Special Estate Tax Valuation of Farmland and the Emergence of a Landholding Elite Class

Roland L. Hjorth
University of Washington School of Law

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SPECIAL ESTATE TAX VALUATION
OF FARMLAND AND THE EMERGENCE
OF A LANDHOLDING ELITE CLASS

Roland L. Hjorth*

Representative Keys: The problems of the survival of . . . the family farm . . . are real ones. The relief brought to these estates is . . . a fostering of our national interest to keep food production in the hands of individual owners . . . **

Senator Kennedy: It appears quite likely that most of the proposals that have been presented to Congress so far will achieve exactly the opposite results from those intended by their sponsors. That is, in the name of providing estate tax relief for farmers, many of these proposals will have the actual result of hastening the demise of the family farm.***

I. INTRODUCTION

The "family farm" is often praised but seldom defined.1 The term awakens in many Americans social images which carry powerful emotive force: images of a closely knit nuclear family, earning its sustenance through hard work and careful husbandry on a comparatively small farming operation, contributing a solid foundation to the fabric

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* Professor of Law, University of Washington; A.B., 1957, University of Nebraska; LL.B., 1961, New York University.


1. But see WASH. REV. CODE § 90.66.040(1) (Supp. 1977). "'Family farm' means a geographic area including not more than two thousand acres of irrigated agricultural lands, ... the controlling interest in which is held by a person having a controlling interest in no more than two thousand acres of irrigated agricultural lands in the state of Washington . . . ." Id. See Comment, The Family Farm and Use Valuation—Section 2032A of the Internal Revenue Code, 1977 B.Y.U.L. REV. 393, 357 n.19. In this article the term denotes a farm or ranch providing the principal income of persons who own and operate the enterprise.
of society and to the free enterprise system. These images played a part in the adoption of two provisions of the Tax Reform Act of 1976, codified as sections 2032A and 6166 of the Internal Revenue Code, which are of particular interest to persons who believe that the family farm should continue to be a dominant institution in American agriculture.


3. Many persons believe, apparently, that these provisions will protect the family farm. For example, Senator Lloyd Bentsen stated that "[t]he old $60,000 exemption, set back in World War II, was forcing the widows and children of farmers, ranchers and small businessmen to sell their property to pay the tax." 122 Cong. Rec. S16.020 (daily ed. Sept. 16, 1976). Representative Floyd J. Fithian stated that in voting for § 2032A "[w]e will, in a sense, be voting for the American family." 122 Cong. Rec. H 10.235 (daily ed. Sept. 16, 1976). The sections have been noted with approval in Comment, supra note 1, and Comment, An Analysis of the "Actual Use" Valuation Procedure of Section 2032A, 56 Neb. L. Rev. 860 (1977).

The author's views to the contrary are shared by others. Senator Edward Kennedy quoted a 1975 study which stated in part as follows:

[L]ow death tax exemptions and relatively high rates have some tendency to preserve an agriculture where operators own at least part of their land. Higher exemptions and lower rates have an opposite effect. They facilitate moving toward a financially elite landholding class in agriculture, and landholding by other than farm operators.


The University of Illinois study considered estate taxes generally and did not address itself to special estate tax relief for full-time farmers. Considering these special provisions, an agricultural economist has observed,

In its early years, our Nation took conscious action to prevent the development of a hereditary landowning class such as was found in European countries. . . . Some of the new estate tax provisions move us back in this direction and will assuredly make it more difficult for young persons from non-landowning families to enter agriculture.

Section 2032A applies to estates whose major asset is a farm or ranch. Its principal feature is the "productive formula" of land valuation. This formula values farmland solely by reference to current net income yield, disregarding totally any value attributable to anticipated growth in dollar value of that land. Section 2032A can reduce the value of a single estate by up to $500,000; in one husband-wife generation, the total reduction can be as much as $1 million. Maximum estate tax savings in one such generation can amount to $700,000.

Section 6166 applies to any estate in which a closely held business, including a farm or ranch, is the major asset. It allows the executor to defer payment of the entire estate tax for a period of five years and, thereafter, to pay tax in installments over the next ten years. The interest rate on the estate tax attributable to the first $1 million of farm or other closely held business property is reduced to a permanent rate of 4%. It has been observed that this provision can result in savings through legislation which distorts the economy. See Senate Hearing, supra at 138 (statement of William P. Cantwell).

4. I.R.C. § 2032A(b)(2)(A). Section 2032A also applies to any estate in which real estate is a major asset of a closely held business which is in turn the major asset of an estate. Id. § 2032A(b)(2)(B). The "productive formula" of § 2032A(e)(7), however, applies only to farmland. Section 2032A(e)(8) provides a "multiple factor" method of valuation, which applies when § 2032A(e)(7)(A) does not, but it is difficult to determine whether this alternative method will benefit nonfarm estates to any degree. The multiple factor method is neither objective nor certain, and considers such factors as capitalization of income (without stating the rate), capitalization of rent value (without stating the rate), assessed land values in states providing use differentials for property tax purposes, comparable sales of land sufficiently removed so that nonagricultural use is not a factor, and "any other factor which fairly values the farm or closely held business value of the property." Id. § 2032A(e)(8)(E). It may become significant if it can be used to achieve "productive formula" results in cases where the "productive formula" cannot be applied (e.g., where there are no comparable "adjusted cash rent" figures available). Because this method is not likely to have any great effect on farm valuation, it is not discussed at any length in this article.

5. Id. § 2032A(e)(7). This method has also been termed the "farm method" of valuation. See General Explanation of the 1976 Act, supra note 2, at 539, 1976–3 (vol. 2) C.B. at 551. The term "productive formula," which was apparently coined by Senator George McGovern, see Senate Hearing, supra note 3, at 155 (statement of Sen. McGovern), is used herein, because it better describes the valuation method under § 2032A(e)(7).

6. See Part IV–B infra.


8. See Part VII infra.

9. For example, if a husband and wife die in a common disaster and leave a community estate worth $6 million or more, reduction of that estate by $1,000,000 reduces estate tax by $700,000. I.R.C. § 2001.

10. Id. § 6166(b)(1). Unlike § 2032A, § 6166 will be significant for nonfarmers as well as farmers. This article considers the section only as it applies to farm estates.

11. Id. § 6166(a)(1).

12. Id. § 6601(j)(2).
of from 28.5% (assuming a normal interest rate of 7%) to 47.5% (assuming a normal interest rate of 9%) of estate tax attributable to the first $1 million of farm property;13 in dollar terms this subsidy can range from $85,000 to $142,000.14

It appears generally to be assumed that these estate tax subsidies, which benefit only the wealthiest 2% of the population,15 will help save the family farm.16 This article examines that assumption and concludes that it is unfounded. Indeed, it seems more probable that sections 2032A and 6166 will contribute to the decline and possible demise of the family farm. Several factors point to this conclusion:

(1) Sections 2032A and 6166 promise both to increase the demand and to reduce the supply of farmland in the market, with the likely result that land prices will become so high in relation

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13. Comment, supra note 1, at 380 & n.171.
14. The total value of the subsidy is the excess of market rate interest over § 6601(i) interest. If the deferred tax is $300,000 and the market interest rate is 9%, the subsidy is 5% per year of the amount of the tax. Because no tax need be paid for five years, the subsidy could come to $75,000 before payments are due. The tax can then be paid in 10 annual installments, with interest on the unpaid balance. Making available another subsidy of about $75,000.

Arguably, the subsidy is only the difference between 4% and the floating rate authorized by § 6621 (now 6%). See note 104 infra. To the extent § 6621 authorizes an interest rate lower than the market interest rate, however, that section is itself a tax subsidy.

15. Ninety-three percent of all estates prior to the 1976 Act paid no federal estate tax. Senate Hearing, supra note 3, at 40 (statement of Sen. Edward M. Kennedy). The unified credit, when fully phased in, will almost treble the level at which estates are exempt, so that only the largest 2% of all estates are exempt, so that only the largest 2% of all estates will be taxed. Reforming the Tax Laws, Wash. Post, Sept. 13, 1976, § A, at 22. col. 1, reprinted in 122 CONG. REC. H 10,237, at H10.238 (daily ed. Sept. 16, 1976) (submitted by Rep. Morgan F. Murphy).

The assumption which appears to have dominated the Congressional debates on § 2032A and § 6166 is that they protect the "little man." As Professor Stanley S. Surrey noted, there is a vast difference between speaking of the "little man" under the individual income tax and the "small estate" under the estate tax. Yet proponents of a low estate tax carry over to the "small estate" the protectionist attitudes involved in the reference to the "little man." The "small estate," it is true, is less than a dwarf in the scale of large estates, but viewed from the perspective of almost all our population the "small estate" represents wealth beyond the realities of almost everyone. Unless that perspective is kept constantly in mind, the estate tax will never be an effective tax on the transfer of wealth in the United States.

Senate Hearing, supra note 3, at 186 (statement of Prof. Surrey).

16. See note 3 supra; Comment. The Family Farm and Use Valuation—Section 2032A of the Internal Revenue Code, 2 B.Y.U.L. REV. 353 (1977). The comment concludes, without data, that the potential burdens of estate taxes "under prior law constituted a serious threat to the survival of many family farms," that valuation of farmland at fair market value "contributed materially to the irreversible conversion of farmland to nonagricultural uses," and that the new provision "for use valuation of farmland constitutes a substantial step toward the resolution of these problems." Id. at 428.
to current yield that only those with substantial outside income will be able to enter the agricultural market.17

(2) The subsidies benefit owner-operators of farms, but do not benefit tenant farmers, who will find it increasingly difficult to buy any of the land they till as prices rise.18

(3) The subsidies grant larger benefits to wealthy owner-operators than to operators owning farms of modest size, and the small owner-operators will themselves find it increasingly difficult to buy more land if the provisions grant them only a small benefit but drive up the price of land significantly.19

(4) The subsidies are unavailable to the estates of persons who have sold their farmland during their lifetimes; thus, they interfere with any desires which retiring farmers may have to sell to other farmers and further restrict the supply of land.20

(5) Families that own land but have no relatives who wish to farm the land will be encouraged to transform landlord-tenant relationships into sharecropping arrangements in which decisions concerning the day-to-day operations of the farm will be made by absentee landlords.21

Sections 2032A and 6166 also raise difficulties unrelated to their threat to family farms. They complicate estate planning by making it more difficult to draft marital deduction clauses in wills and by making post-mortem administration and planning extremely burdensome.22 Because they apply only to the estate tax, they interfere with the general policy behind the 1976 Act of treating inter vivos and testamentary transfers similarly for transfer tax purposes.23 Finally, because their advantages are available only to families which have a member who "participates materially" in the operation of the farm or ranch, relatives of persons who inherit or own land will find it easier to rent land than will persons who are not so related.24

In short, we have no assurance that sections 2032A and 6166 will help save the family farm. The difficulties they create, however, are substantial and bear careful examination.

17. See Part IX–A infra.
19. See Part IX–B infra.
20. See Part VI infra.
22. See Parts VII–VIII infra.
23. See Part IV–B infra.
II. ECONOMIC CHARACTERISTICS OF FARMLAND

The value of any asset is a function both of its current income yield and of its potential growth in dollar value. Farmland and ranch land generate a low current yield in relation to value, but have a high potential for growth in dollar value. Although rates of current return undoubtedly differ, depending on the locality and the use to which agricultural land is put, the average current return on agricultural investments is about 3% of current value. On the other hand, the per acre value of farmland has multiplied over thirteen times between 1942 and 1977, compared to a less than fourfold increase in prices generally.

The current yield on American farmland investments is a genuine, albeit modest, yield because the land itself does not generally decline in value. A 7% return on bonds is illusory if the inflation rate is also 7% per year. A 3% return on an asset whose value keeps pace with

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25. Most authorities estimate the return on farm capital as 2% to 3%, more or less. See Federal Estate and Gift Taxes: Public Hearings and Panel Discussions Before the House Comm. on Ways and Means, 94th Cong., 2d Sess. 652 (1976) (statement of Rep. Mark Andrews) [hereinafter cited as House Hearings]; Comment, supra note 1, at 377 n.152. From 1960 to 1976, the average ratio of net rent paid to non-operator landlords to the land's value was 3.8%. Economic Research Service, U.S. Dep't of Agriculture, Agriculture Information Bull. No. 411, Balance Sheet of the Farming Sector 1977, at 37 (1977) [hereinafter cited as 1977 Balance Sheet]. For a recent study of farmland values and ratios of rent to value, see Economic Research Service, U.S. Dep't of Agriculture, Farm Real Estate Market Developments 53 (July 1977) [hereinafter cited as 1977 Farm Developments]. The study shows cash rents ranging from 2.3% to 8% of current value, without apparently taking a landlord's expenses, such as property taxes and maintenance, into account. Similarly, ratios for pastureland range from 2.1% to 7.2% before deducting expenses. Id. at 55 (Table 36).

26. U.S. Department of Agriculture statistics show that the gross value of farmland in production in the United States in 1977 was 13.3 times the value of such farmland in 1942. See 1977 Balance Sheet, supra note 18, at 48-49. The increase in the value of each acre appears to have exceeded this figure, because the total number of acres in production decreased slightly during the same period. See 1977 Farm Developments, supra note 25, at 25-26. Census figures show that 1,065,113,774 acres in the U.S. were farmland in 1940, compared to 1,017,030,357 in 1974. 1 Bureau of the Census, U.S. Dep't of Commerce, 1974 Census of Agriculture, pt. 1, at I-1 (December 1977). Cf. 1977 Farm Developments, supra note 25, at 25-26 (1971-1977 figures).

27. Bureau of Labor Statistics figures show that the general price level in 1977 was 3.7 times the 1942 level. Council of Economic Advisors, Economic Report of the President Together with the Annual Report of the Council of Economic Advisors 313 (1978). Similarly, the values of stored crops increased 5.7 times and the value of household goods on farms increased 3.6 times during the same period. 1977 Balance Sheet, supra note 25, at 48-49.

28. With the exception of the years 1939, 1950, and 1954, farm real estate has appreciated every year since 1933. 1977 Farm Developments, supra note 25, at 8.

29. Inflation during the last 10 years has fluctuated between 3% and 11%. See Council of Economic Advisors, supra note 27, at 313. The rate during the period 1975 to 1977 has averaged 6.3%. Id.
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inflation, however, is a genuine return. The value of land in this country has historically outpaced inflation by a significant margin; it is, therefore, a highly attractive form of investment.

These characteristics of farmland definitely limit the class of persons able to acquire it. For example, if the current yield from the land alone is 3% and the current interest rate is 9%, a purchaser of farmland can borrow only one-third of the land's cost if current yield is the only source of funds for paying the interest on the debt. The balance of the purchase price would have to come from the borrower's own funds. If the borrower already owns farmland or other property which generates, in excess of current consumption needs, net income equal to the interest payments, the borrower could, in theory, borrow the entire cost of the land. In sum, those who already own land can acquire more, but those who own no excess investment property cannot enter the market.

This is, of course, not the end of the story. Historically, the current percentage yield on land has remained relatively constant notwithstanding the high rate of increase in the value of land. If the land's

30. See notes 19-20 and accompanying text supra.

31. Land in the United States remains inexpensive compared to land in other developed nations. The average price per acre of land in the United States was about $350 in 1974. In contrast, 1972 prices in Germany averaged about $2000 and 1974 prices in France averaged $1050 per acre. Japan has the highest land prices in the world, averaging as high as $5000 to $7000 per acre. F. Dovring, Economic Impact of Foreign Investment in Real Estate, in ECONOMIC RESEARCH SERVICE, U.S. DEP'T of AGRICULTURE, FOREIGN INVESTMENT IN U.S. REAL ESTATE 140-41 (G. Wunderlich ed. June 1976).

U.S. agriculture land is even less expensive, averaging $283 per acre in 1977. 1977 FARM DEVELOPMENTS, supra note 25, at 18. Because the economic value of land follows directly from physical scarcity, it is reasonable to assume that population growth and increased foreign investment will continue to cause land values to grow at a rate higher than inflation. See generally G. WUNDERLICH, ECONOMIC RESEARCH SERVICE, U.S. DEP'T of AGRICULTURE, AGRICULTURAL INFORMATION BULL. No. 400, SUMMARY OF THE REPORT: FOREIGN INVESTMENT in U.S. REAL ESTATE (1976).

32. In the past 10 years, interest rates on farm loans have fluctuated between 7% and 10%. ECONOMIC RESEARCH SERVICE, U.S. DEP'T of AGRICULTURE, AGRICULTURAL FINANCE OUTLOOK 11 (November 1977).

33. To illustrate, if farmland with a cost of $300,000 generates a 3% current yield of $9,000 and the current interest rate is 9%, a purchaser expecting to pay interest out of the current land yield could borrow only $100,000. A larger loan would have to be serviced by excess income from other investments or excess earned income not needed for current consumption.

34. This conclusion is buttressed by USDA statistics indicating that those who already own land are in fact those who are purchasing land in the market. 1977 FARM DEVELOPMENTS, supra note 25, at 42 (Table 22).

35. From 1960 through 1976, the amount of net rent paid to nonoperator landlords increased 3.6 times. See 1977 BALANCE SHEET, supra note 25, at 38. During the same period, the value of all farmland increased slightly over threefold. See id. at 49. Because the amount of land available for renting has declined by about 15%, see 1 BUREAU OF
value doubles in six years\textsuperscript{36} and the land still generates a return of \(3\%\) on current value, current yield will be twice as high in strict dollar terms, which would service a debt equal to two-thirds of the cost of the land. If value doubles again in six years, a \(3\%\) return of current value would be more than sufficient to pay interest at \(9\%\) on the entire original purchase price of the land.\textsuperscript{37} Even if the validity of these generalizations continues in the future,\textsuperscript{38} they provide little assistance to those who cannot service a substantial debt in the early years after purchase. Unless lenders can be persuaded to lend on the basis of these projections,\textsuperscript{39} the person with little or no existing property will have difficulty buying land, notwithstanding the land's potential ability, twelve years hence, to generate sufficient income to service the debt.

Another factor that influences who can buy land is the return on labor. If the return on farm labor were sufficiently high, a farmer could finance a purchase of land out of current labor earnings not required for current consumption. Thus, if a farm generates a current capital yield of \(3\%\) of value and the interest rate is \(9\%\), a person whose labor produces income equal to \(6\%\) of value (in excess of current after-tax income required for consumption) could use such excess income plus the farmland yield to pay interest on the entire purchase price.

Unfortunately, farm labor does not appear to generate this kind of income.\textsuperscript{40} This fact makes it difficult or impossible for tenant farmers,

\textsuperscript{36} It has not been uncommon for farmland values to double in a six-year period. See 1977 \textit{Balance Sheet}, supra note 25, at 37 (Figure 17). As of 1977, this overall trend was reversing itself to some degree, and rental rates were rising less quickly than land prices generally. 1977 \textit{Farm Developments}, supra note 25, at 15.

\textsuperscript{37} Using our previous illustration, see note 33 supra, if farmland costing \$300,000 doubled in value in six years to \$600,000, a \(3\%\) return would amount to \$18,000, which would service \(9\%\) interest on a \$200,000 loan. If it doubled again to \$1,200,000, a \(3\%\) return would equal \$36,000, which would substantially exceed the \$27,000 annually needed to service a loan for the entire original purchase price of \$300,000.

\textsuperscript{38} See note 35 supra.

\textsuperscript{39} It is highly doubtful that lenders do take possible future appreciation into account. A lending official with the Federal Land Bank has stated that the Federal Land Bank does not consider future appreciation, although it does consider increased productivity stemming from past appreciation of farmland. Conversation with Mr. Dean Easterbrooks, Manager of Federal Land Bank Association of Puyallup, Washington, July 3, 1978.

\textsuperscript{40} The author has been unable to isolate accurately from available data the economic return on agricultural labor. One commentator has calculated that the aver-
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whose only return is from their own labor, to acquire the land which they farm. Assets having the economic characteristics of farmland are more easily acquired by those who already own substantial amounts of income-producing property or who enjoy large salaries. Farmers who already own substantial amounts of land may fit into the former category, but very few full-time farmers can finance substantial land purchases out of earned income.

Economic factors thus favor wealthy and prosperous persons in obtaining and retaining farmland. Federal income tax laws do more by making agricultural investments especially attractive to such persons. A modest but real return coupled with historically proven growth potential is an ideal investment for persons in high tax brackets. Such persons might indeed prefer no current return if such return could be replaced by increased growth in value over time.41 If a wealthy investor could be assured that farmland would double in value over six years, he might well buy the farmland even if property taxes exceed age "wage" for an owner-operator with an "average" farm (equity = $190,000) is $1.78 per hour. Comment, supra note 1, at 378 n.153. This author is incapable of such precise computation and contents himself with the observation, based largely on personal experience and perception, that it is difficult for a full-time tenant farmer to generate sufficient earned income in excess of current consumption needs to finance substantial land purchases.

This observation is additionally supported by USDA wage statistics. As of late 1977, the average farm wage paid to hired workers was $2.99 per hour. Crop Reporting Board, Statistical Reporting Service, U.S. Dept of Agriculture, Farm Labor 12 (November 23, 1977). This may exceed the actual economic return for labor performed, however, if demand for such labor is high and employers are forced to use part of their capital return to pay workers.

For a compilation which compares the ratio to land values of owner-operators' net income and non-operator landlords' net rent, but which does not take account of capital investment in personalty, see 1977 Balance Sheet, supra note 25, at 37 (Figure 17).

But see Letter from W. Fred Woods, Public Policy Specialist, U.S. Dept of Agriculture, to Roland Hjorth (April 10, 1978) (on file with Washington Law Review). "Farmers can and do finance land purchases out of earned income. The majority of farmland sales are, in fact, to existing farmers. They do not, however, purchase the land out of income earned from the purchased land itself." Id.

41. See Senate Hearing, supra note 3, at 138 (statement of William P. Cantwell). An investor who buys an asset which appreciates in value but generates no current return enjoys the benefit of tax deferral. The economic value of deferral is recognized by many and superbly described in Surrey, The Tax Reform Act of 1969—Tax Deferral and Tax Shelters, 12 B.C. Indus. & Com. L. Rev. 307 (1971). The gain eventually realized upon sale will usually be a long term capital gain available for the deduction of Code § 1202 or the special rate of § 1201. See I.R.C. §§ 1221, 1231. The gain may result in a minimum tax on tax preference items of § 56 and deprive a taxpayer of some benefits otherwise available under § 1348. But the maximum theoretical rate of 52% on a capital gain will probably never be paid, because of the limitation imposed by § 56(e). This maximum rate would always be less than the maximum rate on unearned income. The limitations on the deductibility of investment interest of § 163(d) might, in theory, deter some investments in farm land, but its provisions have no real teeth.
the rent from the land.\textsuperscript{42} The farmer who must derive his living from the land cannot afford this kind of luxury.

Crop failures and adverse market conditions can also affect the status of the farmer who owns land or would like to buy it. Current yield \textit{on the average} may be 3\% of farm value. But in the event of serious drought or adverse market conditions, the farmer without outside income or wealth will be unable to derive income either from farmland ownership or from agricultural labor. The farmer must then borrow to pay for operating expenses and may be unable to pay mortgage debts. If some or all of the farmer's land must be sold to pay such debts, the logical purchaser is the person described above—the individual or corporation with substantial nonfarm income from investments or from labor.

It is easy to agree with Representative Martha Keys that "[t]he problems of the survival of . . . the family farm . . . are real ones."\textsuperscript{43} But those problems are attributable basically to the economic characteristics of farmland and to the federal income tax laws. They have not been shown to be attributable to the federal estate tax.

\section*{III. LIQUIDITY PROBLEMS OF FARM ESTATES}

\subsection*{A. Exemption Levels}

The legislative history of sections 2032A and 6166 contains many statements to the effect that special valuation of farmland with liberal terms for estate tax payment are required because farms are nonliquid businesses that can only afford to pay generational estate taxes by selling part or all of the farmland.\textsuperscript{44} These assertions have not been
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proven by any empirical data. Indeed, existing empirical data indicates that liquidity has not been a major problem in farm estates.\textsuperscript{45} It is likely to be even less of a problem under present exemption levels.\textsuperscript{46}

The unified credit, when fully phased in, will amount to $47,000 and will eliminate any federal estate tax on the first $175,625 of taxable estate.\textsuperscript{47} Many family farms are undoubtedly worth more than $175,625,\textsuperscript{48} but if the property is community property, or is owned by husband and wife as tenants in common, or is initially owned by the first decedent who gives half the property to his spouse outright (with the other half passing in such a way as to avoid taxation in the state tax rates were 100% would a farm estate of $1 million or less have to pay 4% of total value in estate tax interest each year.

\textsuperscript{45} A comprehensive study of probate estates in Iowa indicates that "liquidity" is not a severe problem in large farm probate estates. The study concludes, In any event, the conclusion seems inescapable that whatever liquidity problems were observed among living farmers, they constitute only a temporary condition which either tends to cure itself with the passage of time or is solved by the affirmative actions of the client or his attorney at some point prior to death. Contemporary Studies Project: Large Farm Estate Planning and Probate in Iowa, 59 IowA L. Rev. 794, 930 (1974). Accord, House Hearings, supra note 25, at 1319–30 (statement of Prof. James D. Smith).

\textsuperscript{46} Even under old exemption levels, only 6–7% of decedents' estates were required to pay any federal estate tax. House Hearings, supra note 25, at 1310, 1314 (statement of Prof. James D. Smith). Professor Smith stated that "one is probably safe in saying that only the estates of the richest 5 percent of the population [were] taxed at all under the [pre-1977] estate tax system." Id. at 1314. "Only about 6 percent of the estates filing returns in 1973 had taxes and costs equal to or greater than their liquid assets once all debts had been accounted for." Id. at 1321. He concluded that about 16 percent of farm estates filing estate tax returns had liquidity problems. Id.

By the time the new unified credit is fully phased in, exempting from taxes most taxable estates of $175,625 or less, fewer than 2% of all decedents' estates will have a federal estate tax liability. See note 15 supra. According to Professor Smith's figures, approximately 62% of all estates filing in 1973 that included some farm or noncorporate business assets were smaller than $175,000. See House Hearings, supra note 25, at 1321 (assuming straight-line numerical distribution of estates from $150,000 to $200,000 and excluding lifetime transfers). Assuming that 20% of farm estates have federal estate tax liability and that 16% of these estates have liquidity problems, only about 3% of farm estates will have any liquidity problems. In the absence of statistics, it seems reasonable to conclude that less than 1% of farm estates will have liquidity problems \textit{caused by estate taxation}. Sections 2032A and 6166 are primarily worthy of discussion then, not because of the benefits they bestow on less than 1% of the farm population, but rather because of the adverse effects they may have on the remaining 99% of this nation's farmers.

\textsuperscript{47} I.R.C.\textsection 2010. In the years 1977–1980 the credit will be $30,000, $34,000, $38,000 and $42,500 respectively. The credit may be reduced by up to $6,000 for gifts made after September 8, 1976 and before 1977, but is not reduced for gifts made prior to that date. Id. \textsection 2010(c). The credit may be applied against either the gift tax or the estate tax. To the extent it exceeds any gift tax, it may be credited against estate tax. Id. \textsection 2001. Unless otherwise indicated, this article assumes that a full $47,000 credit is available on a decedent's death.

\textsuperscript{48} American farms in 1976 had, on the average, $213,408 in assets and $32,697 in liabilities. 1977 BALANCE SHEET, supra note 25, at 47.
survivor's estate), the exemption level rises to $351,250 in one generation. With minimum estate planning, then, farms worth $351,250 or less can pass from one generation to another free of federal estate tax even without the benefit of section 2032A. Therefore, most farm families, those owning farms worth less than $350,000 under normal valuation procedures, will be little affected by sections 2032A and 6166.

B. The Million-Dollar Farm

Vice President (then Senator) Walter Mondale suggested in 1976 that a typical farm capable of supporting a farmer and his family would be worth $700,000 to $800,000, substantially more than $350,000. If this assertion is true, the new exemption levels will not exempt typical family farms from the federal estate tax. Indeed, by 1981 when the $47,000 unified credit is fully phased in, such typical farms will likely be worth over $1 million. Thus, it may be appropriate to evaluate the need for the section 2032A and 6166 subsidies by looking at the million-dollar farm.

If a million-dollar farm were split up into two equal taxable estates of $500,000 each, the total federal estate tax in one husband-wife generation would be $217,600. Even if the entire farm were taxed...

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49. See note 191 and accompanying text infra.

50. It has been suggested that farmers should be exempt from this kind of estate planning. After noting that a typical Minnesota farm operation might be worth as much as $700,000 or $800,000, Vice President (then Senator) Mondale referred to the owners of such farms as persons of "modest means" who should not be expected to go through the kind of "estate planning" that is usual for "families of wealth." Senate Hearing, supra note 3, at 55-58 (statement of Sen. Mondale). Vice President Mondale's statement indicated that perhaps persons who own farms worth $700,000 should be concerned about such matters as estate splitting by the prudent use of the marital deduction, but that traditionally they have been unconcerned and therefore need protection from their imprudence. Many Americans might be surprised to learn that owners of farms worth $700,000 are persons of "modest means" who should be spared the inconvenience of employing estate planning advisers.

51. The primary effect of these sections upon smaller farmers is likely to be the acceleration in increases in land prices which they promise to promote. See Part IX-A infra.

52. Senate Hearing, supra note 3, at 55-57 (statements of Sen. Mondale and Carroll G. Wilson, President, Minnesota Farm Bureau Federation).

53. Farm asset values appreciated at a rate of approximately 11 1/2% during the years 1974 to 1977. 1977 BALANCE SHEET, supra note 25, at 49. If this rate of appreciation continues, a farm worth $700,000 in 1976 will be worth approximately $1,200,000 in 1981.

54. The statement assumes a $1 million net value and disregards administration expenses and losses. The tentative estate tax on $500,000 is $155,800. I.R.C. § 2001. After
in one estate, federal estate tax (after subtracting the unified credit) would be $298,800.\textsuperscript{55} A 3% yield on the million-dollar farm would in either event be more than sufficient to service a 9% loan used to pay federal estate tax.\textsuperscript{56}

If this typical farm is already encumbered by substantial debt, an estate tax burden of $200,000 to $300,000 might be intolerable. Such a debt, however, would reduce the taxable estate by a similar amount and reduce the tax. Thus, if one accepts Vice President Mondale’s estimate but assumes that the million-dollar value (as of 1981) is a gross value encumbered by debts of $200,000 to $300,000, the net value of the typical family farm would be only $700,000 to $800,000 by that time and the total federal estate tax (assuming two taxable estates of equal size) would be reduced to $115,000 (two taxable estates of $350,000 each) or $149,600 (two taxable estates of $400,000 each). It has not been demonstrated that such additional debt necessitates forced sales of farmland.

Furthermore, a section 2032A election when a farm is heavily indebted may be more detrimental than allowing the farm to be valued under normal principles. In the event of adverse weather or market conditions causing losses to farm income, the estate or beneficiaries may be unable to service the farm debts and be forced to sell land for reasons unrelated to estate taxation. If such conditions forced a sale to nonfamily members, an additional tax would be imposed,\textsuperscript{57} placing the estate in a worse position that it might have been in under normal valuation.\textsuperscript{58}

C. The Expanding Farm

There is undoubtedly a point at which debt incurred before death can be so substantial that the previous debt, coupled with a federal estate tax debt, can compel sales of land. That point, however, will be achieved in well-planned estates only if the net value of the farm es-

\textsuperscript{55} The $47,000 credit is subtracted, the balance due is $108,800. The tax on two such estates would be $217,600.

\textsuperscript{56} I.R.C. §§ 2001, 2010. The example assumes no lifetime use of any portion of the unified credit.

\textsuperscript{57} See Part IV-\textit{F infra.}

\textsuperscript{58} See Part VIII \textit{infra.}
tate exceeds $350,000 by some undetermined margin. Although it is
difficult to state precisely what that margin is, if the net yield on farm-
land (expressed as a percentage of value) is only one-third the
prevailing interest rate and pre-existing debt is more than one-third
the normal value of the farm estate, then a farm will be unable to sup-
port an estate tax debt out of current yield. For example, if the gross
value of the farm is $900,000 and the farm has debts of $300,000,
the farm would generate an estate tax debt without the special relief of
section 2032A, and this additional debt could not be currently ser-
viced out of farm investment yield under the assumptions set forth
above.

Debts of this magnitude would most often be attributable to the
purchase of additional farmland or other farm property, although
they may have resulted from adverse weather or market conditions. A
tax subsidy to help a family expand its holdings is not a subsidy which
merely preserves the family farm. If we fail to grant a subsidy en-
abling tenant farmers to buy land, it is difficult to justify subsidies en-
abling existing farm owners to expand their holdings.

D. Liquidity Problems Presented by Intra-Family
Purchases and Sales

Liquidity problems can also arise if parents have only one farm but
several children. If only one child desires to operate the farm, the
interests of all the children and of society might be best served if the
one child who operates the farm purchases the interests of the other
children. One existing farm might well be insufficient to pay an estate

59. The textual statement is based on a married couple owning all assets as commu-
nity property, or utilizing the marital deduction in such a manner as to obtain benefits
similar to those in community property states. It also rests on the assumption that the

60. To illustrate, if the interest rate on farm debt is 9%, the annual interest charge
on a debt of $300,000 would be $27,000. If the rental yield on the $900,000 farm is 3%,
the rental yield of $27,000 is exactly equal to the current interest charge, leaving no ex-
cess to service the tax debt. These calculations disregard payments that must be made on
account of principal. To the extent that such principal payments must be made, the ratio
of farm value to farm debt must be increased.

61. I.R.C. § 2032A does not apply to land purchased from a nonfamily member less
than five years before death, but could apply to land purchased from family members.
Id. § 2032A(b). Section 6166 is not so limited.

62. The American Bankers Association Commentary on Proposed Tax Reform Af-
flecting Estates and Trusts pointed out that "[t]he most serious cash problem may not be
payment of the estate or death taxes, but rather 'buying out' the child or children who
will not continue in the business." Senate Hearing, supra note 3, at 98.
tax debt and to finance the purchase of the nonoperating siblings’ interests as well.

It should be clear, however, that estate tax burdens are not the prime cause of this kind of liquidity problem. A farm estate worth $175,000 under normal valuation procedures will generate no estate tax, but if one child desires to purchase the interests of his or her two siblings that child will have a liquidity problem that sections 2032A and 6166 do not alleviate in any way. Moreover, if the farm estate is sufficiently valuable to generate an estate tax under normal valuation procedures, reduced valuation under section 2032A may alleviate, but will not solve, liquidity problems. A specific program of long-term low interest rate loans to farming children who purchase the inherited interest of other family members would do much more to preserve the family farm than a general estate tax subsidy to all families who own and operate farms or ranches.

IV. OUTLINE OF SECTION 2032A

A. General

The purpose of section 2032A is to reduce federal estate taxes for estates whose major asset is a family farm. In essence, if

1. a farm or ranch is the major asset of the decedent,
2. that farm or ranch has been owned and operated by the decedent or a member of his family for the five years preceding the year of the decedent’s death, and
3. the farm continues to be operated by a member of the decedent’s family for fifteen years after his death,

section 2032A can be elected to reduce substantially federal estate taxes on the passing of the farmland in the estate. Most agricultural

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63. If § 2032A drives up price in relation to current income yield, see F. Woods, supra note 3, at 1105; Part IX–A infra, the section will in fact exacerbate the liquidity problems of a purchasing heir.
64. To illustrate, special valuation of a farm might reduce value in the first generation from $600,000 to $350,000 and thereby eliminate any federal estate tax. See F. Woods, supra note 3, at 1105 (Table 2). But if, after the death of the surviving parent, one child purchases the interests of two siblings for $400,000, the purchasing child may still have a substantial liquidity problem.
65. See note 4 supra.
66. I.R.C. § 2032A(b)–(c). The decedent must also have been a citizen or resident of the United States at the time of his death. Id. § 2032A(a)(1). Section 2032A(b) requires
units which would generally be perceived to be family farms will likely meet the conditions necessary to elect section 2032A.

Analytically, section 2032A employs a "carrot and stick" approach to farm valuation. The "carrot" of section 2032A is the productive formula of section 2032A(e)(7).\(^7\) The "stick" is the additional tax, referred to in this article as "estate tax recapture,"\(^6\) imposed by section 2032A(c). Both the carrot and the stick are designed to insure that the decedent or a member of his family will operate the farm for substantial periods of time both before and after the decedent's death.\(^6\)

**B. The Productive Formula**

Section 2032A(e)(7) uses complex language to express a simple concept. We shall consider the language first:

> that the "adjusted" (i.e., net) value of farm real and personal property comprise at least 50% of the adjusted value of the gross estate and that the adjusted value of the real estate element of this property comprise at least 25% of the adjusted value of the gross estate. The real estate must have been acquired at least five years before the death of the decedent. \(\text{Id.} \ § 2032A(b)(1)(c)\). Personal property used in a qualified farm operation apparently need not be acquired five years before death. Some individuals may, therefore, purchase farm personal property (cattle and machinery) within five years of death in order to qualify their estates for the benefits of § 2032A. For a discussion of more technical problems, see Avery & Benjamin, *Valuation of Farm and Closely Held Business Property: Recapture: Special Lien*, in 2 COMMITTEE ON CONTINUING PROFESSIONAL EDUCATION, AMERICAN LAW INSTITUTE—AMERICAN BAR ASS'N, Tax Reform Act of 1976, at 59 (1976).

\(^7\) See note 4 and accompanying text *supra*. Section 2032A(e)(7), entitled "Method of valuing farms," outlines a valuation method which herein is termed the "productive formula." Section 2032A(e)(8), entitled "Method of valuing closely held business interests, etc.," has been dubbed the "multiple factor method." See GENERAL EXPLANATION OF THE 1976 ACT, *supra* note 2, at 540, 1976–3 (vol. 2) C.B. at 552.

The multiple factor method can be used to value farmland, but it employs traditional methods of valuation. It requires only that the land be valued by reference to its "farm or closely held business value." I.R.C. § 2032A(e)(8). It is doubtful that the latter provision will affect valuation of farms far removed from urban areas; those farms are already valued by reference to farming use, because a farming use is the highest and best use for such farms. Section 2032A(e)(8) might nonetheless be useful if farmland near an urban area is worth $10,000 per acre for developmental use, but worth only $1,000 per acre for a farming use. When this is the case, however, § 2032A(e)(7) might further reduce value for estate tax purposes to $500 per acre, depending on the land's productivity.

Section 2032A, under either method, may not do enough in urban areas to allow some farms immunity from inflated valuations. If land is worth $10,000 for developmental use, but worth only $1,000 for a farming use, the $500,000 limitation on value reduction would be used up in a sixty-acre farm estate. See I.R.C. § 2032A(a)(2). Moreover, if the decedent has several children, only one of whom wishes to farm the land, that child may desire to buy the land; the child's siblings, however, are not likely to sell it for $1,000 per acre. See Part III–D *supra*.

\(^6\) The term "recapture" is used in H.R. REP. No. 1380, 94th Cong., 2d Sess. 25 (1976).

\(^6\) See notes 77–101 and accompanying text *infra*.
Estate Tax Valuation of Farmland

(1) The executor must first compute the "average annual gross cash rental" for the five years preceding the decedent's death, by ascertaining per acre rents paid for comparable farmland in the locality.

(2) This figure must be reduced by "average annual state and local real estate taxes" for the same five-year period.

(3) The executor must then divide this adjusted gross cash rental figure by a corresponding five-year average interest rate for all Federal Land Bank loans.\(^7\)

This awkward formula causes farmland to be valued at an amount which, if loaned at Federal Land Bank interest rates, would yield interest equal to the average net cash rental (gross cash rental minus real estate taxes) of land similar to that of the decedent. Under this formula, if the Federal Land Bank interest rate is 7%, a parcel of land which normally generates a net cash rental of $7,000 per year is valued at $100,000 without regard to its actual fair market value. If, in fact, the net rental of land is 3% of value, land yielding $7,000 annual net cash rent should have a true value of $233,333. The excess of true value over "production formula" value, presumably attributable to the growth factor inherent in land, is disregarded except insofar as it is subject to "estate tax recapture."\(^7\)

The productive formula does not apply to valuation of farmland for gift tax purposes. Application of the tax subsidy only to the estate tax would appear to be inconsistent with the general policy of causing inter vivos transfers to be subject to the same tax as transfers taking

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\(^7\) I.R.C. § 2032A(e)(7). Such potential problems as determining what land is "comparable" and the appropriate interest rate, and the nonavailability of the formula in areas where crop rents are the norm, are discussed elsewhere. E.g., Comment, Analysis of the "Actual Use" Valuation Procedure of Section 2032A, 56 Neb. L. Rev. 860, 868-72 (1977).

\(^7\) Valuation under § 2032A(e)(7) will always be a fraction of total value. The numerator of the fraction will be average gross cash rent less property taxes for the five years preceding the year of death (expressed as a percentage of true value); the denominator will be the average Federal Land Bank interest rate for the same period. Thus, if average "net rent" is 3% of true value, and average Federal Land Bank interest rate is 8%, the section 2032A(e)(7) value will be 3% of true value. But even this is not the full story. Because land is valued by reference to average rent, its value, even as discounted, will not be death date value, but will rather be the average of the values for the five years preceding the year of death. If the productivity of land has doubled in the five years preceding the year of death, § 2032A(e)(7) valuation will only be about ¾ of the value it would be if the productivity were measured solely by reference to the year preceding death. For a recent study of farm land values and ratios of rent-to-value, see 1977 Farm Developments, supra note 25, at 53.
Application of the productive formula to the gift tax, however, exposes the artificiality of the productive formula. If the productive formula did apply to the gift tax, for example, a farmer might sell his child a farm with an actual value of $233,333 for a price of $100,000 (i.e., the productive formula value). If land were valued by the productive formula for gift tax purposes, the farmer would have made no gift. Moreover, if the land doubles in actual value before the father’s death, a net value of $366,666 would pass gratuitously from one generation to another without being subjected to an estate tax or a gift tax.

We can be fairly certain that the productive formula will not be extended to the gift tax, for the tax subsidy (as in the example just given) is too obvious to be ignored. But if the subsidy is justifiable in terms of the estate tax, it would appear to be similarly justifiable in terms of the gift tax. Moreover, failure to extend the subsidy to the gift tax causes both parents and their children to be “locked in” to their family farm investments.

C. Maximum Reduction Per Generation

Use of the productive formula cannot reduce gross estate tax valuation by more than $500,000 in any one estate. Part VII below, however, illustrates that the maximum gross estate reduction per husband-
Estate Tax Valuation of Farmland

wife generation can vary from $500,000 to $1,000,000, with maximum estate tax reductions of from $350,000 to $700,000. These variable maximums can depend upon such factors as estate planning, form of ownership, and time of death.

D. The Initial Valuation Test

The productive formula of section 2032A(e)(7) can only be elected to reduce estate tax valuation of farm real estate. It does not apply to machinery, cattle, or even such nonfarm real estate items as oil or mineral rights attached to the farmland. But items such as machinery and cattle can be taken into account in determining whether an estate is eligible to use the productive formula of farmland valuation. First, the adjusted value of all farm property (real estate, machinery, and cattle) must account for at least 50% of the adjusted value of the gross estate. If the first test is met, the adjusted value of farm real estate must account for at least 25% of the adjusted value of the gross estate. In applying the initial valuation test, farmland is valued at its true market value. As is explained more fully below, an initial high valuation of farmland prompted by a desire to meet the initial valuation test of section 2032A(b)(1) could prove to be embarrassing if a subsequent disqualifying event triggers estate tax recapture on the difference between productive formula value and actual value.

Debts attributable to farmland are deducted both in determining the adjusted value of the gross estate and in determining the adjusted value of farmland in the gross estate. Ownership of mortgaged farmland can nevertheless yield bizarre results because, presumably, the farmland will be valued by reference to the productive formula even though any debt on the land, including debt incurred to purchase the farmland, can be deducted in full. To illustrate, if a farmer dies owning nothing more than farmland having a true value of $1 million,

76. See Part VII infra.
77. "If there is an oil lease on a farm, the full value of the mineral rights is to be taken into account for estate tax purposes." H.R. Rep. No. 1380, 94th Cong., 2d Sess. 24 (1976).
78. I.R.C. § 2032A(b). "Adjusted value" means gross value reduced by debts attributable to the property in question. Id. § 2032A(b)(3).
79. Id. § 2032A(b)(3).
80. See Part IV–F infra.
81. I.R.C. § 2032A(b)(2).
subject to a mortgage debt of $500,000, and if productive formula valuation is $500,000, section 2032A(a)(4) reduces the taxable estate to zero. Sale by the farmer's heirs to persons who are not family members (or repossession of the land by the mortgagee) would, however, trigger estate tax recapture82 and adverse income tax consequences.83

E. The Participation Requirement

The participation requirement is probably the most complex part of section 2032A. In general, a family farm that has been owned and operated by one or more of a group including the decedent and any members of his family for five consecutive years before and fifteen years after the decedent's death will meet the requirement.84 But the participation requirement must be understood in detail to appreciate the disastrous effects of sales to nonfamily members. In the narrow and precise statutory sense, “material participation” means active involvement in a farm or business operation;85 it does not require ownership. This article uses the term “participation” more broadly, to mean all of the following:

(i) Ownership by the decedent or by a member of his family,
(ii) Management of the owned property by the decedent or by a member of his family (but the manager need not be the same person as the owner), and
(iii) Use of the property for a ranching or business use.

82. See Part IV--F infra.
83. These consequences stem from the loss of basis resulting from a § 2032A election. See Part VIII--A infra. It is apparently possible for an elderly farmer to borrow money for consumption purposes in retirement years without preventing his estate from making an election under § 2032A.
84. I.R.C. § 2032A(b)(1)(C), (c)(1).
85. It is not clear what constitutes material participation in this narrow sense, although § 2032A(e)(6) refers to the test set forth in § 1402 relating to self-employment income. A typical "sharecropping" arrangement, however, would appear to generate material participation:

Thus, if in addition to the understanding that the owner . . . is to advise or consult periodically with the other person [sharecropper] as to the production of the commodities and to inspect periodically the production activities on the land, it is also understood that the owner is to select the type of crops and livestock to be produced and type of machinery and implements to be furnished and to make decisions as the rotation of crops, the arrangement will be treated as contemplating material participation of the owner . . . in the management of production of such commodities. Treas. Reg. § 1.1402(a)--4(b)(3)(iii) (1963). Because a landlord under a rental arrangement does not participate materially in the farm operation, § 2032A has the effect of discouraging rentals and encouraging sharecropping.
Participation is both a condition precedent to a section 2032A election and a condition subsequent which, if not fulfilled, will result in estate tax recapture. The condition precedent requires participation (as defined above) for at least five out of the eight years preceding the decedent's death.\(^86\) The condition subsequent fails (so that estate tax recapture results) if the land is sold to a nonfamily member within fifteen years after the decedent's death,\(^87\) or if in any eight-year period ending after the decedent's death (and before the expiration of fifteen years from such date or before the death of a qualified heir), there are periods aggregating three or more years during which the land is not operated by the decedent or a member of her family as a farm or ranch.\(^88\) The "family" of a decedent includes the decedent, her spouse, her grandparents, all descendants of her grandparents, and the spouses of all such descendants.\(^89\)

The interplay between the condition precedent and condition subsequent of the participation requirement may be illustrated as follows: If a father (i) purchases land on or before January 1, 1972, and operates it through 1977 (six years); (ii) leases the land to a nonfamily member for a three-year term beginning on January 1, 1978; and (iii) dies on January 1, 1980, then the condition precedent to a section 2032A election will be fulfilled on the date of the father's death because there will have been participation for six out of the eight years preceding the decedent's death. However, the condition subsequent will apparently not be fulfilled because there will be a period of three years out of an eight-year period ending after the decedent's death during which there is no material participation by the decedent, his qualified heir, or their families unless the lease is broken and a family member commences operation of the farm in 1980.\(^90\) Note that a temporary break in active management will not trigger immediate recapture, but a sale to a nonfamily member or devotion to a nonqualifying use after the decedent's death causes immediate failure of the participation condition subsequent.\(^91\)

\(^{86}\) I.R.C. § 2032A(b)(1)(C).
\(^{87}\) Id. § 2032A(c)(1)(A).
\(^{88}\) Id. § 2032A(c)(1)(B), (c)(7)(B)(ii).
\(^{89}\) Id. § 2032A(e)(2).
\(^{90}\) Id. § 2032A(b), (c)(1), (c)(7). Death of the "qualified heir" terminates estate tax recapture, and a "qualified heir" can include any family member to whom a devisee sells his interest. I.R.C. § 2032A(c)(1), (e)(1).
\(^{91}\) Id. § 2032A(c)(1)(A).
F. Estate Tax Recapture on Failure of Participation as a Condition Subsequent

Estate tax recapture is triggered by cessation of qualified use, or by disposition of the property to a nonfamily member. The tentative amount of the recapture is the excess of what the estate tax would have been under normal valuation over the estate tax due under the productive formula of section 2032(e)(7). The tax recapture amount is due within six months after the recapture event. If either disqualifying event (sale or cessation of use) occurs more than ten but less than fifteen years after the decedent's death, the amount of recapture is phased out at the rate of 20% per year, beginning with the eleventh year.

The difference between "cessation of qualified use" or sale to a nonfamily member and failure to maintain participation in the business can be significant. If a qualified heir (or other member of the decedent's family) owns and actively manages the property for a continuous period of thirteen years immediately after the decedent's death, a long-term lease at the end of such thirteen years to a nonfamily member will not trigger estate tax recapture because there will be no period of three years out of an eight-year period within the fifteen-year period during which there was no material participation. But a sale to a nonfamily member or devotion to a non-qualifying use thirteen years and one day after the decedent's death will trigger a recapture of 40% of the tentative recapture amount.

For reasons discussed below, estate tax recapture can cause severe hardship, whether caused by a sale to a nonfamily member, by a

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92. Any disposition of farmland to a nonfamily member triggers recapture, including apparently, a charitable contribution. Id. § 2032A(c)(1)(A).
93. Id. § 2032A(c)(2)(A)-(B). A disposition (or cessation of qualified use) of part of the property triggers partial recapture. Id. § 2032A(c)(2)(D). Thus, if a life tenant triggers recapture, estate tax recapture is apparently imposed only on the difference between true value and § 2032A value of the life estate. Id.
94. Id. § 2032A(c)(5).
95. Id. § 2032A(c)(3).
96. See notes 86–88 and accompanying text supra.
97. 1.R.C. § 2032A(c)(1)(A), (c)(3).
98. See Part VIII–A infra.
cessation of qualified use, or by a failure of material participation. A section 2032A election must therefore be accompanied by an agreement by all persons taking an interest in the land to be bound personally by the recapture provisions. Any estate tax recapture becomes the personal liability of the owner of the land which becomes disqualified (the seller in cases of disqualifying sales), and the conditional interest of the Commissioner in the tax recapture is protected by a lien on the land. Although a sale or gift to a family member does not trigger recapture, a "family" purchaser or donee takes the property subject to its recapture potential whether or not the transferee signed the original agreement.

V. OUTLINE OF SECTION 6166

A. General

Section 6166 authorizes deferred payment of estate taxes attributable to a "closely held business interest" (including but not limited to a farming or ranching business) at a reduced rate of interest. More specifically, if the conditions of the statute are met, it authorizes an executor to defer payment of estate tax attributable to a farm or ranch for a period of up to five years from the due date of the return and to pay the balance in up to ten equal annual installments thereafter. Interest begins to run from the due date of the return. The interest rates are 4% of the tax attributable to the first $1 million of taxable estate

100. Id. § 2032A(c)(6).
101. Id. § 6324B. This lien is in addition to the lien that arises under § 6324A for payment of tax under § 6166. The § 6324A lien is equal to the amount of total tax payable as reported in the return (or as determined upon final settlement). Id. § 6324A(a). The lien of § 6324B covers only the "additional tax" that might be caused by § 2032A(c) estate tax recapture. Id. § 6324B(a). Both liens are effective against purchasers or encumbrancers upon filing under the appropriate recording acts. Id. §§ 6324A(d)(1), 6324B(g).

Clearly, a related purchaser takes the land subject to the lien of § 6324B, assuming that notice of the lien is duly filed. Apparently, this lien also puts a related-party purchaser on notice of potential personal liability for estate tax recapture. Id. § 2032A(e)(1), (c)(6). Section 3 (d)(5) of the proposed Technical Corrections Act of 1978 would permit a qualified heir to avoid personal liability by posting a bond, but the bond would not remove the lien of § 6324B. See S. REP. No. 745, 95th Cong., 2d Sess. 85 (1978).

102. I.R.C. § 2032A(e)(1), (c)(1).
103. Id. § 6166.
and the section 6621(b) rate (presently 6%) on the balance. Qualification requires that 65% or more of the decedent's gross estate consist of an interest in a closely held business, and deferral is possible only for the portion of the estate consisting of that business.

The combined benefits of sections 2032A and 6166 may be illustrated by the following table which assumes that (i) a husband and wife own community property farmland that is a "closely held business interest" with an aggregate true value of $3 million but a section 2032(e)(7) value of less than $2 million, (ii) husband and wife die in a common disaster after 1980, and (iii) the executor elects to defer payment of estate tax pursuant to section 6166.

<table>
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<tr>
<th>Item</th>
<th>Section 2032A Election</th>
<th>No Section 2032A Election</th>
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</thead>
<tbody>
<tr>
<td>(1) Gross, adjusted, and taxable estate (each spouse)</td>
<td>$1,000,000</td>
<td>$1,500,000</td>
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<tr>
<td>(2) Section 2001 Tax</td>
<td>$345,800</td>
<td>$555,800</td>
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<tr>
<td>(3) Unified credit</td>
<td>(47,000)</td>
<td>(47,000)</td>
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<tr>
<td>(4) Balance</td>
<td>$298,800</td>
<td>$508,800</td>
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<tr>
<td>(5) Tax attributable to first $1 Million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(6) Tax attributable to balance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(7) 4 percent of $298,800</td>
<td>$11,952</td>
<td>$11,952</td>
</tr>
<tr>
<td>(8) 6 percent of balance</td>
<td>0</td>
<td>$12,600</td>
</tr>
<tr>
<td>(9) Maximum annual interest per estate</td>
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<td>$24,552</td>
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<tr>
<td>(10) Total Tax after credit (both estates)</td>
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<td>$1,017,600</td>
</tr>
<tr>
<td>(11) Total Annual interest (both estates)</td>
<td>$23,904</td>
<td>$49,104</td>
</tr>
</tbody>
</table>

If principal is paid in ten installments after the five-year deferral period, the largest annual payment of combined interest and principal

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104. *Id.* § 6601(j). Section 6621 directs the Secretary to adjust the interest rate to reflect a rate equal to 90% of the prevailing prime interest rate. The rate cannot exceed 9%. The current rate of 6% is prescribed by Rev. Rul. 77-411, 1977-2 C.B. 480.


106. Inadequate language in § 3(d)(4) of the proposed Technical Corrections Act of 1978 creates a question whether the maximum reduction in this example would be $1 million (two estates) or $500,000 (two estates). See note 171 infra.
with no section 2032A election would be $150,864. The aggregate annual payments would decline thereafter for nine years. Under section 2032A valuation, the largest payment after the five-year deferral period would be $83,664 and the $3 million family farm estate would not, in any year in the fifteen-year period after death, pay more than 3% of death-date value of the farm. During the initial five-year deferral period, interest would be less than 1% of death-date farm value. Even if no section 2032A election is made, the highest interest charge is less than 2% of death-date value, and the highest annual payment would be about 5% of death-date value.

The example given above is simplified and may exaggerate the tax benefit if the decedent dies owning substantial nonfarm assets or substantial farm personal property. The example should nevertheless illustrate the fact that section 6166 is an indirect loan program—available only to families of substantial wealth. The program enables farmers and other businessmen to borrow up to $300,000 at an interest rate of 4%, for a fifteen-year period, with no payments of principal for five years. The author is unaware of any comparable loan program for those without substantial holdings, especially tenant farmers, who are not generally subject to the estate tax.107

B. Qualification—The 65% Test

Qualification under section 6166 requires that 65% or more of the "adjusted gross estate" of a decedent consist of "an interest in a closely held business."108 "Adjusted gross estate" means the gross estate less authorized deductions for expenses, debts, taxes, and losses.109 Although the initial qualification test of section 2032A allows farmland to be valued at true value to determine eligibility, sec-

107. A direct loan program for persons of modest means has been proposed by Senator George McGovern, named the "Young Farmers' Homestead Act of 1975." S. 2589, 94th Cong., 1st Sess. (1975). This program would allow the federal government to purchase farm units up to $200,000 in value, lease them on easy terms for up to seven years, and sell them to the lessees at 75% of fair market value or the government's cost, whichever is greater. Id. §§ 7-8. For a discussion of the Act, see Young Farmers Homestead Act: Hearings on S. 2589 Before the Subcomm. on Agricultural Credit and Rural Electrification of the Senate Comm. on Agriculture and Forestry, 94th Cong., 2d Sess. (1976). An excellent discussion of farm subsidies effected by the income tax laws is contained in McDaniel, Tax Expenditures in the Second Stage: Federal Tax Subsidies for Farm Operations, 49 S. CALIF. L. REV. 1277 (1976).


109. Id. § 6166(b)(6). Cf. id. § 2056(c)(2) ("adjusted gross estate" for marital deduction purposes excludes a decedent's net interest in community property). Because the §
tion 6166 requires the section 2032A valuation to be used (if a section 2032A election is made) in determining whether the estate meets the "65% test." Some executors may, therefore, find that an election to value farmland under section 2032A prevents them from deferring payment of estate taxes under section 6166.

An interest in a closely held business can include interests in partnerships or corporations if

(i) the partnership or corporation has fifteen or fewer partners or shareholders, or

(ii) the decedent had a 20% or greater interest in the capital of the partnership or shares of the corporation.

Section 6166 also contains attribution rules which will sometimes prevent and sometimes legitimate a section 6166 election.

If a decedent's estate consists of interests in two or more closely held businesses, such interests may be aggregated if the decedent's interest (together with a co-ownership interest of his or her spouse) accounts for more than 20% of the value of such businesses. Although these rules are specific, the statute does not define what is meant by a "business." For example, if a farmer incorporates a farm by transferring to the corporation everything except the land, and leases the land to the farm corporation, it is possible that the ownership of the land leased to the farm corporation will not constitute a

2056(c)(2) "adjusted gross estate" differs from the § 6166 "adjusted gross estate." This article will use the term "net estate" to refer to the latter.

110. "In the case of a farm where the executor has elected special use valuation (under Section 2032A), the special use valuation is to be treated as the 'value' for purposes of this extended payment provision . . . " H.R. REP. No. 1380, 94th Cong., 2d Sess. 32-33 (1976) (footnote omitted).

111. For example, assume a decedent owned farmland with a true value of $500,000, cattle and machinery with a true value of $200,000, and nonbusiness assets worth $300,000. Under normal valuation the farm accounts for 70% of the net estate. If the section 2032A(e)(7) value is $250,000, then the farm would account for only 60% of the net estate.

112. I.R.C. § 6166(b)(1).

113. Id. § 6166(b)(2)(c). The purpose of these attribution rules is to "prevent avoidance of the shareholder or partner limitations by the use of partnerships, trusts, or tiers of corporations." H.R. REP. No. 1380, 94th Cong., 2d Sess. 32 (1976).

The provision, however, could also help estates qualify. Where the decedent is a beneficiary of a trust, his proportionate share of the corpus qualifies. Similarly, if he is a member of a partnership holding shares in a corporation, his proportionate part of the shares qualifies, which might cause the decedent to have a 20% ownership interest in the corporation. I.R.C. § 6166(b)(2)(C).

114. I.R.C. § 6166(c).
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"business." If it does not, and if the land accounts for over 35% of the decedent’s net estate, an election under section 6166 would not be possible even if the decedent owned all the land and all shares of stock in the corporation. Similar problems are presented by leases of farmland to relatives. Such leases are permissible under section 2032A, but it is not certain that land leased to a son would constitute a closely held “business” interest.

C. Effect of Section 6166 Election

An election to defer estate tax payments under section 6166 applies only to the tax attributable to “closely held business amounts,” that is, to the value of a decedent’s interest in a closely held business. For example, if a decedent leaves a taxable estate of $5 million, consisting of nonbusiness assets worth $1 million and qualifying business assets worth $4 million, only four-fifths of the tax qualifies for section 6166 deferral. The portion of the tax which may be deferred is determined with reference to the entire tax payable; in other words, the nondeferred tax is neither the tax on the first $1 million ($298,800) nor that on the fifth million ($670,000), but rather it is one-fifth of the total tax ($500,760).

Of the tax that is deferred, only a portion will qualify for the lowest interest rate (4%) in estates larger than $1 million. The “4-percent portion” of the deferred tax is an amount equal to the tax attributable to the first $1 million included in the taxable estate. The balance incurs interest at a variable rate, not to exceed 9%. A ratable por-

115. Rulings under § 6166A indicate that the mere leasing of land does not constitute a trade or business. Rev. Rul. 75-365, 1975-2 C.B. 471. Land owned by a principal in a “sharecropping” arrangement, however, was held to constitute a trade or business. Rev. Rul. 75-366, 1975-2 C.B. 472. Thus, along with § 2032A, see note 85 supra, § 6166 encourages certain farm landlords to transform landlord-tenant relationships into sharecropping arrangements, if by so doing they can qualify for its tax deferral benefits.

116. See note 109 supra.

117. See sources cited in note 115 supra. It is not clear whether these rulings would apply to land leased to controlled corporations or to relatives for purposes of determining eligibility under § 6166. If an estate is not eligible for the privileges of § 6166, its executor may feel compelled to make an election under § 2032A.

118. I.R.C. § 6166(a)(2), (b)(5).

119. Id.

120. Id. § 6601(j)(2). More precisely, the “4-percent portion” is the lesser of total deferred tax or $345,800, reduced by the credit allowable under § 2010(a). After the unified credit is fully phased in, see id. § 2010(b), the 4 percent portion will be the lesser of $298,800 or the total estate tax due.

121. Id. §§ 6601(a), 6621.
tion of each payment of estate tax principal is allocated to the "4-percent portion" and the balance, so that an executor cannot apply principal payments first to the higher interest rate portion of the estate tax debt.122

The tax deferral of section 6166 also applies to estate tax deficiencies. Deficiencies, including, of course, future interest on the amount of such deficiencies, are to be prorated over the entire payment period.123 Any deficiency properly allocable to periods before assessment of the deficiency, however, is payable on notice and demand.124 Estate tax recapture under section 2032A is an "additional tax" rather than a deficiency; consequently, section 6166 does not appear to permit deferral of any payment of such tax.125

D. Effect of Retention and Withdrawals of Estate Income and Principal

1. Undistributed net income

Any undistributed net income of an estate on hand at the end of a taxable year must be paid in liquidation of the section 6166 deferred tax.126 This requirement should not impose a severe burden because "undistributed net income" is specially defined as distributable net income reduced by

(a) distributions to beneficiaries out of income,
(b) current income tax, and
(c) estate tax principal paid by the executor under the deferred payment schedule of section 6166.127

Because estate tax interest payable under section 6166 is deductible in computing both taxable income128 and distributable net income,129 estate tax payments are accelerated only to the extent that current af-

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122. Id. § 6601(j)(3).
123. Id. § 6166(e).
124. Id. § 6166(f)(3).
125. Neither does § 6166A promise to defer any estate tax recapture. See id. § 6166A(f).
126. Id. § 6166(g)(2).
127. Id.
128. Id. §§ 163, 641(b); Scripps v. Commissioner, 96 F.2d 492 (6th Cir. 1938); cf. Estate of Bahr v. Commissioner, 68 T.C. 74 (1977) (estate tax deduction).
129. See id. §§ 63, 163, 643(a).
ter-tax estate income exceeds the sum of current distributions and current section 6166 payments.

2. Distributions, Dispositions, and Withdrawals

Section 6166(g) provides that the privilege of electing to defer estate tax payments pursuant to section 6166(a) is forfeited if an interest or assets accounting for more than one-third of the value of the closely held business are withdrawn from the business or are transferred to any person other than the immediate owner of that business. Section 6166(g) applies to three broad categories of transactions: dispositions of business interests, withdrawals of property from the business, and distributions of property. These will be considered separately.

First, any sales, exchanges, or other dispositions of closely held business interests will accelerate payment of the deferred tax. A transfer of an unincorporated business to a controlled corporation for stock, a merger of an incorporated business into an unrelated corporation, or a gift of any closely held business interest literally falls within this prohibition. Thus, the prohibition is not limited to taxable sales or exchanges. A ruling under section 6166A, however, indicates that a mere change in form of conducting business does not terminate the deferral privilege.

Second, withdrawals of property from the closely held business interest will terminate the deferral privilege. This prohibition seems to be limited to withdrawals for purposes of consumption or for purposes other than the needs of the closely held business interest; its precise scope, however, is unclear.

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130. Id. § 6166(g)(1).
131. Id. § 6166(g)(1)(A)(i).
132. See id. § 6166(g)(1)(C) which, by permitting corporate reorganizations as defined in § 368(a)(1)(D)–(F), excludes all mergers (other than mergers of commonly controlled corporations), tax-free incorporations, and all liquidations under §§ 331 or 333.
133. Rev. Rul. 66-62, 1966-1 C.B. 272. The ruling states, without explanation, that "[w]here a change in the operation of a business from a corporate form to an unincorporated form does not alter materially the business... or the interest of the estate in the business... the change does not... cause a termination of the installment privilege otherwise available." Id. The ruling is based on statutory language almost identical to the language in § 6166(g). It is therefore possible that a closely held corporate business interest could be liquidated (if the estate owned all the stock of the corporation) or that a closely held unincorporated business interest could be incorporated without losing the deferral privilege. But cf. I.R.C. § 2032A(g) (regulations may or may not permit change in business form if a section 2032A election is to be kept in force).
The prohibition against distributing an interest in a closely held business\textsuperscript{135} does not include distributions by the estate of business interests to trusts or beneficiaries named in the will.\textsuperscript{136} Thus, an unincorporated business can be distributed to a beneficiary by the executor so long as the beneficiary allows business property to remain in the business. On the other hand, if an estate or its beneficiaries own shares of stock in a corporation, distributions of cash or assets by the corporation to the estate or to the beneficiaries would fall within the general prohibition.\textsuperscript{137}

The exceptions to these applications of section 6166(g) are not numerous. The first exception provides that a transfer of assets from a corporation in a redemption of stock meeting the requirements of section 303 is neither a distribution, a disposition, nor a withdrawal if all proceeds are used to pay estate tax.\textsuperscript{138} This exception creates its own internal problem because, under the new carryover basis rules, a section 303 stock redemption could generate substantial income tax liability.\textsuperscript{139} If the estate must use all proceeds to pay estate tax it will have to look elsewhere for amounts needed to pay the income tax liability generated by the stock redemption.

The second exception provides that a transfer is neither a disposition, a distribution, nor a withdrawal if an incorporated business is re-capitalized, reincorporated, divided, or if two commonly controlled family corporations are merged.\textsuperscript{140} This second exception significantly omits transfers to controlled corporations in tax-free exchanges, most kinds of acquisitive reorganizations, and all liquidating distributions.\textsuperscript{141}

The complexity of section 6166(g) has created substantial uncertainty. Before making withdrawals or distributions, executors must determine whether the statute applies to withdrawals of income from

\textsuperscript{135} Id., § 6166(g)(1)(A)(i).
\textsuperscript{136} Id., § 6166(g)(1)(D).
\textsuperscript{138} I.R.C. § 6166(g)(1)(B).
\textsuperscript{139} See \textit{id.} § 1023. For a discussion of the “fresh start” rule of § 1023(h) as it applies to property valued under § 2032A, see Part VIII-\textit{A-1} infra. The executor should remember that, if an election is made to value a farm corporation under § 2032A, the “fresh start” adjustment will be smaller so that the basis of property is reduced. A reduced basis, of course, will cause the estate to realize a larger gain on the redemption of stock under § 303.
\textsuperscript{140} Id., § 6166(g)(1)(C).
\textsuperscript{141} But see Rev. Rul. 66-62, 1966-1 C.B. 272.
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the business,\textsuperscript{142} whether it applies to all withdrawals of principal used to pay estate taxes,\textsuperscript{143} and whether the value of the closely held business interest is (i) the death-date true value, (ii) the section 2032A value (if that valuation is used), or (iii) the value at the time of distribution, disposition, or withdrawal.\textsuperscript{144} It appears that the statute does not apply to withdrawals of business income from the estate,\textsuperscript{145} and that "value" under the statute should be the value determined for estate tax purposes.\textsuperscript{146} Withdrawals of estate principal to pay estate taxes should not violate section 6166(g), for such a result would make the deferred payment system self-defeating in any case where the effective estate tax rate exceeds 35%.\textsuperscript{147}

VI. OBSTACLES TO LIFETIME NONTESTAMENTARY ESTATE PLANNING CREATED BY SECTIONS 2032A AND 6166

A. General

Sections 2032A and 6166 may reduce or eliminate the need for most farmers to use lifetime estate planning techniques designed to save taxes.\textsuperscript{148} These provisions may also, however, discourage lifetime estate planning of any kind, whether or not the planning is tax-motivated. In this part we consider new complexities created by the statutes for persons who acquire life insurance, contemplate lifetime gifts, and contemplate lifetime sales.

\textsuperscript{142} Rev. Rul. 75-401, 1975-2 C.B. 474, by holding that withdrawals of income accumulated before death is a withdrawal of property, assumes that a withdrawal of income accumulated after death is not such a withdrawal.

\textsuperscript{143} See notes 138-39 and accompanying text supra.

\textsuperscript{144} See I.R.C. § 6166(g)(1)(A)(i). "Value" is important because up to one-third of "value" can be withdrawn or distributed without terminating the deferral privilege. Id.


\textsuperscript{146} I.R.C. § 6166(b)(4).

\textsuperscript{147} See id. §§ 2001(c), 6166(a)(1), (g)(1)(A).

\textsuperscript{148} It has been asserted that farmers are unaware of potential estate tax problems and engage in no estate planning, or that, if they do, they receive bad advice. Comment, supra note 1, at 366-67; Senate Hearing, supra note 3, at 57-59. The lobbying efforts of farmers in obtaining the passage of §§ 2032A and 6166 cast doubt on the first conclusion. See Senate Hearing, supra note 3, at 46-53, 213 (statements by representatives of farmers' and ranchers' organizations). Furthermore, I am not persuaded that country lawyers are by nature less competent than city lawyers.
B. Life Insurance

Because section 2032A requires that at least half the true net value of a farm estate consists of farm property, the ownership of a substantial amount of life insurance, together with the ownership of other nonfarm assets, may prevent a farm estate from making a section 2032A election. Such a result is not likely to be common in farm estates because, even including insurance proceeds, nonfarm assets will seldom constitute more than half the true net value of the farm estate. On the other hand, the inclusion of insurance proceeds in a gross estate, together with a section 2032A election, could very often prevent a section 6166 election because the section 2032A value of farmland is the value taken into account for purposes of determining whether farm assets comprise 65% or more of the net estate. To illustrate, if farmland with a true value of $600,000 and a section 2032A value of $300,000 is subject to a debt of $100,000, the net value of the farm (assuming productive formula valuation is elected) is $200,000 for purposes of section 6166. In such a case, inclusion of insurance proceeds of $110,000 in the gross estate prevents the family from electing section 6166 if section 2032A is elected for the insurance proceeds will account for more than 35% of the section 6166 value of the adjusted gross estate.

Insurance on the farmer's life owned by a member of the farmer's family might be excluded from the gross estate and would not necessarily affect a farm estate's ability to elect sections 2032A and 6166. But if the proceeds are used to purchase interests in a family

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149. I.R.C. § 2032A(b).

150. This certainly will be true if the typical farm of a commercially sufficient size is worth $700,000 or more. See Part III-B infra. The average net value of American farm assets in 1976 was $180,711 per farm. 1977 BALANCE SHEET, supra note 25, at 47. Even with a farm of this size, it is highly unlikely that nonfarm investments will often exceed half of true value, unless the decedent had substantial nonfarm activities, given the economic incentives and historical tendency of farmers to reinvest in their own farming operations.

The conjunctive requirement of § 2032A(b) could nevertheless create problems. For example, the farmer who owns some land and rents more will often have farm property consisting of more than half the net estate. But the land component might be small. An unmarried taxpayer might own farm real estate worth $100,000 and farm personal property worth $300,000. In this case any amount of insurance or property other than farmland would disqualify the estate from the benefits of productive formula valuation.


151. I.R.C. § 6166(b)(4); see notes 109-10 supra.

152. Under Code § 2042, insurance proceeds on the life of a decedent receivable by beneficiaries other than his estate are not included in the decedent's gross estate if he has no incidents of ownership in the policy. I.R.C. § 2042(2).
C. Gifts

The Tax Reform Act of 1976 attempts to make tax considerations neutral factors in determining whether to give away property during life or to retain that property until death. Estate and gift tax rates have been unified, a unified credit applies to both taxes, and the basis of a devisee will eventually be comparable to that of a donee. As a practical matter, however, lifetime gifts of appreciating property are still generally favored, especially if the donee does not intend to sell the gift, for they still usually result in a smaller tax base and a resultant tax saving. If the owner whose property value will double in six to ten years retains that property until he dies, the amount of property subject to estate tax may be twice the amount subject to gift tax if the property is given away now.

Nevertheless, these considerations do not apply to farmland owned as part of a family farm unless the potential donor is very rich. Even if value doubles between the time of proposed gift and the date of death, the amount subject to tax is not increased by retention during life if

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153. Id. § 6166(g). This problem could, of course, be solved if the beneficiary and owner of the insurance receives the insurance proceeds in lieu of an interest in the farm. For example, if a decedent with two children owns a farm worth $300,000 and his children own $300,000 of insurance on his life, results can vary depending on who owns the insurance. If each child owns one-half of the insurance and inherits one-half of the farm, one child could use his half of the insurance proceeds to purchase the other child’s interest in the farm. But the disposition by the selling child would trigger a capital gain and would terminate the deferral privilege of § 6166. If one child inherits the farm and the other is the sole owner of the insurance, however, the deferral privilege would not be terminated; there would be no immediate taxable event for income tax purposes; and the insurance proceeds might pass outside decedent’s gross estate, depending on when the policy was transferred.

155. Id. at 10–17.
156. See Part VIII–A–I infra (discussion of carryover basis).
157. This fact is noted, without disapproval, by the report of the House Committee on Ways and Means, which acknowledges that “[t]he advantage of avoiding a transfer tax on the appreciation which might accrue between the time of a gift and the donor’s death represents a further incentive for lifetime transfers.” H.R. REP. No. 1380, 94th Cong., 2d Sess. 12 (1976).
section 2032A valuation cuts estate tax value in half.\textsuperscript{158} A lifetime gift does little more than accelerate liability for the transfer tax and deprive the donee of any basis attributable to appreciation in value up to December 31, 1976.\textsuperscript{159}

Sections 2032A and 6166 thus discourage lifetime gifts of farmland; they may also encourage lifetime gifts of nonfarm assets by farmers. Such gifts may be necessary in some cases to cause the farm business to account for 50\% or 65\% of the total net estate, necessary percentages for qualification under those sections.\textsuperscript{160}

D. Sales

Sales of property at a price higher than the seller’s basis, as opposed to retaining such property until the owner's death, are discouraged to some extent by federal income tax laws. The discouragement is attributable largely to section 1023(h), which grants to an heir a basis in property at least equal to the value of that property on December 31, 1976.\textsuperscript{161} That benefit is lost if someone who owned the property before 1977 sells it after 1976. The benefit is lost even if the gain from the sale is reported under the installment method and virtually no gain has been taxed before the decedent’s death.\textsuperscript{162}

\textsuperscript{158} As noted above, § 2032A does not apply to gifts. See notes 72–74 and accompanying text supra. Extremely wealthy farmers and ranchers are nevertheless not dissuaded from making lifetime gifts. For example, assume that § 2032A value is one-half of true value and the potential donor owns farmland with a true value of $2 million. Because § 2032A valuation cannot reduce value by more than $500,000, the donor can give away farmland worth $1 million without loss of any § 2032A benefit.

On the other hand, if the potential donor’s farmland is worth $500,000, a gift now results in a taxable transfer of $500,000. If the land doubles in value by the time the potential donor dies, the taxable transfer under § 2032A will still be $500,000 and the potential donor will have avoided payment of gift tax on the transfer during life.

\textsuperscript{159} The “fresh start” basis adjustment of § 1023(h) does not apply to lifetime transfers not included in the gross estate. I.R.C. § 1015.

\textsuperscript{160} Id. §§ 2032A(b), 6166(a).

\textsuperscript{161} As applied to farmland, the textual statement is an oversimplification. Disregarding depreciation, the “fresh start” adjustment is an addition to the decedent’s basis. The amount added is a fraction of the excess of estate tax valuation over the decedent’s basis: the denominator of the fraction is the total number of days in the holding period of the decedent; the numerator is the total number of days in that holding period occurring before 1977. If land doubles in value every six years, the formula of § 1023(h) does more than bring basis up to December 31, 1976, value. For example, if property with a basis of $100,000 doubles in value from $100,000 to $200,000 in the period from December 31, 1970, to December 31, 1976, and again doubles in value from $200,000 to $400,000 in the period from December 31, 1976, to December 31, 1982, the formula of § 1023(h) produces a “fresh start” basis of $250,000 whereas the actual value on the “fresh start” date was only $200,000.

\textsuperscript{162} This disincentive is not as great as it might appear to be because of the income
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This decreasing income tax disadvantage may well be offset by other factors, especially in the context of the family farm:

(1) One or more children may wish to purchase the farmland because they do not want to be tenants until their parents die.

(2) The parents may wish to convert a low current yield, high growth potential asset such as farmland into a vendor's interest in a real estate contract without growth potential but paying a higher rate of return. Such a transaction might enable the parents to have more income during life and to leave a smaller estate.

Sections 2032A and 6166 discourage sales of farmland during life, because vendors' interests in real estate contracts are neither farmland nor closely held business interests. Parents who sell farmland during life will, therefore, cause their estates to forfeit the benefits of sections 2032A and 6166 to the extent of such sales, even though their estates are not liquid. If an estate is forced to sell its interest in such a land contract in order to raise sufficient liquid assets to pay estate taxes, the heirs will suffer because of the discount inevitable in such a sale. Some land previously sold to a child may even have to be sold to pay the contract creditors.\(^{163}\)

\(^{163}\) For example, if parents sell their farm to a son on contract and bequeath their estate to their three children in equal shares, the child who purchased the land may have to sell some of that land in order to pay the contract claims of his siblings unless the siblings are willing to wait until the farm generates sufficient liquid assets to satisfy their claims.
E. Other Techniques

Ingenious lawyers will undoubtedly contrive estate planning techniques for farm parents who desire to obtain for their estates the benefits of sections 2032A and 6166 and to obtain other tax benefits as well. If a farm is not incorporated, for example, parents and children may form a limited partnership. The parents will receive limited partnership interests that siphon off most of the rental value of farmland but that do not share in the appreciation in value of farmland. The children will receive (by gift or purchase) general partners’ interests that receive little current income but that receive the benefit of all appreciation in land value. If the farm is already incorporated, it might be recapitalized\(^\text{164}\) to give the parents preferred stock with a fixed return but no potential for increase in value. In both these cases, the value of the parents’ interests could be “frozen” without depriving their estates of the benefits of sections 2032A and 6166. This treatment does not attempt to exhaust the estate planning possibilities, but outlines these examples to show that, in large estates, sections 2032A and 6166 will lead to lifetime nontestamentary estate planning techniques that are more complicated than techniques employed in the past.\(^\text{165}\)

Finally, it should be noted that lifetime planning in the case of truly large estates will not be inhibited by sections 2032A and 6166. The major benefits of sections 2032A and 6166 apply to the first $2 million of farm estate value in a husband-wife generation. If parents own land worth more than $2 million, they can give or sell the excess with-


\(^{165}\) Private annuities will obviously be suggested. Prior to the decision in Estate of Bell v. Commissioner, 60 T.C. 469 (1973), it was thought by some that the transfer of a farm by a parent to a child in return for a private annuity was not a taxable event and that the parent would report as income each year only a fraction of the payment. For example, if the parent’s basis in property was $200,000, if the expected return (determined under Treas. Reg. § 20.2031–10, T.D. 7077) was $500,000, and if the value of the farm was $400,000, then three-fifths of each annual payment to the parent would be income (two-fifths would be gain and one-fifth would be the equivalent of interest). This view was supported by Rev. Rul. 69–74, 1969–1 C.B. 43, and may still be the law if the transferor retains no security interest in the property transferred. In the Bell case, however, the transferor retained a security interest and the annuity (under Treas. Reg. § 20.2031–10, T.D. 7077) was worth less than the property transferred. The transferor was held to have recognized all gain in the year of sale and to have made a taxable gift of excess value. Even if no security is retained, it is unclear, despite Rev. Rul. 69–74, what the transferee’s basis in the property would be on the transferor’s death.
out depriving their estates of any benefits under sections 2032A and 6166.166

VII. OBSTACLES TO TESTAMENTARY ESTATE PLANNING CREATED BY SECTION 2032A

A. General

Because the unified estate and gift tax credit is available to each donor-decedent and because the estate and gift tax rates are graduated rates, transfer taxes in one husband-wife generation can be substantially reduced if the total wealth of husband and wife is bequeathed in such a manner that (i) no wealth is taxed twice on one generation and (ii) the taxable estate of each spouse is of approximately equal size.167 If all property is community property, this result can be achieved if the first spouse to die bequeathes or devises his or her share of that community property in such a way that such share will not be included in the gross estate of the survivor.168 For example, if the husband dies first and either bequeathes his share of the community property to his children outright or bequeathes such share to a trust with income to the surviving spouse and remainder to his children, the desired estate splitting is accomplished without benefit of a marital deduction.169

166. See note 158 supra.

167. For a concise exposition of the principles, see G.S.A. WHEATCROFT & G.D. HEWSON, CAPITAL TRANSFER TAX 100–12 (1975). Even before 1977, this kind of planning could effectively double the federal estate tax exemption. Consequently, statements that the $60,000 exemption had not been increased since 1942, e.g., 122 Cong. Rec. H10,237 (daily ed. Sept. 16, 1976) (remarks of Rep. William M. Ketchum), were literally correct but not substantively correct. One author, writing in 1956, stated, At present the estate tax exemption is $60,000, or $20,000 more than it was before World War II. After forty years of estate taxation it is $10,000 higher than it was in the beginning. These contrasts, however, hardly tell the whole story. The difference is not only one of $10,000 or $20,000, as the case may be. There is still another and better exemption which I shall shortly examine. It is known as the marital deduction; it is granted to a decedent who is survived by his spouse; and it may be as much as half of his net assets.

168. See Fernandez v. Wiener, 326 U.S. 340 (1945). Because the survivor's half of the community property is not taxed in the estate of the first estate, community property does not generally qualify for the marital deduction of § 2056. See I.R.C. § 2056(c)(2).

169. The surviving spouse would own half the property by virtue of prior owner-
If all property is the separate property of one spouse, the same results can be achieved under the marital deduction if, but only if, the initial owner of property dies first. In adjusted gross estates of more than $500,000, the maximum marital deduction is one-half the net value of the decedent's separate property. The owner of property that yields an adjusted gross estate of $500,000 could, by bequeathing $250,000 to his spouse outright and by bequeathing the balance in such a way that it is not included in the survivor's gross estate, accomplish the same kind of estate splitting that follows automatically from the nature of community property ownership. The marital deduction bequest would reduce the estate of the first decedent by $250,000 and cause the survivor to have a gross estate of $250,000.

It is clear that a section 2032A election dilutes the value of a marital deduction in large estates. The maximum marital deduction is one-half the net value of the decedent's separate estate when that separate estate is $500,000 or more, and, if the value of the estate is reduced by a section 2032A election, the amount of the maximum marital deduction is reduced similarly.

Section 3(d) of the Technical Corrections Act of 1978 attempts to remove the disparity between community property and common law property estates in § 2032A elections. H.R. 6715, 95th Cong., 1st Sess. § 3(d)(4) (1977). The amendment provides that if the decedent and his spouse held qualified real property as community property, the interest of the surviving spouse in such property shall be taken into account under this section to the extent necessary to provide a result under this section with respect to such property which

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election could cause a marital deduction bequest of an amount equal to the maximum marital deduction to be greater than intended by the testator.172

B. The Minimum Marital Deduction

The Tax Reform Act of 1976 has expanded the marital deduction to provide for a “minimum” marital deduction of $250,000.173 If the property of the first decedent is community property, this minimum is the amount by which $250,000 exceeds the first decedent’s share of the community property.174

In order to illustrate the combined effect of section 2032A and this new minimum marital deduction, assume first that the sole asset owned by the decedent was separate property farmland with a true value of $500,000 and a section 2032A value of $250,000. If the decedent bequeathed to his spouse a pecuniary marital deduction bequest175 (satisfied at estate tax valuation) equal to the maximum mari-

is consistent with the result which would have obtained under this section if such property had not been community property.

Id.

This provision is woefully inadequate and appears to reveal an ignorance of community property law. The committee reports indicate that the entire value of community property shall be considered to be the property of the decedent for purposes of determining whether his or her estate meets the percentage and other requirements of section 2032A. S. REP. No. 745, 95th Cong., 2d Sess. 85 (1978); H.R. REP. No. 700, 95th Cong., 1st Sess. 71 (1977). But literally the language of the amendment seems only to say that community property will be considered to be property held in some form of common law co-ownership for purposes of §2032A; this is what community property becomes when domiciliaries of community property states move to separate property states. Quintana v. Ordono, 195 So. 2d 577 (Fla. Dist. Ct. App. 1967); Depas v. Mayo, 11 Mo. 314 (1848); Edwards v. Edwards, 108 Okla. 93, 233 P. 477 (1924). Property held in co-ownership before death would normally give rise to two effective $500,000 reductions in one generation, precisely the present effect of community property ownership. If the statute, on the other hand, were designed merely to give the surviving spouse a carryover basis determined without reference to the community property character of the land, see I.R.C. § 1014(b)(6), it is difficult to understand why the statute specifically states (twice) that the “community” character of the property shall be disregarded “for purposes of this section.”

Because of the advantage accorded co-ownership under §2032A, a parent who wishes to bestow the full benefits of the section upon the next generation may wish to devise farmland to his child and that child’s spouse as tenants in common, rather than to the child alone.

172. See Part VII–B infra.

173. Id. § 2056(c)(1)(A)(i).

174. Id. § 2056(c)(1)(C). More precisely, the minimum deduction is $250,000 minus the amount by which the decedent’s community property exceeds the portion of expenses, indebtedness, taxes, and losses attributable to such community property. Id.

tal deduction authorized by section 2056, it is clear that, under normal valuation, the surviving spouse would receive one-half the farm. But if section 2032A is elected with a resultant estate tax value of $250,000, it is possible that the survivor would receive the entire farm because the "minimum" maximum marital deduction is $250,000.176 Similarly, if all the property is community property, the survivor already owns one-half. A section 2032A valuation would reduce the value of the decedent's half from $250,000 to $125,000 and the amount received by the surviving spouse, under a maximum marital deduction bequest, would be the amount by which $250,000 exceeds the value of the decedent's interest in the community property.177 If a section 2032A election reduces that value to $125,000 for all purposes, then such a bequest would also appear to have the effect of passing all property to the surviving spouse.

These same anomalies would be present if the property involved had a true value of between $500,000 and $1 million, again assuming that section 2032A value is one-half of true value. Assume, for example, that the farmland has a true value of $700,000 and a section 2032A value of $350,000. A pecuniary formula maximum marital deduction bequest coupled with a section 2032A election would appear to give the surviving spouse $250,000 of section 2032A value.178 If the section 2032A value is half of true value, the true value of the marital deduction property would be $500,000, and only $200,000 of true value would pass under a residuary clause.

These anomalies could be avoided, of course, by a provision to the effect that the amount passing to the wife should be valued at true value even if a section 2032A election is made. Such a provision would, however, reduce the value of the marital deduction. Assume, again, a farm owned separately by the husband with a true value of

176. Because an election under § 2032A requires the consent of the beneficiaries, they might be deemed to have made a taxable gift of $250,000 to the surviving spouse under these circumstances. See I.R.C. § 2032A(a)(1)(B), (d). If the agreement of § 2032A(d) were held to be a gift transfer, the election would seem to be a "disposition" for purposes of § 6166(g) with the result that the deferral privilege of that section could be terminated. See notes 130-37 and accompanying text supra.

177. See note 172 supra.

$800,000 and a section 2032A value of $400,000. A devise of one-half the farm to the wife would, absent a section 2032A election, give rise to a marital deduction of $400,000. A section 2032A election, by reducing total estate tax value to $400,000, would reduce the gift and hence the marital deduction to $200,000.

C. The Maximum Marital Deduction in Estates of More than $1 Million

Section 2032A may reduce an estate's value no more than $500,000.179 Thus, if a couple's only property is community property farmland and the property is worth more than $1 million, the maximum reduction in estate tax valuation granted by section 2032A is $500,000 per estate or $1 million. But if all property is the separate property of the first decedent, the maximum reduction in value in one generation is reduced to $750,000.180 To illustrate:

1. Husband and wife own community property farmland with a true value of $2 million and a section 2032A value of $1 million. They have no other property and neither estate will have any debts or administration expenses. Husband and wife die in a common disaster, each spouse leaving his or her property to their children. A section 2032A election reduces the value of each estate from $1 million to $500,000. The total reduction under section 2032A is $1 million.

2. Husband owns farmland with a true value of $2 million and a section 2032A value of $1 million. Husband devises one-half his property to his wife, and she is presumed to survive in a common disaster. They die in a common disaster. A section 2032A election for each estate would reduce the value of the husband's gross estate to $1,500,000. Even though half the farmland passes to the wife, the maximum marital deduction is $750,000. The taxable estate of the husband is therefore $750,000. A section 2032A election for the wife's estate would reduce the value of her gross estate from $1 million to $500,000, but note that the total reduction in taxable value is $750,000—not $1 million.

179. Id. § 2032A(a)(2).
180. See note 171 supra.
Because of the uncertainties noted above, pecuniary formula marital deduction clauses should be avoided in cases where farmland is worth less than $1 million. It is not the purpose of this article to suggest forms of marital deduction clauses for farm estates. However, this consideration of the added complexity in drafting marital deduction bequests and of the uncertain effect of any such clause caused by section 2032A suggests that a tax subsidy designed in part to eliminate the need for careful estate planning can often have precisely the opposite effect.

VIII. POST-MORTEM ESTATE PLANNING AND ADMINISTRATION

A. When Should Productive Formula Valuation Be Elected?

1. Adverse consequences of election

If a section 2032A election does not reduce estate taxes, or reduces them only slightly, the election should not be made because such an election can have adverse estate and income tax consequences.

The first adverse tax consequence to consider is the loss of income tax basis that can result from a section 2032A election. As applied to nondepreciable farmland, section 1023(h) authorizes a basis adjustment to reflect appreciation accruing prior to 1977.182 The formula by which this adjustment is made may be illustrated by an example:

181. Section 3(d) of the proposed Technical Corrections Act of 1978, H.R. 6715, 95th Cong., 1st Sess. § 3(d) (1977), would prevent a further disastrous result of electing under § 2032A when such a clause is used, i.e., gain by the estate on the difference between § 2032A value and true value when farmland is used to satisfy a pecuniary bequest. See I.R.C. § 1040; H.R. Rep. No. 700, 95th Cong., 1st Sess. 70 (1977).

182. I.R.C. § 1023(h); General Explanation of the 1976 Act, supra note 2, at 539, 1976-3 (vol. 2) C.B. at 553. As to stocks and bonds for which there is an established market, the law does precisely what Congress intended. But for other property, a formula approach was required to avoid the necessity of appraising all assets as of December 31, 1976. In computing this adjustment, the executor first ascertains death-date value and the decedent's adjusted basis. A fraction of the excess of death-date value over adjusted basis is added to the decedent's basis as a first step in determining the "carryover basis" of the estate or a devisee in the property. The denominator of the fraction is the total number of days the property was held by the decedent before death; the numerator is the number of days the property was held before 1977. I.R.C. § 1023(h)(2)(C).

If property is subject to an allowance for depreciation, the formula is much more complex. Id. § 1023(h)(2)(B). Farm real estate could include buildings subject to an allowance for depreciation, but the portion of total value attributable to buildings is likely to be small. The text example therefore disregards this complication, which is
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(i) Adjusted basis at death $200,000
(ii) True value at death $800,000
(iii) Excess of value over basis $600,000
(iv) Total days held 45,000
(v) Days held before 1977 30,000
(vi) "Fresh start" adjustment
\[
\left(\frac{30,000}{45,000} \times $600,000\right) \quad $400,000
\]
(vii) Carryover basis before other adjustments $600,000

A section 2032A election does not change the "applicable fraction" (30,000/45,000, or 2/3 in the above example), but it does change the excess of death-date value over the decedent's basis because the value used is the section 2032A value. If that value in the above example is reduced from $800,000 to $400,000, then the two-thirds fraction is applied against an "excess" of only $200,000, and the "fresh start" adjustment is reduced from $400,000 to $133,333. The reduction in basis caused by a section 2032A election will be a significant factor to consider even if the heirs intend that the farm will not be sold to outsiders. If one child sells his interest in the family farm to another child, for example, a previous section 2032A election may not invoke estate tax recapture, but the election will increase substantially the capital gain of the selling heir.

A second adverse tax consequence is the possible loss of the deferral privilege provided by section 6166. As noted above, section 6166 requires that the value of a "closely held business interest" account for at least 65% of the "adjusted gross estate" as defined in section 6166. The estate tax valuation of a farm is used for this purpose.

more easily applied than explained. The purpose of the depreciation formula is to restore to an estate the excess of pre-1977 accelerated depreciation deductions over straight line depreciation deductions. Such "excess" deductions do affect basis, but have no real effect on intrinsic value. In other words, the purpose of § 1023(h)(2)(B) is to eliminate any difference on carryover basis that might be attributable to pre-1977 methods of depreciation. See S. REP. No. 1236, 94th Cong., 2d Sess. 612-13 (1976).

183. "[I]f property is valued under [§ 2032A] in the case of a farm . . . that . . . special value is to be used to determine the amount of appreciation for purposes of making all the adjustments to the carryover basis." H.R. REP. No. 1380, 94th Cong., 2d Sess. 39 (1976).

184. I.R.C. § 6166(a).

185. When "the executor has elected special use valuation (under section 2032A), the special use valuation is to be treated as the 'value' for purposes of this extended payment provision (sec. 6166)." H.R. REP. No. 1380, 94th Cong., 2d Sess. 33 (1976).
Accordingly, if the true value of a farm is more than 65% of the adjusted gross estate, but if the productive formula reduces the value of the farm to less than 65% of the adjusted gross estate, the privileges of section 6166 are forfeited.

A third adverse consequence of a section 2032A election is the estate tax recapture or “additional tax” imposed by section 2032A(c) in the event of sale, cessation of qualified use, or failure to maintain family participation. As noted above, the “additional tax” is the excess of the estate tax that would have been imposed under normal valuation over the estate tax imposed under productive formula valuation. If this additional tax is imposed because of cessation of qualified use, the decedent or devisee merely pays at a later time a tax that should have been imposed at an earlier time. If the additional tax is imposed because of a sale to a nonfamily member, however, not only will the tax be due within six months, but (i) any tax deferred under section 6166 is due immediately, and (ii) the capital gain on sale will presumably be much larger than the gain would have been if no section 2032A had initially been made. Therefore, the combined income tax and estate tax burdens falling upon the estate can be disastrous.

2. Circumstances of no benefit or marginal benefit

Because of the unified credit, with its eventual exemption level of $175,625 per estate, section 2032A should never be elected when the taxable estate (together with taxable gifts) is $175,625 or less. If

186. See Part IV—F supra.
187. It has been suggested that some executors may elect § 2032A valuation even if they know that estate tax recapture will occur by reason of cessation of qualified use because of the tax deferral involved. See Comment, supra note 1, at 407. Such action would, in the author’s opinion, be unwise if the election has the effect of reducing the income tax basis in the property. See text accompanying notes 182–83 supra.
188. I.R.C. § 2032A(c)(5).
189. The textual statement assumes that one-third or more in value of the business is sold. Id. § 6166(g)(1).
190. See notes 182–83 and accompanying text supra.
191. The exemption levels increase as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Unified Credit</th>
<th>Exemption Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>$30,000</td>
<td>$120,666</td>
</tr>
<tr>
<td>1978</td>
<td>$34,000</td>
<td>$134,000</td>
</tr>
<tr>
<td>1979</td>
<td>$38,000</td>
<td>$147,333</td>
</tr>
<tr>
<td>1980</td>
<td>$42,500</td>
<td>$161,563</td>
</tr>
<tr>
<td>1981</td>
<td>$47,000</td>
<td>$175,625</td>
</tr>
</tbody>
</table>
the property is community property, section 2032A should not be elected by the estate of the first decedent if the net community estate is worth $351,250 or less. The same conclusion applies if the property is the separate property of the first decedent, and if the maximum marital deduction is available in the first estate. In well-planned estates, then, section 2032A benefits only those family farms in which the parents have an interest in excess of $350,000.

Even if the net value of the older generation's interest exceeds $350,000, the estate tax benefit of section 2032A will often be marginal when compared to the other tax detriments of such an election. First, if the marital deduction is used, the benefit of a section 2032A election is usually halved; but despite this reduction in benefit of section 2032A, the loss of income tax basis from a section 2032A election remains constant. For example, if a husband dies owning farmland worth $1 million which has a basis of $100,000 and is valued at $500,000 under section 2032A, the maximum marital deduction is reduced from $500,000 to $250,000. The gross estate reduction of $500,000 results in a taxable estate reduction of only $250,000. But the diminution of the "fresh start" adjustment occasioned by a section 2032A election is the same whether or not the adjusted gross estate is reduced by the marital deduction. If no sale of the land is contemplated, the basis loss may not appear to be a major factor, but the election locks the surviving spouse into the family farm. If she were to sell her inherited one-half interest to her children, for example, she would be liable for a larger capital gain tax than if no section 2032A election had been made, even though she received no benefit from the election.

If the property is entirely community property, a section 2032A election does not reduce the benefit of a marital deduction because there is no such deduction for community estates in excess of $250,000.

I.R.C. § 2010. Until 1981, therefore, some benefit may be obtainable from special valuation even if the taxable estate is less than $175,000— if it is more than $120,666.

192. See notes 168–69 and accompanying text supra.

193. See text accompanying note 170 supra.

194. See notes 179–81 and accompanying text supra.

195. See notes 182–83 and accompanying text supra.

196. Id. If, in the text example, the excess of death-date value over the decedent’s basis were $900,000, and the § 1023(h) “applicable fraction” were 2/3, a § 2032A election would reduce the carryover basis adjustment from 2/3 of $900,000 to 2/3 of $400,000. The “basis loss” would be $333,333.

197. The textual statement assumes that all estate taxes are payable out of the residue and not out of the marital deduction property.
A section 2032A election does, however, appear to reduce the carryover basis of the surviving spouse in his or her share of community property, even if no section 2032A election is made by the estate of the surviving spouse. Consequently, in cases where estate planning results in the creation of two taxable estates of equal size, a section 2032A election should be utilized in the estate of the first decedent only if that estate is very substantial.

3. Circumstances of substantial benefit

After the “fresh start” rule of section 1023(h) becomes less significant because of the passage of time, a section 2032A election will often be advantageous upon the death of a surviving spouse if the taxable estate under normal valuation procedures amounts to substantially more than $175,000. It will also be of substantial benefit at such time if the adjusted gross estate of the first spouse to die exceeds $350,000. In order to retain the benefit, however, the farm must be kept in “qualifying use” for a period of up to fifteen years after the decedent’s death.

B. Consequences of Productive Formula Valuation

1. No disqualification

If all the conditions subsequent of section 2032A are met, the primary adverse consequence of productive formula valuation is a reduced income tax basis in farmland under section 1023(h). If a

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198. The marital deduction in an estate entirely composed of community property is available only under the “minimum” marital deduction provision of § 2056(c)(1)(A)(i). See I.R.C. § 2056(c)(2). This deduction equals $250,000 less the amount of the community estate, adjusted for expenses. Id. § 2056(c)(1)(C). Therefore, a community property marital deduction is not available in community estates which exceed $250,000 by more than the amount of their expenses attributable to community property.

199. Upon the death of one spouse, the basis of the survivor in his or her half of the property is “stepped-up” to the extent provided in § 1023. See I.R.C. §§ 1014(b)(6), 1023(a)(1). Section 3(c)(3) of the Technical Corrections Act of 1978, H.R. 6715, 95th Cong., 1st Sess. § 3(c)(3) (1977), would apparently prevent the estate of a surviving spouse of a marital community from receiving a second “fresh start” basis adjustment under § 1023(h). S. REP. No. 745, 95th Cong., 2d Sess. 78 (1978). If section 2032A is elected upon the death of the first spouse, the basis of the surviving spouse is therefore reduced even if no section 2032A election is made in the second estate. See note 183 supra.

200. I.R.C. § 2032A(c).
section 1023(h) "fresh start" adjustment is unavailable in any event, a section 2032A election has as its only necessary adverse consequence the requirement that the family farm continue to be owned and operated as a farm by a member of the family for at least fifteen years after the decedent's death. 201

2. Disqualification

The disastrous consequences of a disqualifying sale and, to a lesser extent, of a disqualifying use of farm property subject to a section 2032A election can hardly be overemphasized. The most immediate consequence is the additional tax of section 2032A. 202 It might seem that the imposition of the additional tax is nothing more than a tax that would have been paid earlier if a section 2032A election had not been made. Imposition of estate tax recapture, however, has the following additional adverse effects:

(i) A section 2032A election reduces the amount of the adjustment to basis otherwise available under section 1023(h). 203 The "additional tax" of section 2032A(c) does not appear to restore the basis adjustment originally lost by the initial section 2032A election. 204

(ii) Sections 6166 and 6166A do not appear to apply to the additional tax of section 2032A(c) even if the land is retained by the family. 205 Thus, the additional tax will be payable in a lump sum only.

(iii) Even though a surviving spouse receives no direct benefit from section 2032A if her interest is a marital deduction share,

201. Id.
203. See note 183 and accompanying text supra.
204. The amount of the additional tax might, however, be treated as a capital expense and added to basis. Some support for this result may be found in the reasoning of Kirschenmann v. Commissioner, 488 F.2d 270 (9th Cir. 1973).
205. Sections 6166(3) and 6166A(f) allow estate tax deficiencies to be prorated to the installments payable under those sections, but the "additional tax" of § 2032A(c) is not termed a "deficiency." Section 6211 defines a deficiency as the excess of tax imposed by subtitle A (income tax) or subtitle B (estate and gift tax) over "the amount shown as the tax by the taxpayer upon his return." I.R.C. § 6211(a)(1)(A). While this may suggest that an estate tax recapture amount is a "deficiency," such determination would imply that interest is due from the due date of the original estate tax return. See id. § 6601. Interest is not payable, however, on estate tax recapture. Id. § 2032A(c)(5). Therefore, the "additional tax" does not appear to be a deficiency.
the additional tax of section 2032A(c) applies to that share.\textsuperscript{206}

(iv) It appears that the holder of a life estate will be personally liable for a portion of the additional tax of section 2032A(c) if that holder does not keep the property in qualified use.\textsuperscript{207}

(v) Disqualification by reason of sale to a nonfamily member triggers a capital gain larger than would have resulted if no sec-

\textsuperscript{206} The textual statement disregards possible benefits in smaller estates which may result from the application of § 2032A in such a way that the survivor receives more property under the minimum marital deduction. \textit{See} notes 176-77 and accompanying text \textit{supra}. To illustrate the difficulty, assume, for example, that a post-1980 adjusted gross estate is $1 million under normal valuation but only $500,000 under special valuation and that the decedent leaves one-half the property to his surviving spouse and the balance to his children. The taxable estates and taxes with and without special valuation would be as follows:

\begin{tabular}{|c|c|c|c|}
\hline
 & Normal & Community & Special & Community \\
\hline
Adjusted gross estate & $1,000,000 & ($500,000) & $500,000 & ($250,000) \\
\hline
Marital deduction & $500,000 & (0) & $250,000 & (0) \\
\hline
Tentative tax & $155,800 & ($155,800) & $70,800 & ($70,800) \\
\hline
Credit & $47,000 & ($47,000) & $47,000 & ($47,000) \\
\hline
Final tax & $108,800 & ($108,800) & $53,800 & ($53,800) \\
\hline
\end{tabular}


Assuming a separate property inheritance, if all property is sold to an unrelated party within 10 years of the decedent's death, the total "additional tax" would be $55,000. \textit{Id.} § 2032A(c)(2). The additional tax with respect to the surviving spouse's interest would be $27,500 (assuming her interest accounts for one-half the difference between special and normal valuation). \textit{Id.} § 2032A(c)(2)(B). The surviving spouse is personally liable for this tax. \textit{Id.} § 2032A(c)(6). The agreement under § 2032A(d) could, of course, give her a personal claim against the other heirs because she derives no direct benefit from the § 2032A election.

If the property is instead community property, results are totally unclear. On one hand, it could be argued that because the surviving spouse received nothing from the decedent, she is not a "qualified heir," and that, even though her basis in property is determined by reference to the basis of her deceased spouse, her property is not subject to estate tax recapture. On the other hand, § 1014(b)(6) indicates that, for tax purposes, a surviving spouse's share of community property is deemed to have passed to her from the decedent. Moreover, in "item theory" community property states, any division of property would involve a technical exchange by the surviving spouse of her interest in some estate "items" for the decedent's interest in other estate items; California, Louisiana, New Mexico, Texas, and Washington appear to follow the "item" theory. W. REPPY, JR. & W. DeFUNIAK, COMMUNITY PROPERTY IN THE UNITED STATES 444 (1975). The "item" theory is based on the principle that the spouse who dies first should not be able to deprive the other spouse of an interest in any given item of community property. \textit{See} In re Estate of Patton, 6 Wn. App. 464, 494 P.2d 238 (1972). Because a "qualified heir" can include a purchaser, a surviving spouse who acquires some farmland might hold that property subject to the "section 2032A taint."

Section 3(d)(4) of the proposed Technical Corrections Act of 1978 contains language that only confuses these matters further. \textit{See} H.R. 6715, 95th Cong., 1st Sess. § 3(d)(4) (1977); H.R. REP. No. 700, 95th Cong., 1st Sess. 71; note 181 \textit{supra}.

\textsuperscript{207} Assume, for example, a taxable estate of $1 million with a § 2032A valuation of $500,000. Decedent devises the property to his wife for life, remainder to his children. The "additional tax" would be computed as follows:
Estate Tax Valuation of Farmland

...tion 2032A election had been made. Moreover, the sale terminates any deferral under sections 6166 or 6166A.

It is not difficult to illustrate problems presented by disqualification. Assume, for example, that a husband devises one-half his farmland to his wife and the balance to his children, with an intervening life estate in the children's half to his wife. If a section 2032A election is made and the wife later leases the farm to someone other than a family member for a four-year term, the lease will trigger imposition of an additional tax. The widow, as holder of a fee interest in one-half the land and as holder of a life estate in the other half, would appear to be liable for more than one-half the amount of additional tax. No deferral of that tax under section 6166 or section 6166A would appear to be possible. The widow might therefore have to sell some of her property to pay the tax. If she does so, the capital gain from the sale is larger than it would have been if no section 2032A election had been made. This disaster is not without its advantage, of course, because the transaction may deplete the estate of the widow to such an extent that it will have no federal estate tax problem.

As a result of the potential disaster and uncertainty surrounding a section 2032A election, the election is likely to be made only in (i) cases of extremely large estates where the tax benefit is large and where activities can be monitored so as to prevent estate tax recapture, and (ii) cases where the estate is already encumbered and cannot

| Post-credit tax on $1,000,000 | $298,000 |
| Post-credit tax on $500,000  | 155,800  |
| Additional tax              | 143,000  |

The House committee report indicates that a three-year lease by the widow would trigger full recapture. H.R. Rep. No. 1380, 94th Cong., 2d Sess. 26 (1976). The widow, however, is liable only to the extent of the recapture attributable to her interest in the property. The value of her life estate might be 50% of total value. See Treas. Reg. 20.2031-10 (1970). In such a case, she would be liable for $71,500 and the remaindermen would be liable for the balance. If the Government forces a sale of the property by virtue of its lien under § 6324B, the respective interests of the wife and children would presumably be determined under state law. See Riggs v. Del Drago, 317 U.S. 94 (1942). The main problem here, of course, is that a life tenant can cause estate tax recapture, part of the burden of which could fall on the remainderman.

208. See note 183 and accompanying text supra.
209. This statement assumes, of course, that more than one-third of the value of the closely held business is disposed of. I.R.C. § 6166(g)(1).
210. The additional tax will be triggered unless the lease arrangement satisfies the participation requirements. See Part IV-E supra.
211. See note 207 supra.
212. See note 205 supra.
afford an estate tax burden. For example, if the spouse who dies last leaves a farm worth $1 million, but subject to debts of $500,000, the net value of the estate is $500,000 and could generate a substantial tax under normal valuation. Section 2032A valuation might reduce net value to zero. The executor and qualified heirs might choose productive formula valuation in order to avoid payment of estate tax. But it is precisely this kind of heavily indebted estate that may have to sell land to pay debts in the event of drought or adverse market conditions. If the qualified heir is forced to sell to pay the farm debts, new debts in the form of capital gains taxes and additional estate taxes are created. Section 2032A is thus a statute that benefits only very large estates but is a trap for the unwary beneficiaries of “medium size” estates. It is not a provision that will protect the average family farm.

IX. EVALUATION AND ASSESSMENT

A. General

It is perhaps not difficult to persuade persons who derive no immediate benefit from a tax subsidy that the subsidy is bad. Tenant farmers who own no land can perhaps most easily appreciate that the subsidy of sections 2032A and 6166 harms them if the provisions cause the price of land to increase in relation to current yield. Farm families who own farmland but who can escape federal estate taxation by minimal estate planning even without the benefit of the tax subsidy may believe they benefit by any law which tends to drive up the dollar value of land they own, but surely the purpose of sections 2032A and 6166 is not to raise artificially the value of a farm estate from $350,000 to, say, $500,000. In any event, families with modest amounts of farmland, or with existing estates of less than $350,000, can probably recognize the detriment of a tax subsidy that drives up farmland prices if those families with to buy more farmland. It is undoubtedly most difficult to persuade an immediate beneficiary of a tax subsidy, for example, a family that saves $50,000 by a section 2032A election, that the long-range effects of a subsidy are detrimental.

This article has suggested that sections 2032A and 6166 will drive

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213. See Part III-B supra.
up the price of farmland in relation to current yield. Section 2032A purports to limit its subsidy to working farmers. Even if the subsidy is so limited, it will inflate farmland prices because it discourages sales by existing owners, thereby decreasing the supply available to buyers. In addition, sections 2032A and 6166, by making land ownership more advantageous and less expensive generally and by subsidizing most heavily the larger farms, encourage purchases of more land by existing owners, thereby increasing demand. An application of basic economic principles to these facts makes it reasonable to surmise that this combination of reduced supply and increased demand will increase the price of farmland in relation to current yield.

Sections 2032A and 6166 may trigger a further, indirect increase in demand for farmland. If they increase the value of farmland in relation to current yield, they may also increase the growth potential of the land and cause nonfarm investors to drive up the price still further. For example, if farmland now generates an average cash rent of 3% and doubles in value every ten years, then farmland is a very desirable investment for a high bracket taxpayer who is more interested in long-term growth than in current yield. If sections 2032A and 6166 increase price to the extent that farmland generates an average cash rent of 2% but doubles in value every five years, high-bracket nonfarm investors will consider farmland a more attractive investment even if they derive no estate tax benefits from its ownership. Section 2032A has been advocated and defended on the ground that current yield is low in relation to price. The provision may well cause the current yield of farmland to be even lower in relation to price. This effect may or may not be desired by farmers with estate tax problems, but it is difficult to see how such provisions preserve the family farm.

It has already been recommended that the present limitations of section 2032A should be abolished so that its benefits might be available to all investors. If such a suggestion is adopted, farmland will become the great estate tax shelter and it is doubtful whether any farmers could afford to buy or own it. Even if present limitations on the subsidy are maintained, farmers and nonfarmers alike should ask

214. See Part IV–E supra.
216. Senate Hearing, supra note 3, at 52 (statement of James Whittenberg).
whether the benefit of an immediate estate tax saving is worth the
detriment of higher farmland prices.

B. Immediate Beneficiaries

Parts IV and V of this article show that the immediate beneficiaries of sections 2032A and 6166 will be, for the greatest part, families in which the combined net wealth of farmer parents exceeds $350,000. Families of parents who have combined wealth of less than $350,000 and families of tenant farmers who own no land are left only with the adverse economic side effects of sections 2032A and 6166.

Families who own farms with a net value exceeding $350,000 derive two benefits: (1) if sections 2032A and 6166 drive up the price of their land, they will become richer, and (2) they will receive estate tax benefits that can be substantial in amount. We have seen that the maximum reduction in estate tax valuation available under section 2032A is $500,000 per estate. But viewed from the perspective of a family, the reduction can amount to as much as $1 million in one husband-wife generation. Moreover, if the family is defined in the broad terms of section 2032A, value reductions in a given generation can be immense. For example, if a father and mother own a farm which they devise to their four children and the spouses of those children as tenants in common, the maximum value reduction in the generation of the parents is $1 million. The maximum valuation reduction in the first generation of children (four children and their spouses) is $4 million. This reduction in the second generation is available even if only one member in the group manages the farm property. Such centralized management will not be difficult to achieve because the Secretary is authorized to promulgate regulations which will extend the benefits of section 2032A to interests held in partnerships, corporations, estates, and trusts.\footnote{\textit{I.R.C. § 2032A(g)}.}

Sections 2032A and 6166 therefore amount to a graduated tax subsidy. Tenant farmers and owners of small farms receive no subsidy but are subject to the adverse side effects of the subsidy. The very wealthy will receive subsidies of up to $500,000 per taxable estate under section 2032A and an indeterminate amount under section 6166.
Estate Tax Valuation of Farmland

C. Indirect Effects on Beneficiaries of the Estate Tax Subsidy

The impact of sections 2032A and 6166 upon estates that receive some estate tax benefit, but not a maximum benefit, is difficult to determine. For example, a farm with a net value of $500,000 will usually derive some immediate benefit from these sections. It is not clear, however, whether families who own farms of this size will receive a long range benefit. As agricultural technology improves, these families may wish to acquire more land. If sections 2032A and 6166 drive up the price of land, these families will have an advantage over tenant farmers and farmers who derive no benefit from section 2032A, but they may find that the increased price of land in relation to current return makes purchases of additional land more difficult for them also. Intrafamily purchases of land will also become more difficult if the farmer child who desires to purchase interests of siblings finds that he or she must pay more because these sections have driven up the price.

D. Effects on Farmers Who Rent Land

Many tenant farmers own none of the land they till while others own some land and rent additional land. As of 1969, over 38% of all farmland in the United States was rented. Sections 2032A and 6166 may increase the difficulty of renting land under traditional cash rent and crop rent lease arrangements. Section 2032A requires "material participation" in the operation of a farm or ranch. "Material participation" requires active management by the owner or a member of his family. Landlords who desire the benefits of sections 2032A and 6166 will be encouraged either to rent land to relatives or

219. Census figures for 1974 reveal that 35% of American farmland is operated by owners who rent no land, 53% is operated by persons owning part of their land, and 12% is operated by tenants owning no land of their own. 1 BUREAU OF THE CENSUS, supra note 26, pt. 51, at I-2 (Table 3).

220. The predominant trend has been away from full ownership and toward part ownership, apparently because farmers are renting land as a means of expanding their operations. See B. JOHNSON, ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, AGRICULTURAL ECONOMIC REPORT NO. 249, FARMLAND TENURE PATTERNS IN THE UNITED STATES 3, 17-19, 24-25 (1974); R. REINSEL & B. JOHNSON, ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, AGRICULTURAL ECONOMIC REPORT NO. 190, FARM TENURE AND CASH RENTS IN THE UNITED STATES 2 (1970). In 1974, part owners operated 53% of all acreage, compared to 52% in 1969, and tenants operated 12% of farm acreage, down from 13% in 1969. 1 BUREAU OF THE CENSUS, supra note 26, pt. 51, at I-2 (Table 3).
to transform lease arrangements into sharecropping arrangements.\textsuperscript{221} Some tenants will therefore find themselves without land to till or will find that their status will be reduced from that of a tenant to that of a sharecropper.

\textit{E. A Proposal}

It may be futile at this point to suggest the repeal of sections 2032A and 6166 given the powerful social images which induced their passage. A proposal to extend the benefits of section 6166 to tenant farmers and other small farmers should, however, be welcomed by those who profess concern for the family farm. Section 6166 is essentially a government loan program.\textsuperscript{222} I propose that the program be extended to existing full-time farmers or farm workers who do not now own substantial amounts of land: (1) Loan to such persons up to an amount equal to the 2032A and 6166 subsidies now given landed estates, for purposes of buying land. (2) Require repayment of that loan precisely as now provided in section 6166, that is, with no principal payments for five years and payment of the loan balance in ten equal installments thereafter. (3) The interest rate on the loan should be 4\%. Such a program may also cause the price of farmland to rise, but it would at least bestow to poorer farmers the same benefits now extended to rich farmers.

The present economic characteristics of farmland, federal income tax law, and now federal estate tax law all portend the emergence of a landholding elite class in America. Although federal income and estate tax laws could be revised to prevent this discrimination against the tenant class, it is not realistic to expect such revisions. Absent such revisions, the subsidies now granted to the rich should be accompanied by subsidies available to the tenant farmers and owners of small farms in America.

\textsuperscript{221.} See notes 85–90 and accompanying text \textit{supra}.  
\textsuperscript{222.} See note 107 and accompanying text \textit{supra}.  

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