuation method.* (emphasis added).[315]

This is supported by the language of the statute, which refers to "the tax imposed by section 2001 or 2101."[316] The recapture tax is imposed by section 2032A(c), not by section 2001 or 2101. Thus, it is likely that no increase in basis will be allowed on the imposition of a recapture tax.[317] The result of a 2032A election will be a lower basis for the qualified real property. As under "stepped-up" basis, the task of the estate planner is to estimate the likelihood of a recapture event occurring within fifteen years of the decedent's death. If a recapture event is likely, it is highly dubious if the deferral of a portion of the estate tax will be a sufficiently significant benefit to outweigh the increased capital gains which will occur due to the 2032A election.[318]

B. *Preliminary Considerations in Estate Planning*

The benefits of section 2032A make several preliminary considerations applicable. Some of these may seem obvious, but they are of substantial importance. First, any estate where the taxable estate (plus adjusted taxable gifts) is under the exemption level should never elect section 2032A. The reason for this is that the application of the unified credit will result in no estate tax payable.[319] Since the benefit derived from a section 2032A election

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315. General Explanation, *supra* note 3, at 557. *See also* House Report, *supra* note 44., at 39.

316. I.R.C. § 1023(c)(1).

317. Most of the commentators on § 2032A agree with the conclusion that no increase in basis will be allowed under § 1023(c) for the portion of the recapture tax attributable to appreciation. *See, e.g.,* J. McCord, *supra* note 2, at 86; Tax Research Inst. of America, the RIA Complete Analysis of the '78 Revenue Act ¶ 108 at 19 (1978); Dyer, *supra* note 215, at 104; Kelley, *Valuation of Farm and Ranch Land After the Tax Reform Act,* 1 Agricultural L. J. 75, 94-95 (1979). Note, however, the somewhat cryptic statement in the House Report: "While the recapture tax is generally treated as a separate estate tax, it is treated as a tax on the estate of the decedent for the purposes of the previously taxed property credit." House Report, *supra* note 44, at 27.

318. It is necessary to reemphasize that the increase in the basis of property under carryover basis rules is reduced two ways if a § 2032A election is made: a lower fresh start adjustment and a lesser increase in basis for the portion of federal and state estate taxes attributable to appreciation. Moreover, the reduction is magnified since the adjustment for estate and gift taxes depends on the basis as determined after the fresh start adjustment is made.

319. The credits and exemption levels are as follows:

Year	Unified Credit	Exemption Level
1979	$38,000	$147,333
1980	42,500	161,563
1981	47,000	175,625

is to reduce the estate tax (or, in case a recapture event occurs, to defer a portion of the estate tax), there is no benefit from such an election where no tax is payable. In fact, only a detriment occurs in such a case, in the form of increased capital gains tax.

Second, special valuation does not apply to inter vivos gifts.[320] This signifies that the estate planner should use caution in advising lifetime gifts of potential section 2032A property. Such gifts may bring the value of the property below the fifty percent and twenty-five percent minimums necessary for qualification.[321]

Lastly, the estate planner should not ignore sections 6166 and 6166A.[322] In order to qualify for deferral under section 6166, more than sixty-five percent of the adjusted gross estate must consist of an interest in a closely held business.[323] If a section 2032A election is made, the section 2032A value must be used to determine qualification under section 6166.[324] In certain cases, a section 2032A election may result in the loss of the benefits of section 6166.[325]

Section 6166A also provides for a deferral of a portion of the estate tax attributable to an interest in a closely held business. The deferred tax is payable in no less than two or more than ten installments.[326] The interest rate is not as favorable to the estate as that under section 6166[327] and there is no five year deferral of principal payments. To qualify for a section 6166A

I.R.C. § 2010.

320. *See* I.R.C. § 2032A(a), (b). There is some question of whether property which is the subject of a gift and is includable in the gross estate (for example, if the gift was made within three years of death and thus was includable under I.R.C. § 2035) will qualify for special use valuation. There appears to be nothing in the statute or legislative history preventing such property from qualifying, and it is likely that the special valuation election will be available in such cases. *See* Dyer, *supra* note 215, at 98; Hjorth, *supra* note 39, at 641-42.

321. I.R.C. §§ 2032A(b)(1)(A), (b)(1)(B).

322. Each of these sections provides for deferral of a portion of the estate tax. Basically, § 6166 authorizes the deferral of that portion of the estate tax attributable to a closely held business interest for five years from the date the return is due and the payment of the balance in up to ten equal annual installments. I.R.C. § 6166(a). The interest rate is four percent on the first $1,000,000 of taxable estate and the rate under § 6621(b) on the balance. *See* Hjorth, *supra* note 39, at 631-39 for a further description of this section.

323. I.R.C. § 6166(a)(1).

324. House Report, *supra* note 44, at 32-33.

325. *See* Hjorth, *supra* note 39, at 634, n. 111.

326. I.R.C. § 6166A(a)(1).

327. The interest is determined under I.R.C. § 6601, which refers to § 6621. Section 6621 provides for an interest rate of nine percent or an adjusted rate established by the Secretary of the Treasury. An adjusted rate is to be established when the prime rate during September of any year (rounded to the nearest full percent) is at least a full percentage point more or less than the interest rate then in effect. The adjusted rate is the adjusted prime rate, rounded to the nearest full percent and becomes effective February 1 of the succeeding year. However, 23 months must elapse between the date of adjustments changing the interest rate. I.R.C. § 6621(b).

election, the value of the interest in the closely held business must exceed either thirty-five percent of the value of the gross estate or fifty percent of the value of the taxable estate.[328] Again, a reduction in the value of the qualified real property by virtue of a section 2032A election could result in not meeting the requirements of section 6166A.

It should be noted that one preliminary problem raised under section 2032A has been solved by the proposed regulations. Suppose gifts or other factors have reduced the value of qualified real property such that it does not meet the fifty percent or twenty-five percent tests for qualification. Changes resulting from the audit of the return (such as a decrease in the fair market value of other property at date of death or exclusion of other property from the gross estate)[329] could result in the property qualifying for special use valuation. But since the election must be made when the estate tax return is filed,[330] by the time the executor knows that the property qualifies for special use valuation the time for making the election will have passed. The proposed regulations[331] provide for the making of a protective election by the filing of a notice of election with a timely filed estate tax return and, if it is subsequently determined that the estate qualifies for special use valuation, the filing of an additional notice of election within sixty days of the date of the subsequent determination.[332]

C. *Absolute Bequest to One Beneficiary (Not the Spouse)*

The situation where the value of the estate is greater than the exemption levels and a qualified heir intends to continue to farm presents the least complications from the standpoint of the estate planner. In determining whether an election under section 2032A should be made, the estate tax savings must be weighed against the increased capital gains tax, and the importance (in terms of availability of assets to pay the estate tax) of tax deferral weighed against the likelihood of the occurrence of a recapture event. In

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328. I.R.C. § 6166A(a). Certain other qualification rules for § 6166A also differ from those under § 6166.

329. Initial qualification is based on the values of the gross estate and the real and personal property determined without regard to § 2032A. I.R.C. § 2032A(b)(3).

330. I.R.C. § 2032A(d)(1).

331. Proposed Treas. Reg. § 20.2032A-8(b), 43 Fed. Reg. 30,072 (1978).

332. The notice of protective election must include:

(1) The decedent's name and taxpayer identification number as shown on the estate tax return;

(2) The qualified use; and

(3) The items of real and personal property shown on the return which meet the § 2032A requirements (identified by schedule and item number). A protective election does *not* extend the time for payment of tax. The additional notice of election must include all the information required in a notice of election where the estate initially qualifies for special use valuation and must be attached, together with an agreement by all persons with an interest in property to be personally liable for the recapture tax, to an amended estate tax return. *Id.*

planning to keep the option available, material participation by the owner or a member of his family during the owner's life must be insured. Moreover, if the qualified heir is not the executor, the will should make provision for material participation.[333] In this situation, particularly if the qualified heir is committed to engage in farming and it is unlikely that he will sell or otherwise dispose of the farm and there is no problem with material participation, a section 2032A election may result in substantial tax savings.

D. *The Surviving Spouse as Beneficiary*

1. *Drafting Problems*

Very often one spouse may wish to bequeath the family farm to the other spouse. This is entirely natural, especially in the case of a farm family who has lived on and worked on the farm for their entire lives. However, the interrelationship of sections 2032A and 2056 raises a number of difficult questions.

First, the use of a marital deduction makes a section 2032A election inadvisable for any decedent having a gross estate of less than $351,250 or perhaps of less than $425,625.[334] This significantly reduces the number of estates which can profitably consider a section 2032A election.

Second, an election under section 2032A clearly dilutes the value of a marital deduction in large estates. This is a result of the reduction in the value of the gross estate. For example, suppose the decedent owned a farm having a fair market value of $3,000,000 and a section 2032A value of $1,500,000. The maximum marital deduction would normally be $1,500,000, but if a section 2032A election were made, the marital deduction would be

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333. This could presumably be accomplished by a provision in the will directing the executor to permit the qualified heir to operate the farm (perhaps making decisions jointly with the executor if there is concern that the executor would be abrogating his fiduciary duty by leaving total control in the hands of the qualified heir) during the period of administration. The will could also relieve the executor from liability for losses occasioned by the qualified heir's operation of the farm during this period. Alternatively, an agreement between the executor and the qualified heir regarding operation of the farm could be drafted prior to the owner's death, approved by the executor named in the will and the qualified heir, and executed immediately after the executor qualifies.

334. This conclusion applies after 1981, when the unified credit has been fully phased in. Again, the rationale is that there is no purpose in making a § 2032A election if there is no estate tax. The Tax Reform Act of 1976 changed the maximum marital deduction allowable to the greater of $250,000 or fifty percent of the adjusted gross estate. I.R.C. § 2056(c)(1). If the decedent bequeaths his spouse the maximum marital deduction, no tax will be payable on an estate valued at less than $425,625. It may be argued that such a bequest will cause the spouse to have a gross estate of $250,000, thus causing an estate tax on her estate; however, if the spouse dies owning qualified real property, there is no reason why her estate cannot make a § 2032A election (assuming the other requirements of the section are met), even though her spouse did not elect § 2032A.

$1,125,000.[335] This is a necessary result of the statute but is more than compensated for by the reduction in value of the gross estate. However, the interplay of the two sections could cause either a substantial overfunding or underfunding of the marital deduction. This can be easily illustrated by assuming a decedent owning as his only asset a farm with a "highest and best use" value of $500,000 and a section 2032A value of $250,000. Assume decedent's will contained a pecuniary formula maximum marital deduction[336] (to be satisfied at estate tax values) which amount was bequeathed outright to his spouse. Without section 2032A, it is clear that the surviving spouse would receive one-half of the farm. However, an election under section 2032A would reduce the gross estate to $250,000, thus creating the possibility that the surviving spouse would receive the entire farm (and the entire estate).[337] These problems could be solved by a provision in the will to the

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335. The maximum reduction in the value of the qualified property is limited to $500,000. I.R.C. § 2032A(a)(2).

336. There are two basic types of formula marital deduction provisions: the pecuniary formula provision (also known as the legacy provision) and the fractional share of the residue provision. The best description and treatment of the types of provisions is found in R. Covey, The Marital Deduction and the Use of Formula Provisions 8-20 (2d ed. 1978).

337. This would present a difficult problem of construction to a court. Courts have shown a tendency to favor the surviving spouse and to give effect to decedent's tax planning. *See, e.g.*, Osborn v. Osborn, 334 S.W.2d 48 (Mo. 1960), holding that a widow's share was to be paid in full and all general and specific bequests be abated where testator bequeathed his wife an amount necessary to obtain the maximum marital deduction, on the ground that testator's intention to take advantage of the maximum marital deduction overruled the normal order of abatement. *But see* Estate of Schwartz, 92 Misc. 2d 40, 399 N.Y.S. 2d 386 (Surr. Ct. N.Y. County 1977), holding that a bequest of "an amount which shall be equal to the maximum marital deduction" in a will executed prior to January 1, 1977 of a decedent dying prior to January 1, 1979 was to be governed by the law as it existed prior to the Tax Reform Act of 1976. Though the decision rested on § 2002(d)(1)(B) of the Tax Reform Act, providing that the increased marital deduction does not apply to a decedent dying before January 1, 1979 leaving a will executed prior to January 1, 1977 containing a maximum marital deduction clause, the court appears to be attempting to effectuate what it views to be testator's intention. It is entirely possible that a court could follow a line of reasoning similar to the example given in the text to rule that decedent intended his spouse to receive only one-half of the farm, despite the intention to receive the maximum martial deduction, by interpreting testator's words in the light of the will as a whole (perhaps viewing the existence of a residuary clause as evidence of decedent's intention not to bequeath the entire estate to the spouse). The example in the text is taken from Hjorth, *supra* note 39, at 647-48. Professor Hjorth has hypothesized that since a § 2032A election requires the consent of the beneficiaries, their consent might be interpreted as an implied taxable gift to the spouse of $250,000. However, a question may be raised in this situation as to whether the residuary beneficiaries have the "interest" required before they must sign the agreement required by § 2032A(d). In the example, suppose the surviving spouse instituted proceedings in the local probate court to construe the will, with the executor obtaining an extention of time to file the estate tax return. The probate court determines that the surviving spouse is entitled to the entire estate if a § 2032A election is made. Do the residuary beneficiaries then have an "interest" in the qualified real property for the purposes of § 2032A(d)? On the other hand, assuming the residuary beneficiaries have a cause of action against the executor for a breach of fiduciary duty in making the § 2032A election (whether they would be

effect that the surviving spouse's share should be computed by valuing all assets at fair market value regardless of whether a section 2032A election is made.[338] However, this will provision in the above example, would reduce the spouse's share (and the marital deduction) to $125,000. A serious question arises, entirely apart from tax considerations, whether such a result would be desired by most farm testators (or, for that matter, non-farm testators).[339] At a minimum, the estate planner should not leave the question to chance and, if considering the use of a pecuniary formula marital deduction, should explain the problems and consequences clearly and carefully to the testator.

The problems discussed have led one author to recommend avoiding the use of pecuniary formula marital deduction clauses, at least where the farmland is worth less than $1,000,000.[340] This is sound advice, at least until the uncertainties discussed are clarified.

2. *Technical Problems*

There are also certain technical problems in the relationship between section 2032A and the marital deduction. Assuming part or all of the family farm is bequeathed to the surviving spouse, the spouse becomes liable for the additional estate tax imposed by section 2032A(c).[341] Will this reduce the value of the marital deduction because it is an estate tax or an encumbrance on the property?[342] This question is not resolved as easily as the question previously discussed of whether the imposition of a recapture tax

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successful or not), is this a sufficient "interest" under § 2032A(d)? To be added to the pot is the fact that the IRS would not be bound by the probate court decision. Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). The answer to this type of question must await litigation.

338. Hjorth, *supra* note 39, at 648-49.

339. This result is contrary to a recent study indicating that, in general, testators desire a large portion or all of their estate to go to the surviving spouse, even if they have living children. *See generally, Contemporary Studies Project, supra* note 16.

340. Hjorth, *supra* note 39, at 650.

341. I.R.C. § 2032A(c)(6).

342. I.R.C. § 2056(b)(4) provides:

> Valuation of interest passing to surviving spouse—In determining for purposes of subsection (a) the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section—
>
> (A) there shall be taken into account the effect which the tax imposed by section 2001, or any estate, succession, legacy, or inheritance tax, has on the net value to the surviving spouse of such interest; and
>
> (B) where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.

See J. McCord, *supra* note 2, at 351-52.

increases the qualified heir's basis under the carryover basis rules.[343] Presumably, Congress did not intend to reduce the marital deduction because of the possibility of a recapture tax. A forceful two-pronged argument can be made for this position. First, even though section 1023(c)(3), specifically defines "federal estate tax," the word should be given the same meaning in sections 1023, 2032A and 2056 in these circumstances. If the recapture tax is not an estate tax for the purposes of carryover basis adjustments, it should also not be an estate tax for the purpose of reducing the marital deduction. Secondly, the words "any estate, succession, legacy or inheritance tax" in section 2056 may be interpreted as referring to taxes imposed by the states, rather than the federal estate tax.[344] Assuming this hurdle is overcome, the question is whether the recapture tax is an encumbrance. One author has argued that if estate tax values are used to fund the marital deduction, no problem will result, since the recapture tax and the section 6324B lien will attach to the "excess value" of the qualified real property not included in the gross estate, not to the marital deduction value.[345] This argument is persuasive, but it does not, as the author recognizes, solve the problem when date of distribution values are used.[346] These questions should be answered by regulations; it is hoped that the regulations will reflect the presumed congressional intent that the marital deduction not be reduced simply because of the possibility of a recapture tax or the imposition of a special lien.[347] Relevant to the question of whether the recapture tax will reduce the marital deduction, and of great significance to the draftsman, is whether the testator's will can direct that someone other than the qualified heir pay the recapture tax. A clause commonly found in wills directs the payment of all estate and inheritance taxes from the portion of the property not qualifying for the marital deduction. There is no evidence that Congress considered this question. The statute says only that the qualified heir shall be personally liable for the recapture tax with respect to his interest.[348] It can be in-

343. I.R.C. § 1023(f)(3) defines "Federal estate taxes" as "the tax imposed by section 2001 or 2101, reduced by the credits against such tax." In contrast, I.R.C. § 2056 (b)(4) refers to "the tax imposed by section 2001, or *any* estate, succession, legacy or inheritance tax." (emphasis added).

344. This interpretation is supported by the reference in § 2056(b)(4)(A) to the tax imposed by § 2001, rather than a reference to federal estate taxes generally. Note also I.R.C. § 2011(a), which uses the term "any estate, inheritance, legacy, or succession taxes" as referring to taxes paid to any state or the District of Columbia, in reference to the state death tax credit.

345. J. McCord, *supra* note 2, at 351.

346. *Id.*

347. The closest analogy to this problem is whether the special lien provided for under I.R.C. § 6324A when an extension of time to pay estate taxes is granted under I.R.C. §§ 6166 or 6166A is an encumbrance reducing the marital deduction. Unfortunately, research has disclosed no cases in which this question was decided.

348. I.R.C. § 2032A(c)(6). There is no discussion of this question in the House or Senate reports.

ferred from the two existing federal estate tax apportionment statutes,[349] however, that a testamentary direction that the tax be paid by someone other than the person receiving the qualified property will be ineffective. It is clear that Congress knew how to permit a testator to alter a statutory tax apportionment scheme. Both section 2206, relating to life insurance, and section 2207, relating to property over which decedent had a power of appointment, provide that the total estate tax shall be apportioned and the beneficiaries of such property are liable for that portion of the tax bearing the same ratio to the total tax as the value of the property (or the proceeds of insurance) bears to the taxable estate, *"[u]nless the decedent directs otherwise in his will."* (emphasis added).[350] This clear permisson for testator to vary the tax apportionment by his will was not included in section 2032A(c)(6). Its absence suggests that Congress did not intend to permit the testator to relieve the qualified heir of liability for the recapture tax[351] and it is likely that the IRS will not recognize such an attempt to direct against the imposition of the recapture tax by will.

3. *Problems Solved by Revenue Act of 1978*

Lastly, it should be noted that two important problems were solved by the Revenue Act of 1978. These problems affected both pecuniary bequests to the surviving spouse and to other beneficiaries. The first question is whether, when the estate distributes property qualifying for special use valuation in satisfaction of a pecuniary bequest, the property is considered to have been acquired from or passed from the decedent. Generally, the satisfaction of a pecuniary bequest by distribution of property is treated as a taxable transaction and thus as not having been acquired from or passed from a decedent.[352] The Revenue Act of 1978 added section 2032A(e)(9) to the Code, providing that property distributed by an estate in satisfaction of a pecuniary bequest and property distributed by a trust in satisfaction of a right to receive a specific dollar amount from a trust which is the equivalent

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349. I.R.C. §§ 2206, 2207.

350. *Id.*

351. Of course, it could be argued that the personal liability of the qualified heir mandated under § 2032A(c)(6) was intended as a back-up in case the IRS was unable to collect the recapture tax from funds reserved by the executor or to proceed against the property. This interpretation would permit the decedent to direct that the tax be paid from property bequeathed to another. However, this argument ignores the transferee liability imposed by § 6901 of the Code. This section permits the IRS to collect the estate tax from any transferee of the property. The recapture tax is included since § 6901(a)(1) refers to a tax imposed by chapter 11 of the Code, which includes § 2032A. Furthermore, § 6901(h), defining transferee, includes anyone personally liable for any part of the tax under § 6324(a)(2). A beneficiary who receives property included in the gross estate to the extent of the value of such property is such a person. Since "back-up" liability is already imposed on the qualified heir, there is no reason to read § 2032A(c)(6) as repeating provisions already in the Code.

352. *See* General Explanation, 1978, *supra* note 286, at 422.

of a pecuniary bequest shall be considered to have been acquired from or passed from the decedent.[353]

The second question is raised by the provision of the Tax Reform Act of 1976 requiring that when appreciated carryover basis property is distributed to satisfy a pecuniary bequest, gain is recognized to the extent that the fair market value exceeds the estate tax value of the property on the date of the exchange.[354] When property as to which a section 2032A election has been made is used to satisfy a pecuniary bequest, a large amount of gain would often be recognized due to the reduced estate tax value. It was clearly not the intent of Congress to subject the difference between the fair market value and the special use value to income taxation on distribution of the property to satisfy a pecuniary bequest.[355] Therefore, the Revenue Act of 1978 amended section 1040(a) to provide that the estate tax value for the purpose of recognizing gain under that section would be determined without regard to section 2032A.[356] The effect of the revised section is that gain will be recognized only to the extent of the difference between the fair market value of the property on the date of distribution and the fair market value on the decedent's date of death or alternate valuation date.

E. *Outright Bequest to Several Beneficiaries*

Assume Farmer Brown has three children: Jim, who has helped on the farm all his life and who wishes to operate the farm after Farmer Brown's death; Jane, who has married a teacher and moved to a large city; and Joe, who is about to enter law school. Assume further that Farmer Brown's estate consists of the farm (including the house located thereon and all machinery, livestock, etc. necessary to operate the farm), with a fair market value of $700,000 and a section 2032A value of $400,000, and $200,000 of insurance. Farmer Brown wants to treat all his children equally, yet, he also wants the farm to pass intact to the next generation and for Jim to be able to operate it. This scenario is not uncommon. However, when section 2032A is injected into the situation, it enhances the possibility of conflicts among the beneficiaries.

Farmer Brown has several alternatives. First, he may decide that preserving the farm for Jim is more important than equality among the children and leave the farm outright to Jim, and the insurance proceeds equally to the other children. The likely results of such an estate plan will be that Jane and Joe will be angered at being "slighted" and take their anger out on the favored child, Jim. This potential for conflict among the children existed before the enactment of section 2032A and was presumably in many cases a

353. Revenue Act of 1978, *supra* note 82, § 702(d)(2).
354. I.R.C. § 1040(a).
355. General Explanation, 1978, *supra* note 286, at 423.
356. Revenue Act of 1978, *supra* note 82, § 702(d)(3).

major reason for other arrangements. Another possibility is that both the farm and the cash could be divided equally with a requirement that the beneficiaries agree to permit Jim to operate the farm during his life or some other requirement assuring Jim's control of operation of the farm.[357] Even though Jane and Joe might be disappointed in being required to wait a long period of time to obtain cash, creating the potential for some conflict among the children, there was little they could do about it. The existence of section 2032A, however, increases the possibilities of conflict. Ignoring debts and administration expenses, the tax on an estate of $900,000 is $228,840,[358] whereas with a section 2032A election the tax is reduced to $129,400. Jim, of course, will desire that a section 2032A election be made, since the estate is illiquid. Assuming Jim has few liquid assets of his own, in the absence of a section 2032A election he will have to borrow some money to pay his portion of the estate tax. Jane and Joe, however, are motivated by other considerations. Joe needs money to finance his law school education. He might well rather pay the increased estate tax and sell his share of the farm in order to raise the necessary money. Jane would likely prefer to invest her share of the estate in high income-producing assets rather than in the farm or use some of her share for immediate purchases. If a section 2032A election is made, however, Jane and Joe will be unable to dispose of their shares for fifteen years. Thus Jane and Joe will undoubtedly pressure Jim to sell the farm. Moreover, section 2032A will give Jane and Joe a weapon to exert more pressure on Jim than they could before section 2032A was enacted. A section 2032A election requires the filing of an agreement signed by each person having an interest in the property consenting to personal liability for the recapture tax.[359] By refusing to sign the agreement, Jane or Joe can block the section 2032A election. The conflicts between the children can easily destroy any family feeling that previously existed among the children.[360]

Even if Farmer Brown has sufficient liquid assets to leave the farm to Jim and other assets of equal value to Jane and Joe, section 2032A has the potential for creating family conflicts. Suppose Farmer Brown specifically bequeaths the farm to Jim and the residue of his estate equally to Jane and Joe. The residue of the estate is charged with the payment of all estate taxes.[361] In this case, the previous situation is reversed. Jane and Joe will

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357. Often this takes the form of granting the farm child an option to purchase the share of the other beneficiaries over a long period of time at the estate tax value.

358. Assuming decedent died after 1981 when the § 2010 unified credit is fully phased in.

359. I.R.C. § 2032A(d)(2).

360. Farmer Brown could, of course, require Jane and Joe to sign the agreement under § 2032A or be disinherited. This would preserve the farm for Jim, but might cause increased hostility among the children. Farmer Brown could also adopt some other form of disposition, such as leaving the entire estate in trust with the income distributed equally among the children and appointing Jim as trustee, but such a disposition would not cure the conflict potential discussed.

361. This will be required in most cases since few farmers have sufficient liquid assets to

desire the election of special use valuation, since they will receive all the benefit of an estate tax reduction. However, Jim will obtain no benefit from the special use valuation. Moreover, the value of his interest will be reduced in several ways. First, his ability to dispose of the farm for fifteen years will be restricted. Second, he will assume liability for the recapture tax and a section 6324B lien will be placed on the farm. Third, his basis for the farm will be lower if special use valuation is elected, resulting in increased income taxes if and when he sells the farm. Thus, similar conflicts to those discussed above are inevitable.[362] Here, however, it is Jim who holds the club,

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both equalize the bequests to the non-farm children and pay estate and inheritance taxes.

362. This example is taken basically from Dyer, *supra* note 215, at 100-01. Dyer, however, does not mention the reduction of the value of Jim's interest because of the lower basis. Dyer advocates the following three solutions to the problem. (1) Give all the children an equal fraction of the farm and cash. As discussed above, this solution does not insure the peaceful resolution of the conflicts among the children. (2) Equalize the value of the gifts after taking into account the benefits and burdens caused by special use valuation. Dyer states that this solution requires a provision that unless the farm child agrees to sign the agreement required by § 2032A, the children receiving the residuary also receive a portion of the farm child's bequest equal to the tax savings which would have been achieved by electing special use valuation. *Id.* at 100 n.53. Dyer rejects this option on the ground that it is wiser to permit the beneficiaries to decide after the decedent's death whether to elect.

However, this is not the crux of the problem, since it could be solved by a will provision providing the adjustment would not be made if the beneficiaries agree that special use valuation should not be elected. The problem is that Dyer assumes the exceedingly unlikely event that in addition to the cash (or other liquid assets) necessary to pay debts, administration and funeral expenses, and estate and inheritance taxes, the farmer-decedent also has sufficient assets so that some cash will pass to the farm child. The unlikelihood of such an occurrence is illustrated by a recent study of Iowa farms, which found that in farm estates in excess of $200,000, 57% of the assets were in farm real estate, 25% in non-realty farm assets, 9.5% in investments, 6.5% in insurance and 2% in miscellaneous. *Contemporary Studies Project*, *supra* note 16, at 894. The farm estates having liquid assets remaining to distribute to the farm child, after the payment of estate expenses, taxes, expenses of continuing the farming operations and equalization bequests to non-farm children, as Professor Dyer postulates, will be exceedingly rare. However, if such a situation arises, the provision discussed should be seriously considered as a means of minimizing family conflicts.

(3) Disinherit any beneficiary who does not agree to a § 2032A election (if the executor determines that the benefits of an election would outweigh the burdens) together with an indemnity agreement by which the non-farm children agree to pay a portion of any recapture tax which may become due. First, it is doubtful that this solution would avoid conflicts between the children. Second, Professor Dyer gives little guidance as to how the executor is to determine when the benefits of an election outweigh the burdens. Third, Professor Dyer states that the executor should make this determination without taking into account the individual tax situations of the beneficiaries, since there is no way the executor can evaluate or predict the tax situation of the beneficiaries. Dyer, *supra* note 215, at 101-05. The potential income tax problems, previously discussed in this article, are as likely a source of family conflict as the estate tax benefits and burdens of a § 2032A election. If the aim is to avoid conflict among beneficiaries, income tax considerations causing such conflicts cannot be removed from the picture. Professor Dyer implicitly agrees when he says:

> I recommend the executor be instructed to minimize the estate taxes considered alone unless all the children agree not to elect special valuation. I admit that this

since he has the only interest in the property and completely controls whether special use valuation will be elected.

It is probably not possible in many situations to avoid all the conflicts among beneficiaries discussed above. Furthermore, other arguments between beneficiaries may result during the fifteen-year period when recapture is possible, due to investment opportunities.[363] However, these conflicts may be minimized by complete discussion during the testator's lifetime with the testator and prospective beneficiaries of the options available and the consequences of electing 2032A.[364] In addition to the possible minimization of conflicts, the discussions could focus the testator's thinking more sharply on the possible result of his intended scheme of disposition, perhaps leading

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> means the children will be left to resolve the conflict themselves, and their negotiations will be made extremely difficult by the fact that each will know approximately what the other has to gain or lose, but the executor cannot estimate realistically the children's tax situation.

Id. at 105.

The problem has no easy solution. This author's experience indicates, however, that less family conflict exists when the proposed estate plan and its consequences are explained clearly and completely to the beneficiaries prior to the death of the testator, and that the most bitter conflict among beneficiaries occurs where the beneficiaries attempt to bargain with each other after testator's death. This may be caused primarily by the grief felt by the children over the testator's death; emotions are near the surface and anger transfers easily. Thus, if it is the testator's wish that a beneficiary be disinherited for not agreeing to a § 2032A election if the executor determines that the benefits of the election outweigh the burdens, the best way of minimizing the conflicts among the beneficiaries is for the situation to be fully discussed with each beneficiary before testator's death. Furthermore, the executor should be given the power to make the determination considering all factors, including his best estimate of the effects of the election on the income tax situation of all beneficiaries.

However, there is an even more important objection to Dyer's final solution. Implicit in it is an assumption that a testator would view continuation of the family farm in one heir as a goal important enough to disinherit a child who thwarted testator's wishes in this regard. In some cases, this may be true. However, this assumption is never clearly stated by Professor Dyer nor does he provide any information or statistics supporting the assumption. It is more reasonable to believe to the contrary, that most testators will be very reluctant to disinherit a child, regardless of any faults or attitudes of the child. Given the choice of a higher estate tax (or a possible inequality of the benefits among the children) because of a refusal to agree to a § 2032A election or the disinheritance of a child, many (and perhaps most) testators would chose not to disinherit the child who refuses to sign the agreement. The desire to keep the farm in the family is strong among farmers, but love and affection for all their children is as strong if not a stronger motivating factor in their dispositional desires.

363. For example, during the recapture period, the farm child could decide to sell the qualified property for a variety of reasons: he may no longer wish to farm, he may have an opportunity to purchase a better parcel, or illness in his spouse's family may require that he lives elsewhere. The non-farm children may be forced to engage in material participation or pay their share of the recapture tax. Either alternative may cause a significant disruption of their lifestyles and substantial ill feelings will often result. *See* M. BOEHLJE & N. HARL, *supra* note 50, at 41.

364. It is possible that some of the conflicts may be avoided or minimized by the form of organization chosen for the farm. *See* Section VI F *infra*.

him to a decision to change his dispositive plan to reduce these conflicts.

F. *Partnerships and Corporations*

It is clear that Congress intended qualified real property owned in the partnership and corporate farms to be eligible for a section 2032A election, assuming the other qualification requirements are met.[365] Partnerships and corporations have become increasingly popular forms of ownership for farms in recent years, primarily because they offer continuity into succeeding generations and tend to preserve the greater efficiency of operation often attained by an individual as he gains increased management ability and experience (which tends to decline as the farmer attains advanced age).[366] Despite Congress' obvious intention, however, not only are there problems with the application of section 2032A to corporations and partnerships, but there is no statutory language to aid in solving these problems.

At the outset, it must be recognized that there are two relevant time periods involved: the initial qualification under section 2032A, and the fifteen-year period of possible recapture. Most of the problems involving partnerships and corporations involve initial qualification, so we will begin there.

The first problem is the reference in the *House Report* tying the special use value election to qualification under section 6166.[367] The first question that has been raised is basic: Will the entity's ownership of real and per-

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365. The bill directs the Treasury Department to prescribe regulations setting forth the application of these special use valuation rules (and the security requirement, discussed below) to situations involving otherwise qualifying real property held in a partnership, corporation or trust which, with respect to the decedent, is an interest in a closely held business. Your committee intends that a decedent's estate generally should be able to utilize the benefits of special use valuation where he holds the qualifying real property indirectly, that is, through his interest in a partnership, corporation or trust, but only if the business in which the property is used constitutes a closely held business (as defined in section 6166, as amended by section 5 of this bill) and the real property would qualify for special use valuation if it were directly by the decedent.

House Report, *supra* note 44, at 24. Section 2032A(g) mandates the issuance of regulations specifying how § 2032A applies in the case of a partnership, corporation or trust which is a closely held business (within the meaning of § 6166(b)(1)). Presumably, Congress intended that such interests would qualify for special use valuation.

366. N. Harl, Farm Estate and Business Planning 156 (1978). An extended discussion of the tax and non-tax disadvantages of partnerships and corporations is beyond the scope of this article. They share the advantage of continuity and possess the income tax advantage of permitting a shifting of income to lower bracket taxpayers. The corporation, however, has much more flexibility with regard to the latter. For a discussion of the advantages and disadvantages of each form, *see id.* at 155-240. For a short summary of the advantages and disadvantages of corporations, *see* Note, *Estate Tax Planning in Agriculture: How to Save That Farm From the Tax Collector,* 47 U. Mo. - K.C.L. Rev. 417, 421-26 (1978).

367. House Report, *supra* note 44, at 24.

sonal property be attributed to decedent? Presumably, the reference in the *House Reports* to section 6166 was intended to permit the property owned by the entity to be attributed to the decedent. In fact, section 6166(b)(2)(C) provides that property owned by or for a corporation, partnership, estate, or trust shall be considered as being owned by its shareholders, partners or beneficiaries proportionately. In light of the clear congressional intent, presumably the rule will apply under section 2032A for the purpose of meeting the qualifications of that section and the decedent will be deemed to own the entity's property in proportion to his interest in the entity.[368] Curiously, the proposed regulations state only that "[w]here the ownership [of qualified real property] is indirect, however, the decedent's interest in the business must qualify under the tests of section 6166(b)(1) of the Code as an interest in a closely-held business in addition to meeting the tests for qualification under section 2032A."[369] However, one of the examples given by the proposed regulations implies that ownership of the assets of the entity will be attributed to the decedent for the purposes of qualification under section 2032A.[370]

A second basic question has been referred to as the possibility of a circular disqualification for a section 2032A election.[371] The explanation is that section 6166(b)(4) requires that the value of an interest for the purposes of section 6166 be determined by the Chapter 11 (estate tax) values. Chapter 11 includes section 2032A. Therefore, the possibility exists that, though the decedent's interest in the closely held business would qualify under section 6166 using fair market value, using section 2032A values the interest would not qualify.[372] One possibility to solve this problem would be to use the same value for purposes of qualification under section 6166 as was used to determine qualification under 2032A, that is, the value of the property determined without reference to section 2032A.[373] This would be consistent with the congressional intent. In order to do this, however, a court would

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368. J. McCord, *supra* note 2, at 329.

369. Proposed Treas. Reg. § 20.2032A-3(b), 43 Fed. Reg. 31,040 (1978).

370. Proposed Treas. Reg. 20.2032A-3(f) (Example 5) states:

> Decedent I owned 90 percent of all outstanding stock of X Corporation, a qualified closely-held business which owns real property to be specially valued. I held no formal position in the corporation and there was no arrangement for him to participate in daily business operations. I regularly spent several hours each day at the corporate offices and made decisions on many routine matters. I is not deemed to have materially participated in the X Corporation despite his actvity because there was no arrangement requiring him to act in the manner in which he did.

Id., 43 Fed. Reg. at 31,042. If the real property was not attributed to I through his ownership in the corporation, the estate would not have qualified to elect special use valuation under §§ 2032A(b)(1)(A) & (B) and the question of whether or not there was an arrangement would not have been reached.

371. *See* J. McCord, *supra* note 2, at 330; M. Fellows, *supra* note 260, at 105.

372. J. McCord, *supra* note 2, at 330.

373. I.R.C. § 2032A(b)(3).

have to read the words "without reference to section 2032A" into section 6166(b)(4) based on presumed congressional intent. However much good sense this argument makes, several authors have warned that until regulations are issued clarifying these areas, farms organized as partnerships or corporations cannot be assured of complying with section 2032A.[374] If qualification under section 2032A is a major goal, sole proprietors should think carefully about changing the form of organization, despite other advantages of the partnership or corporate form.

These are not the only problems of using the partnership or corporate form in connection with section 2032A. One of the major advantages of the corporate form is the ease of transferability of shares of stock. This greatly facilitates gifts to minors, shifting income to lower bracket taxpayers and providing an assured source of income (through issuance of preferred shares) for older shareholders while concentrating ownership in the next generation.[375] Another use of preferred stock or debt securities is to concentrate ownership in a farm child while giving non-voting securities to off-farm heirs.[376] Reducing decedent's voting control below twenty percent of the value of the corporation will result in inability to elect special valuation.[377] Diversifying ownership among more than fifteen persons will also result in losing the opportunity to elect special valuation.[378] Presumably, these problems can be minimized by careful planning, but other problems are not so easily solved.[379]

The proposed regulations have at least partially solved the problem of material participation (which is the major recapture tax problem regarding specially valued property held in a corporation or partnership) in the case of indirect ownership. The proposed regulations state:

> Where the real property is indirectly owned, however, even full-time involvement must be pursuant to an arrangement between the entity and

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374. J. McCord, *supra* note 2, at 331; M. Fellows, *supra* note 260, at 105-06.

375. N. Harl, *supra* note 366, at 196, 227.

376. *Id.* at 250.

377. *See* I.R.C. § 6166(b)(1)(c)(i).

378. *See* I.R.C. § 6161(b)(1)(c)(ii).

379. Some major problems mentioned by McCord include:

(1) Are secured liabilities of the entity "passed through" to the decedent, reducing the value of his interest?

(2) What is the effect of the attribution rules on buy-out or cross-purchase agreements, or § 303 redemptions, if any, which may be a necessity to ensure control in the farm child and to continue the business? And, particularly crucial for many farm corporations,

(3) How will the attribution rules as to property owned by an entity operate when preferred stock is outstanding, if the preferred stock has a priority claim to the real property or tangible assets of the corporation? *See* J. McCord, *supra* note 2, at 330-31, for a discussion of these and other problems. Without knowledge of the answers to these questions, estate planners are faced with extremely difficult, if not impossible, problems in advising clients. On one hand are the advantages of the corporate and partnership forms but, if they are used, the decedent may lose all opportunity to elect special use valuation.

> the decedent or family member specifying the services to be performed. Holding an office in which certain material functions are inherent may constitute the necessary arrangement for material participation.[380]

Thus, presumably, if the qualified heir is the president (or chief operating officer) of the corporation, the nature of the duties of the office would constitute material participation. Due to the vagueness of the last sentence above quoted, however, in any corporate situation a written arrangement should be entered into between the corporation and the decedent or member of his family (before death) and the corporation and the qualified heir or family member (after death) clearly providing for material participation. It should not be left to the Service or a court to decide whether the inherent duties of the office constitute material participation.[381]

G. *Trusts*

A trust is one of the most useful tools available to estate planners, primarily due to its flexibility.[382] It is highly useful in many farm situations.[383] However, by its lack of specificity and perhaps by inadvertence, in enacting

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380. Proposed Treas. Reg. § 20.2032A-3(e), 43 Fed. Reg. 31,041 (1978).

381. These dangers are illustrated by Proposed Treas. Reg. § 20.2032A-3(f) (Example 5) discussed in note 370, *supra*, stating that ownership of 90% of the outstanding stock of a corporation is not in itself enough to constitute material participation without an arrangement. *See also* Proposed Treas. Reg. § 20.2032A-3(f) (Example 6) stating that a senior partner in a law firm (a qualified closely held business), who had ceased to practice law five years prior to his death, would not meet the material participation requirements though he remained a full partner and received a share of firm profits each year if the payments were not pursuant to a retirement agreement. The reason given is that decedent did not meet the requirement of "actual personal material participation." Query: Suppose the decedent received his share of firm profits pursuant to a retirement agreement. Would he have satisfied the material participation requirement? It should be noted that the proposed regulations also provide:

> Where property is owned by a corporation or partnership, participation in the management and operation of the real property itself as a component of the closely held business is the determinative factor. Nominally holding positions as a corporate officer or director and receiving a salary therefrom or merely being listed as a partner and sharing in profits and losses will not alone support a finding of material participation. This is so even though, as partners, the participants pay self-employment income taxes on their distributive shares of partnership earnings under § 1.1402(a)-2. Further, it is especially true for corporate directors in states where the board of directors need not be an actively functioning entity or need only act informally. Corporate offices held by an owner are, however, factors to be considered with all other relevant facts in judging the degree of participation.

Proposed Treas. Reg. § 20.2032A-3(e)(2), 43 Fed. Reg. 31,041 (1978).

382. *See* E. Scoles & E. Halbach, Problems and Materials on Decedents' Estates and Trusts 226-30 (2d ed. 1973). Some of the same problems to be discussed in this section are present in similar arrangements, such as the creation of life estates and remainders. However, to simplify the discussion, this subsection will deal exclusively with the trust. The reader should have no problem in applying the discussion to similar arrangements.

383. *See* N. Harl, *supra* note 366, at 129-38.

section 2032A Congress has created many problems in the use of trusts by farm families wishing to elect section 2032A valuation.[384]

As in the case of corporations and partnerships, the problems with the use of a trust arise both as to initial qualification and as to recapture. In this instance, the problems with recapture will be discussed first.

1. *The Separation of Interests Problem*

For this purpose, a simple example may be instructive. Assume Farmer Green owns a farm in fee simple. In his will he bequeaths the farm in trust with the income to be paid to his son, Albert, for life, remainder to Albert's issue. His plan is for Albert to operate the farm, so he includes a provision in his will directing the trustee to permit Albert to operate the farm during his lifetime if he so desires. At the time of Green's death, Albert has two children, ages seven and five. Seven years later, Albert, tired of farming and short of cash, decides to sell his life estate.[385] When the farm is sold, or ceased to be used as a farm, a recapture event occurs and the recapture tax comes due.[386] Two immediate questions arise: how much tax is due and who is liable for the tax?

At first blush, the statute is open to an interpretation that only a portion of the adjusted tax difference or tax savings will be recaptured. This interpretation comes from the language of section 2032A(c)(2), which states that the recapture tax imposed with respect to any interest shall be the lesser of "the adjusted tax difference attributable to such interest" or "the excess of the amount realized with respect to the interest . . . over the value of the interest."[387] Moreover, the *House Report* makes clear that when more than one qualified heir receives the property or receives an interest in the property, "the adjusted tax difference is to be allocated among the property interests in proportion to their respective reductions in value."[388] Since "in-

384. Again, it is clear that Congress intended to permit an estate to elect special use valuation when the property was held in trust by the decedent or when the decedent bequeathed the property in trust. *See* House Report, *supra* note 44, at 24.

385. A life estate is alienable. *See* T. Bergin & P. Haskell, Preface to Estates in Land and Future Interests 39 (1966). The conclusions drawn would be equally applicable if Albert decided to move from the farm and discontinue farming or to use the farm for some non-qualified use.

386. I.R.C. § 2032A(c)(1).

387. I.R.C. § 2032A(c)(2)(A).

388. House Report, *supra* note 44, at 26. The only relevant ruling so far issued by the IRS on this matter lends support to the argument that only a portion of the tax savings will be recaptured. In IRS Letter Ruling 7934007 (April 30, 1979), 3 Fed. Est. & Gift Tax Rep. (CCH) ¶ 12,304, decedent bequeathed her husband what the service determined to be a fee simple in a ranch qualifying for special use valuation. Some time after decedent's death, her husband transferred the ranch to persons who were not qualified heirs, receiving a lease for his life and a mortgage securing a promissory note for less than full and adequate consideration. The lease was to be effective only if the purchaser would obtain new state leases and federal agency per-

terest" is not defined in section 2032A, there is no reason to exclude life income interests or remainders from inclusion as interests. Therefore it could be argued that only the adjusted tax difference attributable to the life income interest should be recaptured. However, such an interpretation opens possibilities of estate tax avoidance. Assume Albert is living fifteen years after his father's death. No further tax would be recoverable since the remaindermen had not sold their interests or done anything to trigger recapture.[389] Under this interpretation, the decedent's family has discontinued participation in active farming operations on the qualified real property, but the entire estate tax savings has not been recovered, contrary to congressional intent. The same situation is possible if the remaindermen were adults and disposed of their interests while Albert continues to operate the farm.

There is some indication that Congress intended to treat the recapture tax as a unit. In this regard, the *House Report* notes:

> However, if the decedent leaves qualified real property for which special use valuation was elected to two or more qualified heirs with successive interests in the property, potential liability for the recapture tax is not diminished and none of the property is to be released from potential liability for the recapture tax until the death of the last of the qualified heirs (or, if earlier, upon the expiration of 15 years from the date of the death of the decedent).[390]

Though the statement is ambiguous, it could be interpreted as merely stating that if the remaindermen later disposed of their interests to non-family members within fifteen years of the decedent's death, the remainder of the adjusted tax difference would be recaptured. However, the tax avoidance possibilities indicate that perhaps it should be read as treating the successive interests as a unit, with the recapture tax imposed in full if the owner of any interest disposes of his entire interest to a non-family member or ceases to use the property for a qualified purpose. However, it should be noted that this interpretation seems to contradict the section 2032A(c)(2) statutory scheme of carefully allocating the adjusted tax difference among the various "interests" in the property.

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mits. The Service held that the transfer triggered the recapture provisions of § 2032A. The taxpayer, however, contended that only the additional tax attributable to the remainder interest was due, since the leaseback of the ranch was equivalent to a retained life estate. The Service held that the full recapture tax was due, but indicated that its opinion was influenced by the necessity of obtaining the state leases and permits. The Internal Revenue Service stated: "The sale and leaseback arrangement entered into by the decedent's husband has many of the elements of a retained life estate." The letter ruling indicates a tentative policy of the IRS to read the statute as requiring that only a portion of the tax savings be recaptured if only one of several successive interests is sold.

389. *See* I.R.C. § 2032A(c)(1).

390. House Report, *supra* note 44, at 26.

If possible, who pays the tax is even more unclear than how much tax is due on a recapture event. Returning to the example at the beginning of this subsection, suppose Albert actually sells the farm. A recapture tax is due. Let us assume for the moment that, due to the possibility of tax avoidance if only the portion of the tax allowable to Albert's life estate is due, the entire adjusted tax difference is recaptured. Does Albert pay the entire tax or is it apportioned?

Albert can make a strong argument that the tax should be apportioned. The argument is similar to that made previously on how much tax is due and is again based on section 2032A(c)(2). Albert, since he only disposed of his life estate (his interest) should pay only "the adjusted tax difference attributable to such interest."[391] Moreover, this interpretation receives support from the *House Report:* "Where more than one qualified heir receives qualified real property with respect to which special use valuation has been elected or receives an interest in such property, the adjusted tax difference is to be allocated among the property interests in proportion to their respective reductions in value."[392] However, if Albert is only liable for his share of the adjusted tax difference, we have the situation of a life tenant being able to force the remaindermen to pay a share of the recapture tax when they did not cause the recapture event, nor could they do anything to prevent recapture. This has all the ingredients of a holdup situation by the life tenant (this would probably not happen in our case, since the remaindermen are his children, but could in other situations) and is an anomalous situation in any event. All dictates of equity mandate that in the example the life tenant should pay the entire recapture tax. But there is almost nothing in the statute or legislative history to indicate such a result was intended.[393]

One other possibility should be considered. The explanation of Tax Reform Act of 1976 prepared by the Staff of the Joint Committee on Taxation states: "Trust property shall be deemed to have passed from the decedent to a qualified heir to the extent that the qualified heir has a *present interest* in that trust property." (emphasis added).[394] The Staff explanation is taken from a statement in the *Conference Report*[395] which is nowhere mentioned in the *House Report*. One can speculate that the conferees to some extent realized that the statute did not solve the problems of how much tax is due and who pays the tax, and attempted to solve the problem by making recap-

391. I.R.C. § 2032A(c)(2)(A)(i).

392. House Report, *supra* note 44, at 26. The *House Report* goes on to say: "A qualified heir is expressly made personally liable for the recapture tax imposed with respect to *his interest* in qualified property." *Id.* (emphasis added).

393. Section 2032A(c)(4) clearly was not intended to apply to this situation, but to the case of two successive recapture events on the same portion of the property (such as ceasing to use the farm for a qualified use and later selling it). *See* House Report, *supra* note 44, at 26.

394. General Explanation, *supra* note 3, at 539.

395. House Conference Report No. 94-1515, *supra* note 102, at 610.

ture depend on the actions of the owner of the first of two or more successive interests in qualified property.[396] The effect of the statement in the *Conference Report* is that only the interest in the real property passing to a holder of a present interest qualifies for special use valuation. This interpretation will solve both of the problems under discussion in most cases. First, in our example, when Albert sells his life interest, the entire adjusted tax difference will be recaptured, because his will be the only interest in the qualified real property. This is because only his interest will be specially valued and cause a reduction in estate tax liability.[397] Furthermore, Albert will pay the entire recapture tax because the entire adjusted tax difference will be allocated to him.[398] However, this interpretation of "present interest" causes problems of its own. First, and perhaps most important, it severely restricts the use of trusts in connection with section 2032A. No non-possessory interest in a trust (e.g., remainders, executory interests, etc.) will qualify. This will cause a large reduction in the tax savings achieved by the use of section 2032A and discourage the use of trusts in situations where special use valuation might be advantageous. In our example, only Albert's life income interest is eligible for special use valuation. Moreover, if Albert is elderly, the value of his life interest may not meet the fifty percent and twenty-five percent limitations of secton 2032A(b)(1)(A) and (B). This will force many decedents who would otherwise create trusts to forego their use to insure qualification under section 2032A. There is no indication in the legislative history that Congress was hostile to the use of trusts in connection with section 2032A, nor is there evidence that Congress wished to disqualify "future interests" from qualifying for special use valuation. Second, and equally significant, although remainders, secondary life estates, reversions and other property interests are often referred to as future interests, it is clear that these interests are present estates, even though the owner will not acquire possession until sometime in the future.[399] Thus, if the *Conference Report* and the *General Explanation* are using the term "present interest" in the sense of "present estate," the remainder in our example will qualify

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396. Section 702(d)(1) of the Revenue Act of 1978 amended § 2032A(b)(1) to provide that qualified real property includes only property "which was acquired from or passed from the decedent to a qualified heir of the decedent." However, this amendment was not directed at the problems under discussion, but rather was passed to insure that special use valuation would be available only for real property passing to qualified heirs. *See* GENERAL EXPLANATION, 1978, *supra* note 286, at 421.

397. *See* I.R.C. § 2032A(c)(2)(B)-(C).

398. *Id.*

399. In fact, they are present estates even if the owner never acquires possession (for example, if testator bequeaths his estate in trust with the income to A for life, then to B for life, remainder to C, B has a present estate from the moment of testator's death, even though, if he predeceases A, he may never receive any income. *See* T. BERGIN & P. HASKELL, *supra* note 385, at 23-26. These estates are present estates because the owner is entitled to present protection of his possible future possession.

as a "present interest." If the conferees used the term "present interest" to mean "present possession," this meaning should have been more clearly defined. Lastly, the imposition of a full recapture tax on the disposition or cessation of qualified use by the first of two qualified heirs owning successive interests could result in frustrating the purpose of the statute in certain cases. For example, suppose Farmer Green had changed his will slightly to give the income to Albert for life, but provided that if Albert ever sold or contracted to sell his interest or ceased to use the property as a farm, his interest would immediately cease and the remainder in Albert's then living issue would accelerate and vest immediately.[400] Even if Albert's children were willing to farm the property, a recapture tax would be due on the sale of Albert's life income interest. Note that in this situation, the congressional purposes of keeping the property in decedent's family and in farming are accomplished, yet the estate tax savings is recaptured.

In addition, in the common discretionary trust, the interpretation of "present interest" as "present possession" would lead to the result that none of the discretionary income beneficiaries has a "present interest" for purposes of qualification under section 2032A. Similarly, giving the trustee discretionary power to distribute income to the income beneficiary or accumulate it for ultimate distribution to the remaindermen could disqualify the trust for special use valuation on the ground that the property did not pass to a qualified heir. If all the possible recipients of the income are qualified heirs, there appears to be no basis for denying special use valuation in this situation.[401]

The statement in the *Conference Report* and the *General Explanation* that property in trust shall be considered as acquired from the decedent only to the extent that the qualified heir has a present interest in the property solves many of the problems discussed above. If the regulations, when they are issued, solve the problem of qualification under such an interpretation[402] and exempt trusts in which an attempted disposition or cessation of use causes, under the terms of the will, a termination of the interest of the holder of first possessory interest, and the holder of the second successive possessory interest is willing to meet the requirements of material participa-

400. A spendthrift provision would work equally well where permitted by state law, as would a provision terminating Albert's income interest and substituting his issue as income beneficiaries during Albert's life on an attempted sale or cessation of use.

401. These interests would not be present interests for purposes of qualifying for the annual exclusion under the gift tax. I.R.C. § 2503(b). See Ward, *Planning for Farmers After the 1976 Tax Reform Act and 1978 Revenue Act: Special Use Valuation Under Section 2032A*, 13 U. Miami L. Center Inst. Est. Plan. 12-8 (1979). It is uncertain whether Congress intended to incorporate the gift tax concept of present interest into § 2032A.

402. Perhaps the regulations will provide that all interests bequeathed to qualified heirs (whether present or not) could be used to meet the 50% and 25% tests of initial qualification (since the word interest is not used in § 2032A(b)), but that "interest" shall mean present possession for the purpses of § 2032A(c).

tion in a qualified use, the statute could be made simple and workable in these situations.

A second major problem of the use of trusts in connection with section 2032A is through what agency will the qualified heir "materially participate." In a trust, the trustee has the legal title to the property; the beneficiaries have equitable title. This could create questions concerning material participation. However, the proposed regulations spell out fairly clearly what will be required for material participation in the trust situation:

> (e) *Special rules for corporations, partnerships, and-trusts* (1) *Required arrangement.* With indirectly owned property as with property that is directly owned, there must be an arrangement calling for material participation in the business by the decedent owner or a family member. Where the real property is indirectly owned, however, even full-time involvement must be pursuant to an arrangement between the entity and the decedent or family member specifying the services to be performed. Holding an office in which certain material functions are inherent may constitute the necessary arrangement for material paticipation. Where property is owned by a trust, the arrangement will generally be seen in one or more of three situations. First, the arrangement may result from appointment as trustee. Second, the arrangement may result from the employer-employee relationship where the participant is employed by a qualified closely held business in a position requiring his material participation in its activities. Third, the participants may enter a contract with the trustee to manage, or to take part in managing, the real property for the trust. Where the trust agreement expressly grants the management rights to the beneficial owner, that grant is sufficient to constitute the arrangement required under this section.[403]

The proposed regulation is clear enough to require little comment. If the regulation becomes final, the will of any decedent who owns property which may qualify for special use valuation should contain a provision providing that if the executor elects special use valuation under section 2032A, the management rights as to any qualified real property should be expressly granted to the qualified heir. Moreover, the trustee should be expressly empowered (if not required) to enter into a contract with the qualified heir or any member of his family (as defined in section 2032A(e)(2)) to manage or take part in the management of the qualified real property.[404]

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403. Proposed Treas. Reg. § 20.2032A-3(e), 43 Fed. Reg. 31,041 (1978).

404. It may be objected that it would be simpler to appoint the qualified heir trustee. However, many qualified heirs, while willing to manage the farm, may not wish to become involved in the detailed record keeping and accounting duties of a trustee. Also, if there is other property in the trust, the qualified heir may either not wish to administer it or may not be the best person to manage it. Problems may also arise when the trust instrument provides for discretionary distributions of corpus to the qualified heir or his family. The route suggested in the text solves these problems. In the proper case, of course, it may be wise to appoint the qualified heir as trustee. Another possibility would be to appoint the qualified heir as co-trustee, but

that in order to elect special use valuation there must be filed "a written agreement signed by each person in being who has an interest (whether or not in possession) in any property designated in such agreement consenting to the application of subsection (c) [the imposition of the recapture tax] with respect to such property."[405] The proposed regulations are fairly detailed as to the interests covered and the effect of the agreement:

> a) *Agreement to special valuation by persons with an interest in property* — (1) *In general.* The agreement required under this section must express consent to personal liability under section 2032A(c) in the event of certain early dispositions of the property or early cessation of the qualified use. The agreement must be executed by all parties receiving any interest in the property being valued based on its qualified use. The agreement is to be in a form that is binding on all parties under applicable local law. It must designate an agent for the parties for all dealings with the Internal Revenue Service on matters arising under section 2032A.
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> (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." (emphasis added).[406]

It is clear that the proposed regulations were drafted by the Internal Revenue Service to impose personal liability on as many persons having interests in the property as possible. This was done to insure, insofar as the IRS is able, that in case a recapture event occurs, the recapture tax will be recovered. Thus it is clear that in the example stated in the beginning of

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405. I.R.C. § 2032A(d)(2). The election must be made when the estate tax return is required to be filed, including extensions. I.R.C. § 2032A(d)(1). The proposed regulations require the attaching of the agreement and a notice of election giving various data to a timely filed estate tax return. Proposed Treas. Reg. § 20.2032A-8(a)(1), (2), 43 Fed. Reg. 30,071 (1978).

406. Proposed Treas. Reg. § 20.2032A-8(c)(1), (2), 43 Fed. Reg. 30,072 (1978).

It is clear that the proposed regulations were drafted by the Internal Revenue Service to impose personal liability on as many persons having interests in the property as possible. This was done to insure, insofar as the IRS is able, that in case a recapture event occurs, the recapture tax will be recovered. Thus it is clear that in the example stated in the beginning of this section, both Albert and those of his children living on Green's death will be required to execute the agreement in order to elect special use valuation. Two groups of beneficiaries, however, present problems in such a scheme. The first group is unborn persons having interests in the property. Both the statute and the proposed regulations avoid this problem by requiring execution only by persons in being.[407] The second group is composed of beneficiaries who, by reason of legal incompetency, minority or other disability, cannot legally bind themselves. The proposed regulations also attempt to deal with this issue:

> (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.[408]

However, finding a representative under local law to bind a minor is more difficult than it may at first appear. The first thought of experienced estate attorneys would be a guardian ad litem (sometimes referred to as a special guardian). The guardian ad litem's traditional function is to represent and defend infants (as well as unborns) in litigation.[409] Though the power of the guardian ad litem to sign the agreement required under section 2032A has obviously never been litigated, a very similar issue has been litigated in the area of termination of trusts. A trust can be terminated by consent of all the beneficiaries (and the settlor, if living) if continuance is not necessary to carry out a material purpose of the trust.[410] However, though the number of cases is small, every case directly confronting the issue has held that a guardian ad litem is incapable of consenting on behalf of the minor beneficiary to the termination of a trust. Perhaps the leading case in this regard is *In re Fletcher's Trust.*[411] The grantor of an irrevocable trust gave the trustee notice that he intended to revoke the trust. The trust agreement provided that the income was payable to the grantor for life, and on

407. I.R.C. § 2032A(d)(2); Proposed Treas. Reg. § 20.2032A-8(c)(2), 43 Fed. Reg. 30,072 (1978).

408. Proposed Treas. Reg. § 20.2032A-8(c)(3), 43 Fed. Reg. 30,072 (1978).

409. E. Scoles & E. Halbach, *supra* note 370, at 377. *See* Hatch v. Riggs National Bank, 361 F.2d 559 (D.C. Cir. 1966).

410. Restatement (Second) of Trusts § 337 (1959); A. Scott, Abridgment of the Law of Trusts 619 (1960).

411. 57 Misc.2d 554, 293 N.Y.S.2d 177 (Sup. Ct. Nassau County, 1968).

his death, the principal was to be disposed of in accordance with the grantor's will. In default of appointment, the income was to be paid to the grantor's wife for life and on her death, the principal was to be distributed to the grantor's issue then living. At the time he attempted to revoke the trust, the grantor had three infant children. After deciding that the grantor's children had contingent interests in the trust,[412] and that therefore the donor could not revoke without their consent, the court stated: "The children here being infants are incapable of giving their consent (citation omitted). Furthermore, the special guardian, as distinguished from a general guardian (citation omitted), appointed to represent the interest of the children is incapable of giving his consent on behalf of the children (citation omitted)."[413]

Fletcher relied in part on *Application of Holman,*[414] a per curiam reversal of an order of the New York Supreme Court dissolving a trust. An infant had a remote interest in the trust. The infant was represented by a special guardian who "submitted the rights of the ward" (presumably meaning he would consent if the court felt this would be beneficial to the infant). Though the opinion is sketchy, it appears that an arrangement was worked out between the parties which made some provision for the infant. The court held the infant could not consent. Though the court never directly stated that the guardian could not consent on behalf of the infant, later courts have cited *Holman* for this proposition and it is the natural reading of the case.[415]

In *Wogman v. Wells Fargo Bank & Union Trust Co.,*[416] the only child and grandchild of testator were attempting to terminate a testamentary trust. The trust provided for the payment of $30 a month from the income to the decedent's third wife Petra, the remainder of the income (and all the income on Petra's death) to his daughter Alda, and if Alda died before the termination of the trust, to pay the income to her children or, if none, to two sisters of the testator. No disposition of the principal of the trust was ex-

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412. The court was concerned with N.Y. Est., Powers & Trusts Law § 7-1.9 permitting the revocation of a trust by the grantor with the consent of all persons beneficially interested and providing that a disposition "in favor of a class of persons described only as the heirs, next of kin or distributees (or by any term of like import) of the creator of the trust does not create a beneficial interest in such persons." The court decided that issue is not a term of like import to heirs, next of kin or distributees.

413. 293 N.Y.S.2d at 180.

414. 271 App. Div. 2d 910, 67 N.Y.S.2d 90 (3d Dept. 1946).

415. It is also clear that the cases of Application of Michael, 70 Misc. 2d 161, 33 N.Y.S.2d 301 (Sup. Ct. N.Y. County 1971), *aff'd per curiam* 39 App. Div. 2d 865, 332 N.Y.S.2d 865 (1st Dept. 1972) and In re Flexner's Trust, 56 Misc. 2d 336, 288 N.Y.S.2d 494 (Sup. Ct. N.Y. County 1968) *aff'd sub nom.* and Matter of Burch, 30 App. Div. 2d 1049, 294 N.Y.S.2d 669 (1st Dept. 1968), to be discussed later in this subsection, clearly recognize and support the proposition that a guardian ad litem is incapable of consenting to the revocation of a trust on behalf of his infant wards.

416. 123 Cal. App. 2d 657, 267 P.2d 423 (1st Dist. 1954).

pressly provided for, but Alda was the residuary beneficiary under testator's will. The trust was to terminate on the later of twenty-one years from the decedent's death or on the death of the survivor of Petra, Alda and Alda's husband. When the suit was brought, Petra had died and the two sisters had died childless. Alda was fifty-five and had only one child, Vincent, age thirty-one, who was married but childless. Alda and Vincent (in addition to Alda's husband) had consented to the revocation of the trust. The court first disposed of a contention that the trust violated the rule against perpetuities.[417] Then the court discussed termination by consent of the beneficiaries. The court stated that the trust corpus would go either to Alda's heirs, who were unascertainable, or possibly to her unborn children, should her only living child predecease her and she have more children. These unborn and unascertained persons were represented by a guardian ad litem who had been appointed to represent them by the lower court. However, the guardian did nothing but file a written appearance, an admission of service and a consent that the case could proceed to trial. He did not participate in the trial nor appeal the lower court judgment ordering termination of the trust.[418] Though not directly confronting the question, the court clearly indicated that allowing a termination of the trust would in itself amount to a lack of representation of the infants, without which, under the California cases, jurisdiction over the unborn and unascertained persons would not be obtained:

> It is also apparent, if his failure to object amounted to an implied consent [to the termination of the trust], that in no true sense were the unborn and unascertained heirs in fact represented. While the guardian did appear on their behalf, he did not "act" on their behalf. Yet the effect of the trial court's decree is to deprive some of these persons from ultimately getting the corpus of the trust. There was no true representation of these unborn and unascertained heirs in this case. This alone would require a reversal.[419]

417. This contention was based on an unusual California statute prohibiting the suspension of the power of alienation for a period longer than lives in being or 21 years from the creation of the suspension of the power.

418. 267 P.2d at 429. The trustee appealed.

419. 267 P.2d at 429-30. A case often cited in support of the rule prohibiting a guardian ad litem from consenting on behalf of his wards to a termination of the trust is McPherson v. First & Citizens National Bank, 246 N.C. 1, 81 S.E.2d 386 (1954). However, that case did not reach the issue. The case involved a trust for the benefit of all the grantor's children. The grantor alleged that certain provisions of the trust for the benefit of his grandchildren and great-grandchildren violated the rule against perpetuities and that because of a mistake of the draftsman, the trust did not reflect the grantor's true intent. The grantor suggested that the trust agreement be reformed as provided in accordance with what he alleged was his true intention. A guardian ad litem was appointed for the living grandchildren and for all persons not in being who may become beneficiaries. The court held that the trust violated the rule against perpetuities, thus cutting off the interests of the grandchildren. The situation then became one in which the wards of the guardian would benefit if the trust was reformed, since the grandchil-

Lastly, and perhaps the clearest and most extensive opinion on the subject, is *In re Small's Estate.*[420] Testator's residuary estate was divided into three shares, one for each of his children. As to the shares for each of his two daughters, each daughter was to receive the income from her share for life. Each daughter had a testamentary power to appoint up to one-third of the income of her share to her surviving husband. On the daughter's death, subject to the power of each daughter to appoint a share of income to her surviving husband, the share of each daughter was to be paid to her surviving descendants who attained age thirty, with the income being used for the education and support of the descendants until each attained age thirty. The income from the share for testator's son was to be paid to him for life. One-third of the corpus of the share of the son was to be paid to him when he attained age thirty, an additional one-third of the corpus was to be paid to him on attaining age forty and the remainder was to be distributed to his surviving issue who attained age twenty-one. The testator's three children, believing that the provision postponing distribution to the daughter's issue until age thirty violated the rule against perpetuities, agreed among themselves to modify the provisions to reduce the age of distribution to twenty-one and make certain other changes in the provision of the trust. They then petitioned the court for approval of the settlement. One of testator's daughters had two minor children, the other had no issue and testator's son had one minor child. Guardians ad litem were appointed to represent the minor and unborn issue of testator's children. The court first ruled that, in accordance with Pennsylvania authorities, a determination of whether the remainder interests violated the rule against perpetuities would be decided only on the termination of the valid preceding interests, because the court would not give a declaratory judgement. In addition, said the court, approval of the agreement required the consent of the minors and unborn parties. Thus the court was squarely faced with the question of whether a guardian ad litem could consent to the modification of a trust on behalf of his wards. The court answered with a resounding NO:

> Guardians and Trustees *ad litem* are in a special sense representatives of the Court. Their function is to represent and protect unrepresented mi-

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dren had a possible interest in the instrument as reformed by the grantor. The court, however, reversed the judgment because the reformed instrument excluded any possible future children born to the donor from the trust because they were not virtually represented by the children in being. The possible unborn children were never represented by the guardian ad litem, who represented the grandchildren. In fact, the court stated that absent virtual representation in the sense of an identical interest with persons in being before the court, an unborn cannot be sued. Thus the crux of the *McPherson* case is that absent virtual representation, no reformation of an instrument is possible against an unborn, rather than that a guardian for an unborn in a case where virtual representation exists could not consent to the reformation (or termination) of a trust on behalf of the unborn. 81 S.E.2d at 396. This latter question was not reached by the court.

420. 67 York Legal Record 1, (Pa. Orphans Ct. York County 1953).

> nors and the interests of those unborn and unascertained; and, where there is such representation the judgment of the court may be conclusive upon all present and future interests (citation omitted). *But it is equally clear that, if such unborn children have an interest in the trust estate, a Guardian ad litem appointed to represent their interests cannot consent to its being divested.* A Guardian *ad litem* has authority to protect the interests of his ward but *never has authority to consent to anything prejudicial to his ward and a Court has no power to authorize him to do so.* (emphasis added).[421]

A case often cited as holding that a guardian ad litem can consent to the termination of a trust on behalf of unborns is *Hatch v. Riggs National Bank.*[422] In *Hatch,* the grantor of a trust sought to modify its provisions. The trust was to pay the income to the grantor for life, and on her death to pay the corpus as the grantor appointed by will or, in default of appointment, to the grantor's next of kin. The case turned on whether the doctrine of worthier title[423] applied in the District of Columbia. If it did, the grantor had a reversion, thereby making her the only beneficiary and enabling her to revoke the trust. If it did not, her heirs had a remainder. The court held that the doctrine was not part of the law of the District of Columbia. Thus, the heirs of the grantor had a remainder and their consent would be necessary. In addition to the grantor's two sisters, the court stated that it was necessary to protect possible unborn and unascertained persons who may in fact be the grantor's heirs. The court said the District Court could appoint a guardian ad litem. It is doubtful whether many authorities would quarrel over the court's assertion that the appointment of a guardian ad litem to represent unborn beneficiaries (or infants or incompetents) is part of the inherent powers of the court. However, this does not solve the problem of whether the guardian ad litem, with or without a "quid pro quo,"[424] can consent on behalf of the beneficiaries to a termination of the trust.

There is a great difference in degree between representing an infant in litigation and engaging in a transaction for the beneficiaries, especially in the light of the traditional rule that all beneficiaries must be sui juris and

421. *Id.* at 8.

422. 361 F.2d 559 (D.C. Cir. 1966).

423. The doctrine of worthier title states that when an heir is given the same estate in quality and quantity as he would have taken intestate, he takes nothing by the will or conveyance, but takes by descent, thus leaving the grantor with a reversion. See P. Bergin & T. Haskell, *supra* note 385, at 117-20. The doctrine, which had become moribund in this country, was revived as a rule of construction as applied to inter vivos transfers by Judge Cardozo in Doctor v. Hughes, 225 N.Y. 305, 122 N.E. 221 (1919).

424. The court suggests that the grantor seeking to revoke or modify the trust "sweeten" the deal by providing a benefit in the form of irrevocably vested interests, in return for the guardian's consent. 361 F.2d at 566. Query: How good a settlement should the guardian hold out for to be free of blame for consenting to a modification of the trust? What if he demands a "sweetener" for himself due to the risk of a later action by the heirs based on the settlement?

consent to a modification or termination of a trust.[425] Apparently the *Hatch* court did not recognize this, because it did not say a word about the problem.[426] Nor did the remand to the District Court, which the Court of Appeals ordered so that the grantor could get the necessary consents, confront the question. The District Court's opinion was concerned solely with whether the suggestion to appoint a guardian ad litem was dicta and whether the court could make an appointment without a statute explicitly authorizing the appointment. The court held it had the power to make the appointment, but did not say a word about the guardian's power to consent to the modification.[427] Thus, every case actually considering the question has held that a guardian ad litem is incapable of consenting on behalf of his wards to a termination of a trust. Since execution of the agreement required to elect special use valuation imposes personal liability, it seems highly likely that a court faced with the issue of whether a guardian ad litem is capable of executing the agreement on behalf of a minor would regard the trust termination cases as persuasive and prohibit such action by the guardian.[428]

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425. *See* RESTATEMENT (SECOND) OF TRUSTS § 337 (1959).

426. What is so frustrating about the *Hatch* opinion is the number of chances the court missed to face the issue concretely. Apparently one of the grantor's two sisters, who were her presumptive heirs, was incompetent. But the court did not even discuss whether a guardian ad litem (or the guardian of her property) could consent. The only mention of this problem is in a footnote, which states: "One of the sisters is not *sui juris*. In referring to her consent, we do not mean to exclude consent by her guardian ad litem." 361 F.2d at 565, n.14. Actually, in that situation, the proper party to consent, if consent could be given, would be the guardian of the sister's property. *See* discussion of *Flexner* in text accompanying note 413 *infra*.

427. Hatch v. Riggs National Bank, 284 F. Supp. 396 (D.D.C. 1968). It should also be noted that another case on the subject, Leonardini v. Wells Fargo Bank & Union Trust Co., 131 Cal. App. 2d 9, 280 P.2d 81 (1st Dist. 1955), states in dicta that a guardian ad litem may consent to a modification or termination of a trust if the invasion is beneficial to the ward (minor or unborn). The court states that there are cases where a guardian was allowed to consent to such an invasion but cites only Mabry v. Scott, 51 Cal. App. 2d 245, 124 P.2d 659 (2d Dist.) *cert denied sub nom.* Title Ins. & Trust Co. v. Mabry, 317 U.S. 670 (1942) *Id.* at __, 280 P.2d at 87. However, a reading of *Mabry* makes it clear that there was virtual representation in that case of the unborn contingent remainderman by the living children of the grantor, thus giving the court jurisdiction over the unborns. Moreover, the court in *Mabry* avoided the question of whether a guardian can consent to the termination of a trust on behalf of his wards by holding that the court was modifying the trust under its inherent power to reform an agreement procured by fraud or undue influence. The court's decision is suspect since there is no indication that either fraud or undue influence was ever proven, and the court shows a desire to evade discussion of the real issue involved. In such situations some states have by statute not required persons who are virtually represented by persons in another class having the same interest to be made parties to the proceeding. *See* N.Y. S.C.P.A. §§ 315, 2207. In many cases no guardian ad litem need be appointed for persons virtually represented by other persons.

428. Though consideration of the wisdom of the rule prohibiting a guardian ad litem from consenting to the termination of a trust is beyond the scope of this article, it may be noted that such a rule is consistent with the law's treatment of contract of minors. If a minor cannot enter into a binding contract because the law believes he is incapable of appreciating the significance

Since a guardian ad litem will be unable to execute the agreement required by section 2032A, another possibility is to have a guardian of the minor's property appointed. There are a number of disadvantages of this method of holding assets for minors, among the most important of which are the necessity under the laws of many states for the guardian to obtain court permission for sales, investments and distributions, resulting in delay and expense to the infant's property[429] and the requirement of filing periodic (usually yearly) accountings with a court which results in additional expenses for legal and accounting fees.[430] Second, and perhaps more important, in many situations where a representative to execute the agreement for the minor is required under section 2032A, the most likely appointee, one of the minor's parents, will be the person standing to benefit most from the election. In the example with which this subsection began, on Green's death, Albert will be the person desiring special valuation. Yet in this situation, no court will allow Albert, as guardian of the property of his infant children, to consent to a section 2032A election, since Albert has a conflict between his own interests and his duties as guardian. This problem will often require the appointment of an outside guardian of the infant's property, a situation not desired by many parents since it takes from them the control over the finances of the children.

The above is academic, of course, if a court will not permit a guardian of the property to consent to the section 2032A election on behalf of his ward. Again, resort must be had to cases involving the termination of trusts. Research has revealed only two cases on the subject, and the two are conflicting.

In re Flexner's Trust[431] was a proceeding to partially revoke an express trust which was created in 1939 with a corpus of $157,000 and had appreciated to $600,000. The grantor's daughter had died, leaving the grantor with

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of his act, there is no logical reason to permit a minor to consent to the termination of a trust in which he has a possible interest or to permit a guardian ad litem to consent for him. That a quid pro quo is given for his consent should logically make no difference, since the law's attitude is that the minor is incapable of intelligently evaluating the benefit and burden and making a binding decision on the matter.

429. *See* H. Weinstock, Planning an Estate 47 (1977).

430. *E.g.*, Iowa Code § 633.670 (1979) (conservators); N.Y. S.C.P.A. § 1719. These costs can be fairly substantial. *See* T. Shaffer, The Planning and Drafting of Wills and Trusts 197-200 (2d ed. 1979). Note also that guardians are often statutorily limited in the kinds of investments they are permitted to make or, even if not limited, are often rather conservative in their choice of investments. *See id.* at 198-200. Other disadvantages mentioned by Weinstock are the possible requirement of a bond (the premium for which must be paid from the minor's property), the inability to hold assets in common for several children and to make unequal distributions tailored to the needs of each child, and the termination of the guardianship at the age of majority (usually 18) when the former minor may not be mature enough to wisely handle the money. H. Weinstock, *supra* note 429, at 47.

431. 56 Misc. 2d 336, 288 N.Y.S.2d 494 (Sup. Ct. N.Y. County), *aff'd sub nom.* Matter of Burch, 30 App. Div. 2d 1049, 294 N.Y.S.2d 669 (1st Dep't 1968).

two minor grandchildren to raise. In view of this burden and the increased cost of living, the grantor requested that the trust be revoked to the extent of $125,000, $50,000 of which was to be divided between her daughter's children. All the other beneficiaries had consented, except for two beneficiaries who were minors. A corporate guardian of the property had been appointed in California and a California court had approved the guardian's consent to the partial revocation. Most of the beneficiaries resided in California and the sole New York contact was the residence of the successor trustee. Despite noting that a special guardian could not consent to the revocation, the court granted the application:

> A special guardian, however, does not have the same authority to deal with his ward's property as does a guardian of the infant's property. The latter has custody and management of the infant's property and pecuniary rights, unlike a special guardian whose function is solely to protect his ward's interests in a judicial proceeding . . . .
> Moreover, and of primary importance in the instant case, a Court of another state, more closely connected with the Trust, authorized the guardian to consent to the partial revocation of the trust on behalf of the infants who are residents of that state. The contact of this State with the Trust is minimal, arising solely out of the residence here of the successor Trustee, and the former residence here when the instrument was executed, of the settlor. While the instrument provides that it shall be governed and construed under the laws of New York, this Court cannot ignore the order of the California Court, above noted, which Court has the most interest, and the closest contact with the subject matter. While the infant beneficiaries reside there, it is also the Courts of that State which govern their actions.[432]

Note that *Flexner* can be interpreted two ways: first, that a guardian of the property of a minor will be allowed to consent to the termination of a trust on behalf of his wards because of the nature of his powers and duties regarding the property of the wards or, second, that whether or not a guardian of the property will be allowed to consent will depend on the view of the courts of the state having the most significant contact with the infants. The only other case to discuss the question, *Application of Michael*,[433] indicates that the second interpretation will control future cases. The question as put by the court, was whether the guardian of the property of an infant "has the power to consent, on behalf of his ward, to the revocation of a trust under EPTL section 7-1.9."[434] The court first discussed the history of the statutory section and determined that no change of previous case law as regards the consent of beneficiaries was made when it was enacted. "The unanimous

432. 288 N.Y.S.2d at 495-96.

433. 70 Misc. 2d 161, 333 N.Y.S.2d 301 (Sup. Ct. N.Y. County 1971), *aff'd* 39 App. Div. 2d 865, 332 N.Y.S.2d 865 (1st Dep't 1972).

434. 333 N.Y.S.2d at 302.

consent of all beneficiaries was and is required. Infants could not consent then, and they cannot consent now (citations omitted)."[435] As to *Flexner,* the court noted that the consent was by a California corporate guardian who had secured approval from a California court, then stated: "The decision was based on the special circumstances of that case."[436] After quoting that portion of *Flexner* dealing with the California contacts of the beneficiaries, the court denied the application on the grounds that infants cannot consent to the revocation of an inter vivos trust.

About the best that can be said of the authority of a guardian of the property to consent on behalf of his wards to the termination of an inter vivos trust is that it is unclear and will depend on whether the court can be convinced that the guardian should have this power.

In summary, it is unclear who, if anyone, can qualify as "a representative authorized under local law to bind such person [an infant or incompetent] in an agreement of this nature . . . ."[437] Given the uncertain state of the law in this regard, no estate planner should rely on obtaining a special use valuation when interests in the property are given to minors.

3. *Initial Qualification: What is an "Interest?"*

Earlier in this article it was suggested that in order to solve certain problems in the application of section 2032A to trusts, the only person having an "interest" in qualifying real property would be the owner of the first of two or more successive interests.[438] From the foregoing discussion and the specificity of the proposed regulations it is clear that such an interpretation cannot possibly be employed when defining "interest in any property" as used in section 2032A(d). However, this does not mean that such an interpretation of "interest" cannot be used for the purposes of section 2032A(c). First, section 2032A(d) uses the parenthetical phrase "whether or not in possession" when speaking of an interest in property, which phrase is nowhere used in section 2032A(c). Second, and perhaps of greater importance, the purposes of the two sections are different. The purpose of the agreement required by section 2032A(d) is to make as many persons as possible having interests in the property personally liable for the recapture tax, so that the IRS will have the greatest likelihood of recovering the tax with a minimum expenditure of resources. Thus it is in the government's interest to give a broad definition of interest for the purposes of section 2032A(d). However, as regards the recapture tax itself, it makes little difference to the Service whether the recapture tax is apportioned among those holding interests in the qualified real property. In fact, if anything, it makes it easier to collect

435. *Id.*
436. *Id.* at 302-03.
437. Proposed Treas. Reg. § 20.2032A-8(c)(3), 43 Fed. Reg. 30,072 (1978).
438. *See* text accompanying notes 394-402 *supra.*

the tax if only the activities of the first possessor must be followed. Also, it is arguably fairer if the entire tax is collected from the holder of the first possessory interest, who alone will have the power to cause a recapture event. Thus simplicity and fairness argue for the interpretation of "interest" earlier suggested and the broad definition of "interest in property" for the purposes of section 2032A(d) is not inconsistent with, and should not prevent the narrow definition of, "interest" for the purposes of section 2032A(c).

H. *Summary*

The optimum situation for employing section 2032A is when the qualified real property will be bequeathed to one person (not the spouse), there is a high probability that the beneficiary will farm the property for fifteen years and the decedent's gross estate will substantially exceed $175,625.[439] Though the interrelationship of section 2032A and the marital deduction, as well as the material participation requirements, may cause problems in individual cases, in many situations where the taxable estate substantially exceeds $351,350, special use valuation should be considered even if the qualified real property is bequeathed to the spouse. However, the estate planner should not fail to calculate the effect of the lower basis for income tax purposes, whether under stepped-up basis, or under carryover basis.[440] If carryover basis is retained, special use valuation will become more widely applicable to marital deduction bequests as we move farther away from the December 31, 1976 date on which the fresh start adjustment is based. Outright bequests to farm and non-farm children cause substantial problems in equalizing the bequests because of the effects of section 2032A. Only careful planning and full and complete discussion of the effects of special use valuation can alleviate these problems to any degree, and perhaps resentment is unavoidable. In situations such as those discussed previously, except where there are strong family ties between the children and the children understand the effects of special use valuation on their bequests and agree to these effects, many clients will elect to forego the benefits of special use valuation in favor of family harmony. Because of the many unanswered questions involving partnerships and corporations, a decedent desiring to use special valuation should carefully consider keeping his farm as a sole proprietorship. Any farm held in corporate or partnership form should not rely on obtaining special use valuation.[441] Leaving the farm in trust should

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439. In the lower estate tax brackets, the amount of tax saved by special use valuation will be less than the increased income tax paid as a result of capital gains realized on the sale of the property. Moreover, some of the savings may be lost if special use valuation reduces the estate below the credit equivalent.

440. *See Hjorth, supra* note 39, at 652-54.

441. According to a recent study, 60% of the farms in Iowa are held as sole proprietorships, 23% as partnerships, 13% as corporations, and 5% in other forms. *Contemporary Stud-*

be avoided until regulations are issued clarifying the applicability of section 2032A to trusts, especially when minors have an interest in the property.

VII. Conclusion

The purpose of the enactment of section 2032A was to preserve the family farm by preventing the forced sale of farmland because of estate taxes.[442] In addition, Congress wished as much land as possible to be retained in agricultural production[443] and to provide a reasonably certain and easily calculated valuation of farmland, in order to reduce controversy and eliminate speculative values.[444] However, Congress provided neither a clear nor relatively certain method of valuing farmland. The proposed regulations indicate the resolve of the IRS to continue to litigate valuation of farmland by its restrictive definition of comparable land[445] and its positions on material participation and the disposition of an "interest" as triggering a recaptive tax. Two possible explanations for the IRS position exist. The Service may believe that section 2032A is unwise as a matter of policy, and is therefore endeavoring to restrict its application. Alternatively, the Service may be attempting to implement the congressional view of a family farm by a narrow interpretation of material participation. However, the size of estate necessary before benefits become significant under section 2032A together with the potential income tax disadvantages resulting from special use valuation will prevent many farmers from using the section.[446] That only the wealthiest farmers will benefit from special use valuation indicates that section 2032A will not save the family farm in the sense which Congress viewed the family farm.

The price paid for special use valuation is great. Perhaps the most serious problem is that it has raised grave doubts as to whether farms held as partnerships and corporations will, in most cases, be able to qualify for special use valuation. Moreover, it has effectively removed the use of perhaps the most flexible estate planning tool, the trust, from the hands of the estate planner wishing to take advantage of section 2032A for his clients. Again, when the client's situation calls for the use of a trust, section 2032A will not aid in saving the family farm. In addition, the statute discourages gifts as an

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ies Project, *supra* note 16, at 984 app. I.

442. House Report, *supra* note 44, at 22.

443. *Id.*

444. House Report, *supra* note 44, at 24-25.

445. The farm valuation method of § 2032A(e)(7) is not available where there is no comparable land from which the annual gross cash rental may be determined. I.R.C. § 2032A(e)(7)(B)(i).

446. One author has estimated that only the wealthiest 2% of the population may benefit from § 2032A. *See Hjorth*, *supra* note 39, at 612. From this must be subtracted those persons who have no qualified heir interested in farming the land, or who view the income tax disadvantages as too detrimental to elect special use valuation.

estate planning tool, by a combination of the percentage of estate requirements for qualification and the inapplicability of section 2032A to inter vivos gifts. The material participation requirement permits certain dispositions not resulting in a family farm in the sense Congress used the word to qualify, and disqualifies other dispositions that would keep the farm in the family.

But section 2032A has broader implications. It has been pointed out that section 2032A discourages lifetime sales of farmland and its benefits encourage purchases of additional land by farmers currently owning land.[447] The effect of this will be to simultaneously decrease the supply of and increase the demand for farmland, indicating that the trend of recent years toward increasing the price of farmland in relation to the income derived from farming will continue.[448] This will have two effects: concentrating farms in a smaller number of owners, and preventing tenants and persons wanting to enter farming from purchasing land. This is exactly the opposite of the purpose Congress wished to encourage: the continuation of small, family farms.

In short, section 2032A can be beneficial in a limited number of situations. It offers the most benefits in the case of a relatively large farm where an outright bequest to a family member is contemplated and where there is a great liklihood of the family member materially participating in the operation of the farm for at least fifteen years after the decedent's death. It may also be beneficial in the case of an outright bequest of the farm to a surviving spouse, though the marital deduction will decrease the benefits and increase the size of the estate necessary for use. If the objective of estate planning is to divide the estate in equal shares between farm and non-farm beneficiaries, section 2032A increases the potential for conflict among the beneficiaries and, in the absence of great understanding by the off-farm beneficiaries and a close-knit family, the benefits of section 2032A may often be foregone to help insure family harmony. Unless very liberal regulations are forthcoming, where the qualified farm real property is to be left in trust, or where the farm is held in a partnership or corporation, the problems in qualification and statutory construction will rarely permit the use of section 2032A.

In view of these conclusions, it is highly doubtful that section 2032A contributes significantly to saving the family farm. Because of the restrictions on qualifications, the effect of the recapture tax and the unresolved questions raised by the statute, it will be beneficial to a relatively small percentage of farm estates. Encouraging the congressional ideal of the family farm demands more than a statute directed at one part of a complex problem. The effects of the farm cycle, the income tax and the relatively low

447. *Hjorth, supra* note 39, at 659.
448. *Id.*

yield of farms as well as the interrelationships between these factors and the estate and gift taxes must be studied. Perhaps such a study would determine that the problem is not the estate tax at all. Perhaps lifetime gifts of portions of a farm to family members should be encouraged. Perhaps the major problem is an economic one of improving farm income, or perhaps entry into farming by non-farmers should be encouraged by subsidies. The crucial point is that all aspects of the problem of preserving the family farm must be examined for a solution which treats all aspects of the problem. An attack on one aspect of a problem as complex as this will rarely provide a workable solution. The enactment of section 2032A is a case in point. Far from saving the family farm, section 2032A introduced a great deal of complexity into the Internal Revenue Code. It may have created more problems for farmers than it solved.