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The Family Farm and Use Valuation-Section 2032A of the Internal Revenue Code

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COMMENTS

The Family Farm and Use Valuation—Section 2032A of the Internal Revenue Code

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I. INTRODUCTION

In 1941 Congress established a table of estate tax rates ranging from 3 percent on the first \$5,000 of the taxable estate to 77 percent on the amount of the taxable estate in excess of \$10 million.¹ In 1942 the estate tax exemption was pegged at \$60,000.² Both of these features remained essentially unchanged for 34 years³ while the average equity ownership of farm proprietors increased from \$8,449⁴ to about \$190,000.⁵ The increase in value

1. Revenue Act of 1941, ch. 412, § 401(a), 55 Stat. 704-05 (current version at I.R.C. § 2001).

2. Revenue Act of 1942, ch. 619, § 414(a), 56 Stat. 951 (repealed 1976).

3. H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. 10, 15, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3364, 3369 [hereinafter cited as HOUSE REPORT]. One major change during that period was the creation of the marital deduction in 1948. Revenue Act of 1948, ch. 168, § 361, 62 Stat. 117-21 (current version at I.R.C. § 2056).

4. See ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, AGRICULTURAL INFORMATION BULL. NO. 403, BALANCE SHEET OF THE FARMING SECTOR 1976, at 45 (1976) (\$52.4 billion total equity of farm proprietors in 1942) [hereinafter cited as BALANCE SHEET]; ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, STATISTICAL BULL. NO. 557, FARM INCOME STATISTICS 38 (1976) (6,202,000 farms in 1942) [hereinafter cited as FARM INCOME STATISTICS]. Total assets per farm were \$10,142, of which real estate accounted for \$6,046 (without reduction for debt). See *id.*; BALANCE SHEET, *supra*, at 45.

5. See ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, AGRICULTURAL FINANCE OUTLOOK 5, 20 (1976) (January 1977 total farm equity estimated at \$532.5 billion; 2,786,000 farms in 1976). Total assets per farm in January 1977 were projected to be worth

of farm real estate accounted for about 77 percent of this 21-fold increase in farm equities.⁶ In contrast to this dramatic inflation in farm real estate prices, average realized net income of farm proprietors increased less than sixfold from \$1,411 in 1942 to \$8,079 in 1975.⁷ These figures illustrate two important points: (1) the rising value of farm real estate has been the dominant force subjecting farms to a steadily increasing threat of substantial estate tax liability, and (2) since farm income has lagged far behind the rise in farm values, it appears likely that many farms cannot generate sufficient income to pay off a substantial estate tax liability without extreme hardship or recourse to liquidation of farm assets.

Since the law has required property in decedents' estates to be valued at fair market value,⁸ which is largely determined by the "highest and best use" of the property,⁹ farmland near urban areas is typically valued at a price reflecting its value for development rather than agricultural purposes. In addition, rural farmland is often valued at a price that reflects its attractiveness as a source of tax loss, a recreational investment, a hedge against inflation, or an object of speculation.¹⁰ Thus, regardless of its

about \$228,000; of that amount about \$165,000 represented real estate (without reduction for debt). *Id.*

6. This percentage was derived from data in *BALANCE SHEET*, *supra* note 4, at 3, 45. The average land area per farm has increased from about 180 acres in 1942 to about 400 acres in 1976. *Federal Estate and Gift Taxes: Public Hearings and Panel Discussions Before the House Comm. on Ways and Means*, 94th Cong., 2d Sess. 860 (1976) (statement of Sen. James Abourezk) [hereinafter cited as *House Estate Tax Hearings*]; U.S. DEP'T OF AGRICULTURE, *AGRICULTURAL STATISTICS—1976*, at 417 (1976) [hereinafter cited as *AGRICULTURAL STATISTICS*]; BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, *CENSUS OF AGRICULTURE—1969*, 2 GEN. REPORT ch. 2, at 11 (1973). Thus, only 5.6% of the increase in farmers' equity since 1942 is attributable to expansion of acreage per farm.

7. *FARM INCOME STATISTICS*, *supra* note 4, at 38. In 1942 average farm equity was about six times as great as annual farm income, while farm equity in 1976 was 23.5 times current farm income.

8. Treas. Reg. § 20.2031-1(b), T.D. 6826 (1965).

9. See *Olson v. United States*, 292 U.S. 246, 255-56 (1934); *United Virginia Bank v. United States*, 74-1 U.S. Tax Cas. ¶ 12,972, at 84,334 (E.D. Va. 1974); *Estate of Spicer v. Commissioner*, 33 T.C.M. (CCH) 45, 46, 49 (1974); *Estate of Nail v. Commissioner*, 59 T.C. 187, 189 (1972); *Estate of Dooly*, 41 T.C.M. (P-H) ¶ 72,164 at 72-854 to 855 (1972); *HOUSE REPORT*, *supra* note 3, at 21, reprinted at 3375; *Audit Technique Handbook for Estate Tax Examiners*, [1977] 1 INT. REV. MAN.—AUDIT (CCH) ¶ 520.

10. *Impact of Federal Estate and Gift Taxes on Small Businessmen and Farmers: Joint Hearing Before the Senate Select Comm. on Small Business and the Joint Economic Comm.*, 94th Cong., 1st Sess. 29 (1975) (statement of Sen. Hubert Humphrey) [hereinafter cited as *Joint Hearing on Impact of Estate Taxes*]; *House Estate Tax Hearings*, *supra* note 6, at 26 (statement of Don Woodward), 725 (statement of Edward McGinty), 883 (statement of Rep. Floyd Fithian), 1456 (paper by Dr. Calvin Kent); *Tax Reform Act of 1975: Hearings Before the Senate Comm. on Finance*, 94th Cong., 2d Sess.

location, farmland is commonly valued at a price that is strongly influenced, if not wholly determined, by nonagricultural factors. These factors exert potent pressures on many farm families, particularly those near urban areas, to liquidate their farms and abandon agriculture entirely.¹¹ Despite these pressures, heirs of many farmers desire to continue operating their parents' farms and eventually to pass the farms on to their children.¹² A substantial estate tax liability on the transfer of the farm to the younger generation, however, may require liquidation of much of the farm's production assets,¹³ and, coupled with the pressures described above, threatens to force even the most dedicated farmers to abandon their agricultural ambitions.

Political pressure to remedy this situation finally aroused significant congressional attention in 1976.¹⁴ The Tax Reform Act of 1976¹⁵ included sweeping revisions of the estate and gift tax

408-10 (1976) (statement of National Livestock Tax Committee, American National Cattlemen's Association, National Livestock Feeders Association, and National Wool Growers Association) [hereinafter cited as *Senate Tax Reform Hearings*].

11. Many farmers could increase their annual incomes dramatically merely by investing the proceeds from sale of their farms in tax-exempt bonds or other income-producing assets. In addition, they could thereby escape the long hours of labor, the seven-day-a-week commitment (on farms that include irrigation or livestock operations), the substantial risks of crop failure and market fluctuations, and the necessity of foregoing frequent vacations, recreational opportunities, and other pleasures of life.

12. See STAFF OF HOUSE COMM. ON WAYS AND MEANS, 94TH CONG., 2D SESS., BACKGROUND MATERIALS ON FEDERAL ESTATE AND GIFT TAXATION 397 (Comm. Print 1976) (statement of American Bankers Association); *Small Business Tax Reform: Joint Hearings Before the Senate Select Comm. on Small Business and the Subcomm. on Financial Markets of the Senate Comm. on Finance*, 94th Cong., 1st Sess. 1579 (1975) (letter from Prof. Neil Harl, stating that a major part of his work for the last 17 years has been with farms intended to be continued into the next generation); R. KRENZ, W. HEID, & H. SITLER, ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, AGRICULTURAL ECONOMIC REPORT No. 264, ECONOMICS OF LARGE WHEAT FARMS IN THE GREAT PLAINS 7 (1974) (most wheat farmers surveyed had been raised on the farms they operated and had lived their entire lives there); Boehlje & Boehlje, *Intergeneration Transfers: Is Agriculture Unique?*, 112 TR. & EST. 172, 173 (1973). *Contra*, *Revision of Federal Estate Tax Law: Hearing Before the Senate Comm. on Finance*, 94th Cong., 2d Sess. 28-29 (1976) (statement of Sen. Edward Kennedy, quoting Prof. Neil Harl).

13. See notes 29-52 and accompanying text *infra*. A detailed example illustrating this problem appears in *House Estate Tax Hearings*, *supra* note 6, at 606-10 (paper by Prof. John Hopkin).

14. As of March 1976, 179 bills dealing with estate tax problems of farmers had been introduced in the 94th Congress. *House Estate Tax Hearings*, *supra* note 6, at 448 (statement of Sen. Charles Mathias). A brief summary, comparison, and analysis of many of these bills can be found in STAFF OF HOUSE COMM. ON WAYS AND MEANS, 94TH CONG., 2D SESS., BACKGROUND MATERIALS ON FEDERAL ESTATE AND GIFT TAXATION 49-62 (Comm. Print 1976).

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

laws.¹⁶ Most of the changes were designed to affect both farm and nonfarm estates, but several changes were calculated to give tax relief specifically to farm estates.¹⁷ One of the 1976 revisions aimed especially at farmers was a new section of the Internal Revenue Code, section 2032A,¹⁸ which permits executors under certain conditions to elect to value real property for estate tax purposes at its "use value" instead of its market value. This comment will (1) examine the burden of estate taxes on farms and discuss the tendency of the estate tax to impair agriculture's efficiency, (2) illustrate the substantial impact of section 2032A on farm estates, and (3) evaluate the new section in terms of legislative intent and public policy and point out its significant defects and virtues.

II. THE BURDEN OF ESTATE TAXATION ON FAMILY FARMS¹⁹

Congress decided to reduce the estate tax on family farms because it believed that the burden of estate taxes was so high that it compelled the liquidation of substantial portions of many farms²⁰—forcing some farm heirs to abandon their parents' farms,²¹ impairing efficiency in the agricultural economy,²² and encouraging the conversion of farmland to nonagricultural uses.²³ This portion of this comment will assess the potential estate tax

16. *Id.* §§ 2001-2010, 90 Stat. 1846-97 (codified in scattered sections of I.R.C.); HOUSE REPORT, *supra* note 3, at 3-5, *reprinted* at 3357-59.

17. Notes 155-73 and accompanying text *infra*.

18. I.R.C. § 2032A. Although this section also applies to real property held by non-farm businesses, its benefit to most of them will probably be minimal. See notes 175-77, 237 and accompanying text *infra*.

19. Throughout this comment, the term "family farm" refers to a commercial farm (of which the most valuable asset is farmland) that is largely owned by a single individual and operated by him and members of his family (generally children and grandchildren) as a principal occupation.

20. HOUSE REPORT, *supra* note 3, at 5, 22, 30, *reprinted* at 3359, 3376, 3384. Congress was not significantly deterred in this action by the anticipated revenue loss involved, which it knew to be an extremely insignificant portion of the total federal budget. See notes 198-99 and accompanying text *infra*.

21. HOUSE REPORT, *supra* note 3, at 5, 22, 30, *reprinted* at 3359, 3376, 3384.

22. See, e.g., *Senate Tax Reform Hearings*, *supra* note 10, at 2294 (statement of Sen. Dick Clark); *House Estate Tax Hearings*, *supra* note 6, at 656-58 (statements of Rep. Robert McEwen and Rep. Barber Conable), 669 (statement of Rep. Berkley Bedell); see also notes 96-98, 108 and accompanying text *infra*.

23. E.g., *House Estate Tax Hearings*, *supra* note 6, at 443, 445 (statement of Sen. Glenn Beall), 446-48 (statement of Sen. Charles Mathias); HOUSE REPORT, *supra* note 3, at 22, *reprinted* at 3376. Section 2032A, while directly addressing this problem of loss of farmland to competing development use, also affects the problems of forced liquidation of family farms and agricultural inefficiency.

liability of farms under prior law and examine the problems of farm liquidity and lack of adequate farm estate planning.

A. *Potential Estate Tax Burden on Farms Under Prior Law*

The per acre value of farm real estate multiplied over thirteen times from 1942 to 1976.²⁴ The average annual rate of increase in value was about 6 percent for the first thirty years of that period. Since 1971, however, the average increase has been about 15 percent per year—more than doubling the value of farmland in the last five years.²⁵ As pointed out previously, this inflation of land values accounts for most of the increase in farm equities since 1942.²⁶ A second factor that has also contributed materially to the estate tax difficulties of farmers is an increase in the average value of machinery and motor vehicles per farm from \$482 in 1940 to \$23,648 in 1976.²⁷ Real estate and machinery are the two most valuable types of assets held by the majority of farms and represent most of the average farm's equity.²⁸

The potential impact of estate taxes on an intergeneration transfer of the average farm under prior law can be estimated by basing the calculations on the following assumptions: (1) the husband dies in January 1970, holding sole title to the farm's assets, whose net worth is \$85,718;²⁹ (2) his will passes his entire estate to his wife;³⁰ (3) his wife dies in November 1976;³¹ (4) the farm

24. ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, FARM REAL ESTATE MARKET DEVELOPMENTS 6 (1976) [hereinafter cited as FARM REAL ESTATE MARKET DEVELOPMENTS—1976]; ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, FARM REAL ESTATE MARKET DEVELOPMENTS, SUPP. NO. 1, at 5 (1977) [hereinafter cited as FARM REAL ESTATE MARKET SUPPLEMENT].

25. FARM REAL ESTATE MARKET DEVELOPMENTS—1976, *supra* note 24, at 4-6; FARM REAL ESTATE MARKET SUPPLEMENT, *supra* note 24, at 1, 4, 6. During the year ending November 1, 1976, the average value of farmland in the Corn Belt (Ohio, Indiana, Illinois, Iowa, and Missouri) increased 33%. *Id.* at 1.

26. Note 6 and accompanying text *supra*.

27. BALANCE SHEET, *supra* note 4, at 3. This quantity has also more than doubled since 1970. *Id.*

28. *Id.*

29. This figure represents average equity of farm proprietors as of January 1970. BALANCE SHEET, *supra* note 4, at 3.

30. This assumption accurately reflects the estate plans of many farmers. *Contemporary Studies Project: Large Farm Estate Planning and Probate in Iowa*, 59 IOWA L. REV. 794, 940 (1974) (50% of farmers having wills provided for all property to pass to surviving spouses) [hereinafter cited as *Contemporary Studies Project*]. The tax effect of passing the husband's entire estate to his wife is essentially the same as that of holding all property in joint tenancy between husband and wife. Thus, the assumption that all property passes to the wife is even more realistic in view of the heavy reliance of farmers on joint tenancies and tenancies by the entirety to pass their property to their surviving

assets (net of debts and expenses) are valued in her estate at \$190,000;³² (5) as to both estates, administration expenses and state death taxes are zero;³³ (6) no gain or loss results from the sale of farm assets;³⁴ and (7) neither spouse had substantial life insurance coverage.³⁵ Although no estate tax is imposed at the husband's death,³⁶ the wife's death would trigger an estate tax of \$29,700.³⁷ In addition, the estate would have other debts amounting to about \$34,972.³⁸ Since the farm's liquid and near-liquid assets are worth only \$20,324,³⁹ it is apparent that, unless ade-

spouses. *See id.* at 906, 936-38 (48% of large farms surveyed included some jointly held property; in almost all cases the farmer's spouse was the other joint tenant); *House Estate Tax Hearings*, *supra* note 6, at 1676 (article by Donald Kelley).

31. This assumes that the wife will survive her husband by nearly seven years. This assumption reflects the life expectancy differential between males and females in the United States. *See* BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES—1976, at 60-61 (1976).

32. This figure represents average equity of farm proprietors as of November 1976. Note 5 *supra*.

33. This assumption is obviously unrealistic because costs of administration and state death taxes are generally substantial. *See* INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1972, ESTATE TAX RETURNS 2, 4-5 (1975). Thus, other things being equal, the farm liquidity problem is even more serious than the following analysis suggests.

34. This assumption was made in order to simplify calculations. Under present law, a capital gain is likely to result from the sale of farmland (and other appreciated assets) because of the new carryover basis provisions, I.R.C. § 1023, suggesting that the farm liquidity problem in the future may be even more serious than the following analysis suggests.

35. This assumption is realistic since very little life insurance is purchased by most farm families. *Contemporary Studies Project*, *supra* note 30, at 950-53 (while 88% of farmers surveyed had life insurance, their average insurance coverage was only 7% of their average gross estates); *see* ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, AGRICULTURAL FINANCE OUTLOOK 5 (1976).

36. Since the husband's estate would be entitled to a \$42,859 marital deduction (50% of the adjusted gross estate) and a \$60,000 exemption, it would incur no federal estate tax liability.

37. This tax is computed by deducting the \$60,000 exemption, note 2 and accompanying text *supra*, from \$190,000 and applying the estate tax rates that were applicable prior to the Tax Reform Act of 1976, notes 1, 3 and accompanying text *supra*.

38. This amount is an estimate based on 1975 average farm debt, increased by 20% to reflect November 1976 debt. *See* BALANCE SHEET, *supra* note 4, at 3, 43; *cf.* ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, AGRICULTURAL FINANCE OUTLOOK 5, 20 (1976) (January 1977 debt approximately \$36,000 per farm).

39. This figure is the sum of stored crops as of 1975, BALANCE SHEET, *supra* note 4, at 3, 43, and financial assets as of November 1976, *id.* at 3, 43. No projection of stored crop values for November 1976 was made because that figure declined from 1975 to 1976. *Id.* at 3. The value of financial assets was assumed to have increased by 13% from 1975, based on the increase from 1975 to 1976, *id.*

Although it has been asserted that stored crops are "very nonliquid," *Senate Tax Reform Hearings*, *supra* note 10, at 2293 (statement of Sen. Dick Clark), it seems more realistic to classify such assets as near-liquid because there is generally an active market and a readily ascertainable price for farm commodities.

quate funds are provided by heirs through borrowing, insurance, or otherwise, this farm estate of average size would be forced to liquidate a substantial portion of its production assets in order to pay its debts and estate taxes. If, however, the assumption regarding the husband's will is modified so that one-half of the husband's estate passes to his wife and one-half to their children, either by will or intestacy,⁴⁰ the estate tax liability incurred upon the wife's death would be reduced to a relatively insignificant \$3,900.⁴¹

It is more important, however, to assess the potential impact of estate taxes on farms of larger than average size, designated by the Department of Agriculture as sales classes IA (annual gross sales over \$100,000), IB (sales of \$40,000 to \$99,999), and II (sales of \$20,000 to \$39,999),⁴² because those farms account for over 89 percent of total cash receipts from farming.⁴³ The following table, based on the two alternative sets of assumptions above, summarizes the estate tax and liquidity situations of larger farms:

	Class II	Class IB	Class IA
Jan. 1970 equity ⁴⁴	\$110,126	\$172,095	\$406,155
Tax on husbands' death ⁴⁵	0	2,447	33,623
If husband leaves all to wife	<div style="display: inline-block; vertical-align: middle; font-size: 3em; line-height: 1;">{</div> <div style="display: inline-block; vertical-align: middle;"> Nov. 1976 equity owned by wife⁴⁶ Tax on wife's death⁴⁷ </div>		
	250,286	385,570	846,756
	47,786	88,903	233,351

40. If the estate is well-planned, the wife might be given one-half of the husband's property outright plus the income from the other half, as well as limited powers to invade and to appoint the disposition of the property passing to the children. Such careful marital deduction planning, however, appears to be rare in farm estates. *Contemporary Studies Project*, *supra* note 30, at 940-42.

41. This amount is the tax on an estate of \$95,000 (after deducting debts and expenses), which is one-half of the farm's equity as of November 1976. It is assumed that no attrition of the property inherited by the wife has occurred.

42. *BALANCE SHEET*, *supra* note 4, at 43.

43. *FARM INCOME STATISTICS*, *supra* note 4, at 61 (based on 1975 data). Average equity of proprietors of these farms in November 1976 was approximately \$923,080 for class IA farms, \$391,125 for class IB farms, and \$250,286 for class II farms. These figures are derived from the corresponding data for 1975, *BALANCE SHEET*, *supra* note 4, at 43, by increasing the 1975 equity figures by 25%, based on an increase of 13.5% in farm equity from January 1975 to January 1976, *id.* at 3.

44. These figures were estimated from 1975 equity information by assuming them to be 45% lower than in 1975, reflecting the difference between average farm equity in 1970 and in 1975. *BALANCE SHEET*, *supra* note 4, at 3, 43.

If husband leaves one-half to wife	Nov. 1976 equity owned by wife ⁴⁸	125,143	195,563	461,540
	Tax on wife's death ⁴⁹	10,940	30,390	100,744
Liquid and near-liquid assets ⁵⁰		24,360	42,025	135,408
Debts ⁵¹		35,833	78,594	354,022

Obviously, the estate taxes on intergeneration transfers of farms could be greater in some cases than under either of these sets of assumptions.⁵² On the other hand, farmers could greatly reduce the impact of estate taxes by providing life insurance or other sources of liquidity and by transferring substantial portions of farm assets to a younger generation by lifetime gifts,⁵³ employing the vehicles of trusts, partnerships, and corporations.⁵⁴ The

45. The taxable estate was calculated by deducting the marital deduction and the \$60,000 exemption from the 1970 equity figures. The tax was computed by applying the pre-Tax Reform Act of 1976 tax rates, note 1 *supra*, to the taxable estate figures.

46. These amounts represent the November 1976 average equity of these farm classes, note 43 *supra*, reduced by the 1976 value of the portion of the farm's assets that would have been liquidated to pay the tax on the husband's death in 1970 (based on a 127% increase in equity from 1970 to November 1976). It is assumed that the wife has no property other than that inherited from her husband.

47. The taxable estate was calculated by deducting the \$60,000 exemption from the November 1976 equity figures. The tax was computed by applying the tax rates under prior law, note 1 *supra*, to the taxable estate and subtracting the appropriate (40%) credit for tax on prior transfers, I.R.C. § 2013.

48. These amounts represent one-half of farm equity as of November 1976. It is assumed that no attrition of the property inherited by the wife has occurred, that the taxes on the husband's death were paid from the share of his estate that passed to his children, and that the wife has no property other than that inherited from her husband.

49. Note 47 *supra*.

50. Note 39 *supra*.

51. Note 38 *supra*.

52. For example, if more than ten years intervened between the husband's death and the wife's death, her estate would be entitled to no credit for tax on his estate. I.R.C. § 2013. Alternatively, if the wife died first, owning none of the farm assets, and if the husband died in November 1976, the tax would be greater because no marital deduction would be allowed.

53. Although the Tax Reform Act of 1976 drastically reduced the tax advantages of lifetime gifts, substantial tax savings can still be achieved through gifts under the \$3,000 exclusion, I.R.C. § 2503(b), removing future appreciation of the gifted property from the donor's estate.

54. For discussion of estate planning techniques for farmers, see Boehlje & Boehlje, *supra* note 12; Brugh, *Structuring the Farm and Ranch Operation for Business and Estate*

figures in the table, however, serve to illustrate the point that the estate tax laws prior to the Tax Reform Act of 1976 posed a substantial threat to many farms, especially the larger farms that produce the bulk of this nation's agricultural output.

B. Illiquidity of Farm Estates

As the examples above indicate, there appears to be a serious lack of liquidity in farm estates. Congress and numerous commentators have asserted that this frequent illiquidity of farm estates results in the sale of many farms in order to pay estate taxes.⁵⁵ On the other hand, several authorities, on the basis of empirical studies, have maintained that illiquidity is not a serious or widespread problem.⁵⁶ In order to aid in resolving the dispute over liquidity, this section of this comment will demonstrate the extreme illiquidity of living farmers and examine several empirical studies of the estates of farmers who died in recent years.

One appropriate measure of an estate's liquidity is the ratio of estate taxes plus costs of administration to liquid assets minus debts.⁵⁷ If the ratio is one, greater than one, or negative, the estate is considered illiquid. When this formula is applied to farms owned by living farmers, it is clear that under prior law farms of average size or larger are, in the aggregate, grossly illiquid. If administration costs and state death taxes are assumed to be zero,⁵⁸ the liquidity ratios for living farmers are as follows:

Planning, 54 NEB. L. REV. 262 (1975); Hines, *Special Problems in Planning the Agricultural Businessman's Estate*, 7 INST. ON EST. PLAN. ch. 73-11 (1973); Kelley, *The Farm Corporation As an Estate Planning Device*, 54 NEB. L. REV. 217 (1975); Wright, *Estate Planning for Agricultural Interests*, 25 OKLA. L. REV. 1 (1972); *Contemporary Studies Project*, *supra* note 30.

55. HOUSE REPORT, *supra* note 3, at 30, reprinted at 3384; Hines, *supra* note 54, ¶ 73.1101.6; Wright, *supra* note 54, at 7-8; *Joint Hearing on Impact of Estate Taxes*, *supra* note 10, at 60 (statement of John Kraft); *House Estate Tax Hearings*, *supra* note 6, at 600, 603-04 (paper by Prof. John Hopkin); see Brugh, *supra* note 54, at 266.

56. *Contemporary Studies Project*, *supra* note 30, at 928-30; *House Estate Tax Hearings*, *supra* note 6, at 1319-30 (statement of Prof. James Smith).

57. *House Estate Tax Hearings*, *supra* note 6, at 1319 (statement of Prof. James Smith). Although Professor Smith included only financial assets as liquid assets, it seems reasonable to include stored crops as well. Note 39 *supra*. If his approach were used here, the liquidity problem of farm estates would appear to be even greater than the following figures indicate.

58. Note 33 *supra*. The previous assumptions regarding the absence of gain or loss from sale of farm assets and the absence of substantial life insurance, notes 34-35 and accompanying text *supra*, are also applicable to this analysis of farm liquidity.

		<u>U.S.</u> <u>Average</u>	<u>Class II</u>	<u>Class IB</u>	<u>Class IA</u>
Liquid assets ⁵⁹ less debts ⁶⁰		—\$14,648	—\$11,473	—\$36,569	—\$218,614
If husband leaves all to wife	Estate tax ⁶¹	29,700	47,786	88,903	233,351
	Liquidity ratio	—2.03	—4.17	—2.43	—1.07
If husband leaves one- half to wife	Estate tax ⁶²	\$ 3,900	\$10,940	\$30,390	\$100,744
	Liquidity ratio	—0.27	—0.95	—0.83	—0.46

Since liquid assets are insufficient in each case to cover debts, it may be more useful to examine the ratio of the estate's net liabilities to total nonliquid assets in order to determine the proportion of remaining (nonliquid) assets that would need to be liquidated to pay taxes and debts (unless the funds are provided by the heirs through borrowing, insurance, or otherwise).

		<u>U.S.</u> <u>Average</u>	<u>Class II</u>	<u>Class IB</u>	<u>Class IA</u>
Total nonliquid assets ⁶³		\$209,648	\$264,759	\$427,667	\$1,141,694
If husband leaves all to wife	Net liabili- ties ⁶⁴	—44,348	—59,259	—125,472	—451,965
	Ratio of net liab. to non- liquid assets	—0.212	—0.224	—0.293	—0.396
If husband leaves one- half to wife	Net lia- bilities	—\$18,548	—\$22,413	—\$66,959	—\$319,358
	Ratio of net liab. to nonliquid assets	—0.088	—0.085	—0.157	—0.28

Thus, if the husband's entire estate is left to his wife, even a farm of average size might need to liquidate over 20 percent of its assets that remain after exhausting all of its liquid assets by paying off debts. This proportion rises sharply as the size of the farm increases—class IA farms would be forced to liquidate as much as 40 percent of nonliquid assets (mostly production assets) to pay debts and estate taxes.

Two additional aspects of the liquidity problem should be pointed out. First, a comparison of net liabilities (for debts and taxes after exhaustion of liquid assets) with net farm incomes suggests that most sizable farms would find it difficult or impossible to pay debts and estate taxes (plus interest) out of net income.⁶⁵ If the husband's entire estate passed to his wife, after paying income taxes and providing a living for the farm family, neither a farm of average size nor a class II or IB farm would be able to pay a market rate of interest on its debts, much less repay the principal. A class IA farm could conceivably pay income taxes, provide a living, pay the interest on its \$450,000 debt, and repay the principal, although not within the lifetime of the heirs. At their deaths, these problems would be compounded. Alternatively, if only one-half the husband's estate passed to his wife, a farm of average size or larger could conceivably liquidate its debts over a reasonable period of time by using a portion of its net income to pay interest and principal. Second, if a typical farm does apply any substantial portion of liquid assets and net income

59. For a description of liquid assets and the source for their values, see note 39 and accompanying text *supra*.

60. For the source for and means of deriving the amount of farm debts, see note 38 *supra*.

61. Notes 37, 47 and accompanying text *supra*.

62. Notes 41, 49 and accompanying text *supra*.

63. Total nonliquid assets were computed by subtracting liquid assets from total farm assets as of November 1976. Total farm assets were computed by adding farm equity and debts. For these figures, see notes 43, 51 and accompanying text *supra*.

64. Net liabilities are equal to liquid assets less debts and estate taxes.

65.	<u>U.S. Average</u>	<u>Class II</u>	<u>Class IB</u>	<u>Class IA</u>
Net liabilities if husband's entire estate is left to his wife	—\$44,348	—\$59,259	—\$125,472	—\$451,965
Net liabilities if one-half of husband's estate is left to his wife	—18,548	—22,413	—66,959	—319,358
Net income (1975)	8,079	10,116	17,558	63,236

FARM INCOME STATISTICS, *supra* note 4, at 60.

to payment of estate taxes in addition to previously existing debts, it will probably suffer a serious reduction in net income because it would lack adequate liquid funds to operate efficiently.⁶⁶

The value of conclusions drawn from analysis of the liquidity of living farmers is obviously limited. It would be considerably more helpful to have information concerning the liquidity of the estates of farmers who died in very recent years. Unfortunately, statistics published by the Internal Revenue Service (IRS) on estate tax returns⁶⁷ are aggregated in a manner that makes it impossible to identify which information pertains to farm estates. One economist, Professor James Smith, succeeded, after a long and frustrating struggle, in obtaining computer tapes of estate tax returns from the IRS.⁶⁸ With that information, he attempted to measure the liquidity of estates of persons who died during 1972. He found that only about 6 percent of all estates could be considered illiquid but that about 16 percent of estates that included some farm or noncorporate business assets could be regarded as illiquid.⁶⁹ Thus, even the data presented by Professor Smith is highly aggregative in that it does not isolate estates containing farm assets, much less estates of decedents who were actually farmers.⁷⁰

Pointing out that the crucial issue is not liquidity of the estate, but liquidity of the heirs,⁷¹ Professor Smith analyzed data regarding the liquidity of surviving spouses and concluded that they had virtually no problem with illiquidity.⁷² This conclusion, however, does not shed any useful light on the liquidity problems of farm heirs following an intergenerational transfer, not enjoying the substantial tax savings permitted by the marital deduction.⁷³

66. See *House Estate Tax Hearings*, *supra* note 6, at 606-14 (paper by Prof. John Hopkin); notes 118-21 and accompanying text *infra*.

67. INTERNAL REVENUE SERVICE, *supra* note 33.

68. *House Estate Tax Hearings*, *supra* note 33, at 1312 (statement of Prof. James Smith). This struggle involved the combined efforts of Professor Smith, members of Congress, White House staff members, the Office of Statistical Standards, and other government agencies. *Id.*

69. *Id.* at 1320-21. In comparison, it is interesting to note that farms and small businesses represent about 15% of all taxpaying estates. *Id.* at 1486 (statement of Rep. Bella Abzug). Farms represent about 2 to 3% of all estates. *Id.*

70. It would be most helpful to have data concerning estates of farmers whose heirs desired to continue operating their farms, but this information cannot be gleaned from estate tax returns.

71. *House Estate Tax Hearings*, *supra* note 6, at 1322.

72. *Id.* at 1327.

73. It is probably reasonable to assume that many such heirs are themselves in a highly illiquid situation because of their own debts and farming operations.

Another attempt to discover the true extent of the liquidity problem was a study of the estates of 64 Iowa farmers probated from 1970 to 1973.⁷⁴ That study concluded that illiquidity was not a problem for those 64 estates.⁷⁵ There is serious doubt as to the significance of this finding, however, since 53 percent of the decedents left surviving spouses,⁷⁶ a factor that makes an enormous difference in the estate tax liability because of the marital deduction. In addition, 47 percent of the estates were still open at the time of the study,⁷⁷ leaving a substantial possibility that further expenses or debts might be incurred and perhaps the possibility that an audit might result in greater estate tax liability. The value of this study is further diminished by the fact that most of the property in the estates examined was valued prior to 1973.⁷⁸ Since the average value of farm real estate in Iowa more than doubled from 1973 to 1976,⁷⁹ the estate tax on farms of decedents who died in 1976 would be much greater than for those valued in 1970 to 1973. Thus, there is much more likely to be a serious lack of liquidity in farm estates in 1976 than there was prior to 1973.⁸⁰

There is, in sum, no satisfactory empirical data regarding the liquidity of estates (or heirs) of farmers who have died in very recent years. Nevertheless, the widely held belief that many farm estates do suffer from a serious lack of liquidity⁸¹ is amply justified in view of the extreme illiquidity of living farmers evidenced by the foregoing analysis.⁸² Since the average age of living farmers is about 51 years,⁸³ it is obvious that many of their estates will encounter a serious lack of liquidity unless effective (and probably costly) estate planning measures are taken quickly.

C. Inadequate Estate Planning

While it is apparent that proper estate planning would miti-

74. *Contemporary Studies Project*, *supra* note 30, at 803-04.

75. *Id.* at 928-30.

76. *Id.* at 990.

77. *Id.* at 900, 989. It is not clear from the study whether these estates were open for estate tax purposes or only for probate purposes.

78. *See id.* at 803-04.

79. FARM REAL ESTATE MARKET DEVELOPMENTS—1976, *supra* note 24, at 12.

80. This observation also applies to Professor Smith's study, which examined estates of persons who died in 1972. Notes 68-69 and accompanying text *supra*.

81. Sources cited note 55 *supra*.

82. Notes 58-66 and accompanying text *supra*.

83. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, CENSUS OF AGRICULTURE—1969, 2 GEN. REPORT ch. 3, at 177 (1973). As of 1969 nearly 17% of all farm operators in the United States were age 65 or older. *Id.*

gate the burden of estate taxes on family farms,⁸⁴ there appears to be a dangerous lack of awareness on the part of many farmers of their exposure to the estate tax and consequently a lack of adequate estate planning.⁸⁵ It also appears that farmers who are aware of their estate tax exposure are often unwilling or unable to implement effective estate planning measures.⁸⁶ Some estate planning devices, such as life insurance, may be too expensive for many farmers to employ without serious impairment of cash flow and a resulting decline in net income.⁸⁷ A further difficulty that may exist for farmers who are informed, able, and willing to employ estate planning techniques is the fact that ineffective or impracticable estate plans are often unwittingly adopted⁸⁸ on the advice of insurance salesmen, accountants, or attorneys who are not competent to deal with the unique and difficult problems of planning estates of farmers whose heirs desire to continue operation of the family farm.⁸⁹ This difficulty would seem to be especially significant in isolated rural areas, where an attorney tends to be a jack of all legal trades.⁹⁰

The general lack of awareness of the need for estate planning and the poor quality of estate planning methods used by farmers lend additional support to the view that farm estates typically suffer from a lack of liquidity because liquidity is closely correlated with adequate estate planning where farms are concerned.

84. *House Estate Tax Hearings*, *supra* note 6, at 1224 (statement of Richard Covey); sources cited note 54 *supra*.

85. Boehlje & Boehlje, *supra* note 12, at 172; *Contemporary Studies Project*, *supra* note 30, at 942, 967-69; *House Estate Tax Hearings*, *supra* note 6, at 419 (statement of Sen. Gaylord Nelson) (1976 Wisconsin survey found that only one-third of farmers questioned were aware of potential estate tax liability); *Senate Tax Reform Hearings*, *supra* note 10, at 1942 (statement of Luther Stearns).

86. See *Contemporary Studies Project*, *supra* note 30, at 968-69; *House Estate Tax Hearings*, *supra* note 6, at 797 (letter of Sarpy County, Nebraska, Board of Commissioners), 1451 (letter of Sen. Edward Kennedy).

87. See notes 65-66 and accompanying text *supra*. The cost of several hundred thousand dollars worth of life insurance would be prohibitive for many farmers, even those owning large farms, unless whole life were purchased when the farmer was fairly young.

88. Hines, *supra* note 54, ¶ 73.1106.1; *Contemporary Studies Project*, *supra* note 30, at 968-69.

89. See generally Boehlje & Boehlje, *supra* note 12, at 173; *Contemporary Studies Project*, *supra* note 30, at 940-41.

90. Hines, *supra* note 54, ¶ 73.1106.1; see *Contemporary Studies Project*, *supra* note 30, at 941-42.

III. ECONOMIC AND SOCIAL CONSEQUENCES OF EXCESSIVE ESTATE TAXATION OF FARMS

A. *Forced Liquidation of Farmland*

1. *Complete liquidation of farms*

The number of farms in the United States has steadily diminished since 1935, when there were 6,814,000 farms.⁹¹ As of 1976 the number had decreased to 2,785,780,⁹² and the United States Department of Agriculture (USDA) has predicted that this number will shrink another million by the year 2000.⁹³ Although countless other factors have contributed to this decline in the number of farms, it appears that the federal estate tax, in recent years, has forced the liquidation of a significant number of farms that would have remained in operation but for the tax.⁹⁴ While there is no direct empirical evidence as to the actual extent of this effect of the estate tax, there is good reason to believe that it exists. The burden of estate taxes on sizable farm estates has reached the level at which partial liquidation of production assets is often necessary to pay the estate tax.⁹⁵ Shrinkage of a farm through partial liquidation, which compounds the difficulties encountered at the trough of the family farm cycle,⁹⁶ typically causes a loss of efficiency⁹⁷ and a decline in farm income, problems that can easily lead to further shrinkage and eventually to complete liquidation of the farm. In addition, it is sometimes difficult to dispose of only a portion of a farm because its assets may not be readily divisible or may not be salable in piecemeal form.⁹⁸ Either of these factors could dissuade heirs from continu-

91. FARM INCOME STATISTICS, *supra* note 4, at 38.

92. AGRICULTURAL STATISTICS, *supra* note 6, at 417.

93. *House Estate Tax Hearings*, *supra* note 6, at 774 (statement of Joseph Hubenak). Others have estimated the loss of farms over the next 20 years at a more conservative 200,000 to 400,000. *Id.*

94. HOUSE REPORT, *supra* note 3, at 5, reprinted at 3359; *House Estate Tax Hearings*, *supra* note 6, at 588 (statement of Samuel Guyton); *Senate Tax Reform Hearings*, *supra* note 10, at 1942 (statement of Luther Stearns), 2294 (statement of Sen. Dick Clark).

95. Notes 29-52 and accompanying text *supra*.

96. *House Estate Tax Hearings*, *supra* note 6, at 1681 (article by Donald Kelley); Brugh, *supra* note 54, at 264-65; Hines, *supra* note 54, ¶ 73.1101.4. The family farm cycle refers to the cyclical rise and decline of farm efficiency attributable to age and experience of farm operators and to intergenerational transfer of farm management.

97. *House Estate Tax Hearings*, *supra* note 6, at 1706-07 (statement of L. E. Lohman).

98. *Senate Tax Reform Hearings*, *supra* note 10, at 2294 (statement of Sen. Dick Clark).

ing the farm operation and instead encourage them to liquidate the farm entirely.

Although the potential impact of estate taxes is typically greatest on class IA farms,⁹⁹ it seems unlikely that many of these farms have been completely liquidated as a result of heavy estate taxes because most large farms can absorb a reduction in size without a significant loss of efficiency.¹⁰⁰ In addition, large farms are more likely than smaller farms to be easily divisible for sale in piecemeal fashion. At least a few class IB and class II farms and farms of near-average size, however, may be forced into complete liquidation because of estate taxes. To the extent that the estate tax forces liquidation of relatively efficient farms, society is generally the loser in terms of agricultural output and efficiency.¹⁰¹

2. *Reduction of farms to less efficient sizes*

Although farm economies of size¹⁰² do not lend themselves to easy measurement and analysis, valuable empirical research has been done in this area.¹⁰³ In spite of the fact that there are wide variations both in types of farming, climates, soils, prices, dates of analysis, and methodologies of the studies¹⁰⁴ and in the efficiency of farms of the same size, type, and location due to differences in managerial skill, these studies provide useful insight into the impact of the estate tax on the economic efficiency of agriculture.

Empirical studies of economies of size in crop production tend to show that "a modern and fully mechanized 1-man or 2-man operation can produce efficiently and profitably, achieving all or nearly all of the economies of size."¹⁰⁵ At first glance, this

99. Notes 43-52 and accompanying text *supra*.

100. This conclusion is based on the fact that farms in class IB are often nearly as efficient as class IA farms. Compare note 105 and accompanying text *infra* with note 43 and accompanying text *supra*.

101. *House Estate Tax Hearings*, *supra* note 6, at 605 (paper by Prof. John Hopkin). For explanation of the efficiency implications of forced liquidations of farmland, see notes 102-17 and accompanying text *infra*.

102. The term "economies of size" refers to reductions in total cost per unit of production resulting from increases in the firm's output or in the quantity of resources employed by the firm.

103. See, e.g., J. MADDEN, ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, AGRICULTURAL ECONOMIC REPORT No. 107, ECONOMIES OF SIZE IN FARMING (1967) (summarizing numerous empirical studies); R. KRENZ, W. HEID, & H. SITLER, *supra* note 12, at 36-45 (analysis of rates of return).

104. J. MADDEN, *supra* note 103, at 2.

105. *Id.* at 35.

conclusion might seem to suggest that small farms are highly efficient, but a rough estimate of the value of farmland owned or operated by efficient one-man or two-man farms analyzed in these studies reveals that most of these farms operated land worth about \$300,000 to \$2,400,000 in 1976.¹⁰⁶ In order to determine farmers' equity in such farms, these values must be adjusted to eliminate rented land and debts and to add the value of machinery, stored crops, and other assets. Although it would be difficult to determine the proportion of land that was rented by these farms, it seems clear that they are *not* small farms. Instead, these farms, which represent the smallest size at which cost minimization can occur, are among the largest farms in terms of asset value and are therefore exposed to a very high potential estate tax liability.¹⁰⁷

Since a high estate tax liability often results in liquidation of part of a farm's real estate,¹⁰⁸ the estate tax ultimately reduces the efficiency of some farms operating at minimum cost output levels by causing them to shrink to a less efficient scale. The macroeconomic effect of the estate tax, however, depends on the use to which the liquidated farm assets are put and particularly upon the relative efficiency of farms that ultimately acquire these assets. While many farmers fear that huge corporations are gobbling up farmland and threatening to crowd out the family farm,¹⁰⁹ available statistics suggest that only a very insignificant portion of agricultural land is being purchased and operated by large corporations.¹¹⁰ To the extent, however, that farmland sold by

106. These values were estimated in the following manner: (1) farm acreages at cost-minimizing output levels (as determined by the studies, *id.* at 37-42, 45, 48-54) were ascertained; (2) per acre values of farm real estate in the localities of the farms studied, FARM REAL ESTATE MARKET DEVELOPMENTS—1976, *supra* note 24, at 16, 20, were multiplied by the acreages.

107. Notes 43-52 and accompanying text *supra*.

108. *Contemporary Studies Project*, *supra* note 30, at 934-35; notes 29-52 and accompanying text *supra*.

109. See *House Estate Tax Hearings*, *supra* note 6, at 775 (statement of Joseph Hubenak), 1712 (letter of Ralph Hofstad), 1732 (letter of Wayne and Laura Allen). This fear has resulted in severe restrictions on corporate involvement in agriculture in several states. *E.g.*, KAN. STAT. § 17-5901(a) (1974) (prohibiting any corporation from engaging in agricultural production unless it is a domestic corporation with ten or fewer shareholders (none of which can be corporations), does not "own, control, manage or supervise" over 5,000 acres of land, and complies with other stringent qualifications).

110. OFFICE OF COMMUNICATION, U.S. DEP'T OF AGRICULTURE, FACT BOOK OF U.S. AGRICULTURE, MISC. PUB. NO. 1063, at 28-29 (1976). But see *House Estate Tax Hearings*, *supra* note 6, at 775 (statement of Joseph Hubenak) (eight oil companies own about 65 million acres of farmland; Coca-Cola, RCA, and Standard Oil of California are involved in agricultural production).

efficient family farms is acquired and operated by such corporations, economic efficiency suffers because these firms have frequently been unsuccessful in their farming ventures¹¹¹ and certainly less efficient than most sizable family farms.¹¹² The effect on overall agricultural efficiency of a forced transfer of land from an efficient farm to a significantly smaller farm is similarly adverse in most cases since most small farms are substantially less efficient than larger farms.¹¹³ In other words, the resulting increase in the efficiency of the smaller farm is generally insufficient to offset the loss of efficiency by the larger farm.

In the great majority of cases, farmland sold by an estate is added to the operation of a large farm nearby.¹¹⁴ Since the efficiency gain by the acquiring farm is likely to be comparable to the efficiency loss of the decedent's farm,¹¹⁵ overall efficiency would appear to remain fairly constant in most forced sales of farmland by efficient farms¹¹⁶ if the transfers occurred without transactions costs or friction that induces a loss of efficiency dur-

111. Only 55% of farm corporation income tax returns showed a net profit in 1971. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1971, CORPORATION INCOME TAX RETURNS 10 (1976). For those farms the ratio of net income (less deficits) to business receipts was 0.016. *Id.* In comparison, 95% of farm proprietorships and 65% of farm partnerships showed a profit in 1971. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1971, BUSINESS INCOME TAX RETURNS 79, 115 (1975). The ratio of net profits to business receipts was 0.0591 for farm proprietorships and 0.062 for farm partnerships. *Id.* at 79, 111. The difference in profitability between family farms and large corporate farms is even greater than these statistics suggest because about 90% of farm corporations are closely held family businesses, OFFICE OF COMMUNICATION, U.S. DEP'T OF AGRICULTURE, note 110 *supra*, at 29, whose profitability is probably similar to that of proprietorships and partnerships. Thus, publicly held farm corporations must have been extremely unprofitable in 1971.

112. *House Estate Tax Hearings*, *supra* note 6, at 669 (statement of Rep. Berkley Bedell).

113. See J. MADDEN, *supra* note 103, at 38, 40, 44, 50, 58, 66-69 (graphs of cost curves for various types of farms).

114. See B. JOHNSON, ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, FARM-LAND TENURE PATTERNS IN THE UNITED STATES, AGRICULTURAL ECONOMIC REPORT No. 249, at 17-19, 24-25 (1974); *Senate Tax Reform Hearings*, *supra* note 10, at 2294 (statement of Sen. Dick Clark).

115. This statement assumes that the size of the decedent's farm is comparable to that of the acquiring farm—suggesting that, other things being equal, the two farms are of comparable efficiency. This assumption is not unreasonable in view of the fact that the bulk of farmland sales caused by estate taxes will be made by farms of larger than average size. See notes 43-52 and accompanying text *supra*; notes 156-60 and accompanying text *infra*.

116. To the limited extent that the estate tax forces transfer of farmland from inefficient farms to more efficient farms, long-run economic efficiency is increased. However, most small, inefficient farms are exempt from estate taxation because of their low values.

ing the period in which both the selling and acquiring farms are adjusting to their changes in size and output. However, because the real world is neither frictionless nor costless,¹¹⁷ even a transfer of land from one efficient farm to another generally results in economic inefficiency, at least in the short run.

B. Efficiency Loss from Providing Liquidity or Incurring Debt to Pay Estate Taxes

Obviously, many large farms could prevent the loss of farmland due to estate taxes by providing liquidity through acquisition of life insurance or other financial assets during the owner's lifetime. Another possible method of keeping a farm's real estate intact is borrowing by the heirs to procure funds to pay estate taxes, then repaying the debt out of the farm's net income.¹¹⁸ For many efficient farms, particularly in classes IB and II, neither of these solutions can be realistically employed, because the net income generated by these farms, after income taxes and a living allowance for the farm family, is not sufficient either to purchase large amounts of life insurance or to pay off debt incurred to pay estate taxes in addition to previously existing debts.¹¹⁹ In the case of class IA farms, whose net income averaged over \$63,000 in 1975,¹²⁰ the purchase of substantial amounts of life insurance appears to be feasible although there is serious doubt as to the ability of these farms to pay income taxes, provide a living, and pay estate taxes in addition to previously incurred debts.¹²¹

Assuming that the income of a given farm is adequate to permit acquisition of life insurance or to pay estate taxes in installments, there remains a strong probability that the use of either of these approaches will impair the farm's efficiency (and

117. There are substantial costs involved in transferring farmland from one operation to another: selling costs (*e.g.*, brokers' or auctioneers' fees), financing costs (interest, loan fees, time spent securing credit), and legal fees (title searches, document drafting, etc.). In addition, the transition period involves costs of adjusting both the transferor and transferee farms' labor, machinery, and other inputs to match their modified size and output levels.

118. This approach is roughly equivalent to the use of I.R.C. § 6166A (formerly § 6166), which some regard as the only special tax break that should be extended to farm estates. *E.g.*, *House Estate Tax Hearings*, *supra* note 6, at 511 (statement of Prof. David Westfall) (opposing any relief to farm estates other than liberalization of extended payment provisions), 1693-94 (statement of Hover Lentz) (also opposing special relief for farm estates other than liberalized installment payment provisions).

119. Notes 58-66 and accompanying text *supra*.

120. Note 65 *supra*.

121. Notes 65-66 and accompanying text *supra*.

reduce its future income stream) by diminishing the amount of funds available for replacement of obsolete or worn-out equipment, capital investment in more efficient machinery, and expansion of acreage. This diversion of funds into life insurance or estate taxes interferes with the farm's ability to maintain or increase its efficiency and consequently impairs the overall efficiency of the agricultural economy.

C. *Diversion of Farmland from Agricultural Use*

From 1960 to 1976, nearly 91 million acres of farmland were transferred to nonfarm uses—a disinvestment by the farming sector of over \$26 billion.¹²² Since the per acre value of this land averaged approximately two times the average value of all farmland¹²³ and since farmland near urban areas is typically more valuable than land in rural areas, it is probable that much of the land transferred out of agriculture was in or near urban areas.¹²⁴ The fastest population growth in the United States occurs in suburbs, and the fastest growing part of the suburbs is the "exurban" areas—the outermost fringes of the suburbs.¹²⁵ As the urban sprawl encroaches upon the supply of farmland, it increases the quantity of farmland in or contiguous to exurban areas.¹²⁶ As exurban perimeters expand, the percentage of total farmland whose value is strongly influenced by urban uses increases at an accelerating rate.

As of 1970, 13 percent of the nation's land area was in "standard metropolitan statistical areas," while 30 percent of all land in the northeastern region of the country was in such metropolitan areas.¹²⁷ This intensive urbanization in the Northeast is

122. BALANCE SHEET, *supra* note 4, at 29. This \$26 billion figure is based on market prices of the land sold in each year—not 1976 prices.

123. Compare BALANCE SHEET, *supra* note 4, at 29 with FARM REAL ESTATE MARKET DEVELOPMENTS—1976, *supra* note 24, at 6, 16.

124. See FARM REAL ESTATE MARKET DEVELOPMENTS—1976, *supra* note 24, at 33; ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, FARM REAL ESTATE MARKET DEVELOPMENTS 30-31 (1975).

125. *House Estate Tax Hearings*, *supra* note 6, at 732 (excerpt from New York Times, May 14, 1972).

126. *Id.* at 1639 (statement of Prof. Jack Clarke).

127. R. OTTE, ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, AGRICULTURAL ECONOMIC REPORT No. 250, FARMING IN THE CITY'S SHADOW—URBANIZATION OF LAND AND CHANGES IN FARM OUTPUT IN STANDARD METROPOLITAN STATISTICAL AREAS, 1960-70, at 8 (1974). This statistic understates the urban influence on farmland prices both because it ignores innumerable smaller cities and towns and because it is seven years old.

reflected by the price of farmland there. In New Jersey the average value of farm real estate in 1976 was \$2,852 per acre,¹²⁸ over six times the national average.¹²⁹ Similarly, in Massachusetts, Rhode Island, Connecticut, Pennsylvania, Delaware, and Maryland, the average value of farmland (in each state) exceeded \$1,000 per acre in 1976.¹³⁰

While it is clear that agriculture surrenders a substantial amount of its land to nonfarm uses every year,¹³¹ it is not at all clear to what extent the estate tax contributes to this disinvestment in farmland.¹³² Obviously, the high market value of farmland in urban areas exerts powerful pressure on farm owners to sell their land for nonagricultural development. The estate tax has become an additional source of pressure on farmers, sometimes forcing them (or their heirs) to sell land near urban areas for development purposes in order to pay the tax¹³³ because prior law required all property in an estate to be valued according to its highest and best use.¹³⁴ Moreover, farms in urban areas typically generate low income relative to their market value¹³⁵ and

128. FARM REAL ESTATE MARKET SUPPLEMENT, *supra* note 24, at 4.

129. The national average in November 1976 was \$445 per acre. *Id.* It should also be noted that the fertility and arability of land in the Northeast is substantially inferior to that in many other parts of the country.

130. *Id.* at 4; FARM REAL ESTATE MARKET DEVELOPMENTS—1976, *supra* note 24, at 16.

131. Note 122 and accompanying text *supra*.

132. Nevertheless, Congress provided for use valuation of farmland for estate tax purposes because the estate taxation of transfers of farmland based on fair market value appeared to be a significant factor in the loss of farmland to nonagricultural uses. See HOUSE REPORT, *supra* note 3, at 21-22, reprinted at 3375-76. Indeed, at least one scholar has argued that prevention of this artificially induced transfer of farmland to nonfarm uses is the sole justification for use valuation of farmland. *House Estate Tax Hearings, supra* note 6, at 1240 (statement of Prof. Michael Graetz).

133. HOUSE REPORT, *supra* note 3, at 21-22, reprinted at 3375-76; *Joint Hearing on Impact of Estate Taxes, supra* note 10, at 44 (statements of Sen. Walter Mondale and Sen. Hubert Humphrey); *House Estate Tax Hearings, supra* note 6, at 722 (statement of Edward McGinty). *Contra, id.* at 736 (excerpt from Baltimore Sun, May 19, 1974); *Revision of Federal Estate Tax Law: Hearing Before the Senate Comm. on Finance, 94th Cong., 2d Sess. 28 (1976)* (statement of Sen. Edward Kennedy).

The average value of real estate per farm in 53 rapid-growth counties in 1969 was \$128,150. K. ZEIMETZ, E. DILLON, E. HARDY, & R. OTTE, ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, AGRICULTURAL ECONOMIC REPORT NO. 325, DYNAMICS OF LAND USE IN FAST GROWTH AREAS 6 (1976). Adjusted to November 1976 prices, the value of land per farm in those areas is probably more than \$300,000. See FARM REAL ESTATE MARKET SUPPLEMENT, *supra* note 24, at 5; FARM REAL ESTATE MARKET DEVELOPMENTS—1976, *supra* note 24, at 6. The average value of real estate per farm in New Jersey in 1976 was \$363,400. *Id.* at 19. When livestock, machinery, and other assets are added to land values, it is clear that these farms were potentially subject to substantial estate taxes.

134. Notes 8-9 and accompanying text *supra*.

135. See FARM REAL ESTATE MARKET DEVELOPMENTS—1976, *supra* note 24, at 36.

consequently have even greater difficulty than rural farms in providing liquidity or paying estate taxes out of farm earnings.¹³⁶

The economic impact of this forced transfer of farmland out of agriculture involves several aspects. First, if the lost farmland is not replaced by reclamation of other land, the result is likely to be a permanent reduction in the potential supply of agricultural output, which leads to the conclusion that the price of farm produce is pushed upward by the shrinkage in supply of farmland, other things being equal. Second, even if some of the farmland lost to competing uses is replaced by new farmland, agriculture is likely to suffer a decline in efficiency by exchanging farmland already in a productive condition and proximate to markets and input supplies for more distant land that requires reclamation expenditures to render it as productive as the land lost.¹³⁷ Finally, although the sale of farmland for other uses theoretically leads to more efficient allocation of the entire society's resources by shifting land to its most valuable use,¹³⁸ the unequal pressure of estate taxes and the existence of other market imperfections¹³⁹ probably distort the relative values placed on different uses of land in favor of short-run efficiency while the optimal allocation of land in the long run may strongly favor agricultural use.¹⁴⁰ In the face of uncertainty as to the optimal allocation of land resources, it seems wise to err, if at all, in favor of preserving agricultural use of land because once land is committed to development, it cannot be restored to agricultural use without prohibitive cost. Such a policy of favoring agricultural use of land is particularly justified in connection with estate taxation because the pol-

136. See HOUSE REPORT, *supra* note 3, at 22, reprinted at 337. See also note 58-66 and accompanying text *supra*.

137. This conclusion rests on the assumption that if cheaper land elsewhere were as productive as the farmland lost, the cheaper land would have already been in production. The inefficiency caused by sale of farmland for development may be mitigated, however, by the resultant freeing of farm capital for investment in equipment and improved technology. See BALANCE SHEET, *supra* note 4, at 29.

138. See Hady, *Differential Assessment of Farmland on the Rural-Urban Fringe*, 52 AM. J. AGRICULTURAL ECON. 25, 31 (1970).

139. Examples of market imperfections that may unduly encourage the transfer of farmland out of agricultural use include income tax advantages of land development, zoning ordinances, real property taxes, and externalities (*e.g.*, the increased difficulty and cost of farm cultivation caused by the construction of fences, streets, highways, and buildings on adjacent property).

140. *House Estate Tax Hearings*, *supra* note 6, at 1493 (statement of Rep. Tom Hagedorn). While it is obviously speculative, this statement is worthy of consideration because it articulates one of Congress' reasons for special estate tax rules for farmland. See HOUSE REPORT, *supra* note 3, at 21-22, reprinted at 3375-76.

icy can be furthered merely by reducing or removing the legislatively created tax pressure encouraging sale of farmland for development—no affirmative governmental action is involved.¹⁴¹

D. Other Economic and Social Implications

To the extent that the estate tax forces the heirs of farmers to abandon their chosen occupation as farmers,¹⁴² a misallocation of human capital is the probable result. When a person is not only thoroughly trained to earn a living in agriculture but is also eager to do so, the substantial and valuable investment in human capital embodied in his experience is largely squandered if he is abruptly forced by the sheer weight of taxation to learn another vocation.¹⁴³ If he were instead free to make a choice, unbiased by the estate tax, whether or not to pursue a career in agriculture, his choice would be more likely to lead to an efficient allocation of human capital. In addition to these economic consequences, the compulsory dislocation of farm heirs is thought to cause significant social harm by destroying long-standing family traditions, threatening the livelihood of displaced families, eroding the image of the family farm as the symbolic essence of free enterprise,¹⁴⁴ and provoking intense resentment of a government that bites the hand that feeds its people.¹⁴⁵

Another significant aspect of the involuntary liquidation of farmland to pay estate taxes involves the steadily increasing pro-

141. This argument draws additional strength from the fact that the provision for use valuation is projected to reduce federal revenues by only \$14 million in fiscal 1978. HOUSE REPORT, *supra* note 3, at 8, *reprinted* at 3362. In other words, a valuable reduction in the pressure that promotes the sale of farmland for development purposes is purchased at minimal cost to the Treasury.

142. Although it is apparent that the estate tax has had this effect, HOUSE REPORT, *supra* note 3, at 5, 22, 30, *reprinted* at 3359, 3376, 3384, the precise extent of this problem is uncertain. See sources cited note 12 *supra*.

143. Obviously, such an individual generally has the option to seek employment in farming or agriculture-related jobs. Where this occurs, the negative impact on economic efficiency is mitigated. Unfortunately, it is not known how often this result ensues from forced liquidation of family farms. There is also the theoretical possibility that such an individual could purchase a farm elsewhere and resume his vocation. In recent years this method of entering farming has become increasingly difficult. A professor of economics at the University of Illinois has even maintained that farmland purchased today will never pay for itself. *House Estate Tax Hearings*, *supra* note 6, at 1488 (statement of Rep. Charles Thone); see also *id.* at 846 (statement of B. Powell Harrison).

144. *E.g.*, *House Estate Tax Hearings*, *supra* note 6, at 1475 (statement of Rep. William Hungate), 1479 (statement of Rep. Joseph Vigorito), 1488 (statement of Rep. John McCollister), 1490 (statement of Rep. David Bowen).

145. *E.g.*, *id.* at 1743 (letter of Helen Neary).

portion of farmland that is rented.¹⁴⁶ In view of the fact that farmland purchased at today's prices may never pay for itself in agricultural use,¹⁴⁷ the forced sale of farmland threatens to accelerate the growth of farmland rental because nonfarm interests, often intending to liquidate at handsome tax-preferred capital gains rates, can easily outbid farmers who desire to retain land as part of a family farm.¹⁴⁸ In other words, it is highly probable that an increasing percentage of farmland sold by estates will be acquired by nonfarm interests and rented to farmers.

This development, although economically useful in allowing flexibility of farm operations and more efficient utilization of equipment,¹⁴⁹ presents several serious difficulties. By increasing the proportion of farm income that is siphoned off to nonfarm landlords, the farm's capacity to finance capital replacement and expansion out of earnings may be less than it would be if the land were fully owned by its operator.¹⁵⁰ An accompanying consequence of this siphoning effect is the farmer's reduced ability to absorb losses due to poor weather or market conditions, especially under cash rental arrangements, which usually require the farmer to pay a fixed sum for land rental regardless of the farm's actual output or financial condition.¹⁵¹ Finally, the danger exists that the increasing proportion of farmland owned by nonfarm interests will weaken the incentives of independence and opportunity to own land and to transmit it to their children that have apparently helped motivate farmers to pursue a vocation that offers low returns to capital¹⁵² and an extremely low reward per hour of labor

146. 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) (proportion of farmland being rented has increased steadily since 1954) [hereinafter cited as FARM TENURE AND CASH RENTS]; B. JOHNSON, *supra* note 114, at 3 (37.5% of all land in farms was rented in 1969).

147. Note 143 *supra*.

148. Undoubtedly, an income-producing asset that appreciates at an annual rate in excess of 15%, note 25 and accompanying text *supra*, will attract nonfarm investors.

149. FARM TENURE AND CASH RENTS, *supra* note 146, at 3, 17.

150. In addition, the farmer has less land with which to secure credit for operating expenses.

151. Cash rental arrangements accounted for 20% of total land in farms and 55% of all farmland rented as of 1964. FARM TENURE AND CASH RENTS, *supra* note 146, at 1, 7. Cash rentals are expected to become increasingly common in the future. *Id.* at 16-17. Share rentals, which do not place the entire risk of crop failure on the farm operator, do not present this difficulty.

152. The average rate of return on farm capital is generally estimated at 2 to 3%. Brugh, *supra* note 54, at 266; Kelley, *supra* note 54, at 218; *House Estate Tax Hearings*, *supra* note 6, at 652-53 (statement of Rep. Mark Andrews).

expended¹⁵³ while exposing farmers to substantial risks and depriving them of many of the social and recreational amenities enjoyed by nonfarmers.¹⁵⁴ As these incentives dwindle, the price society pays for its food will surely rise. While it is clear that these effects of the growing significance of farmland rental would exist in the absence of estate taxation, the crucial point is that the estate tax tends to encourage these untoward consequences.

IV. SUMMARY OF ESTATE TAX RELIEF¹⁵⁵ FOR FARMS UNDER THE TAX REFORM ACT OF 1976

A. *Tax Relief Measures of General Applicability*

The most dramatic change in the estate tax laws is the significant increase in the maximum size estate that can be transferred without estate tax liability.¹⁵⁶ The Tax Reform Act of 1976 replaced the prior \$60,000 estate and \$30,000 gift exemptions with a unified estate and gift tax credit of \$30,000 (equivalent to an exemption of \$120,667) for estates of decedents dying in 1977.¹⁵⁷ This credit will be increased about \$4,000 each year until it reaches \$47,000 (equal to an exemption of \$175,625) in 1981.¹⁵⁸

153. It is difficult to estimate an average hourly "wage" for farm operators, but one can demonstrate that it is low by subtracting from average farm net income (\$8,079, note 65 *supra*) a 2.5% return, note 152 *supra*, on average farm equity (\$190,000, note 5 and accompanying text *supra*), leaving a residue of \$3,329 per year as compensation for labor and managerial effort. Assuming an average work week of 36 hours, see AGRICULTURAL STATISTICS, *supra* note 6, at 468 (5,283 million hours used for farm work in 1975), 418 (2,808 million farms in 1974), the hourly return on farm operators' labor is \$1.78 per hour.

154. Note 11 *supra*.

155. As its title suggests, the Tax Reform Act of 1976 provided tax relief in some areas and tax increases in others. Changes that tend to increase taxes include the new rules for carryover of basis, I.R.C. § 1023, certain aspects of the unification of gift and estate taxes, *id.* §§ 2001, 2010, 2502, 2505, and rules for taxation of generation-skipping transfers, *id.* §§ 2601-2622. Congress made numerous changes other than those described in this comment that tend to benefit taxpayers, but it would be beyond the scope of this comment to discuss each of these changes, which include simplification of gift tax filing, *id.* § 6075(b), exclusion of self-employment retirement benefits from the gross estate, *id.* § 2039(c), a new exclusion for orphans, *id.* § 2057, the qualification of certain trusts as Subchapter S shareholders, *id.* § 1371(f), access of taxpayers to IRS valuation information, *id.* § 7517, and amendment of the rules for taxation of property held jointly by husband and wife, *id.* § 2040(b).

156. The combined effect of the unified credit, *id.* § 2010, and the unified rate schedule, *id.* § 2001, will be a revenue loss of \$441 million in calendar 1977, increasing steadily to \$1.232 billion in calendar 1981. HOUSE REPORT, *supra* note 3, at 8, reprinted at 3362.

157. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a)(1)-(2), 90 Stat. 1846-48 (codified in I.R.C. §§ 2001, 2010).

158. I.R.C. § 2010. This change from an exemption to a credit was intended to increase the progressivity of the estate tax by reducing the tax on low-bracket estates and increasing it on high-bracket estates. HOUSE REPORT, *supra* note 3, at 15, reprinted at 3369.

Unfortunately, this change provides very little tax relief for estates consisting of farms in classes IA, IB, and II,¹⁵⁹ and the only farms that will benefit substantially from the new unified transfer tax rates and credit are the frequently inefficient farms of average and below average size that produce a relatively insignificant part of the nation's agricultural output.¹⁶⁰

Congress also expanded the former marital deduction, which allowed the value of qualifying transfers to the decedent's surviving spouse to be deducted to the extent of one-half of the adjusted gross estate.¹⁶¹ The new law allows a marital deduction equal to the *greater* of \$250,000 or one-half of the adjusted gross estate.¹⁶² While this change provides significant relief for interspousal transfers of estates worth less than \$500,000, it has no effect on estates worth more than \$500,000 or on intergenerational transfers. Thus, it offers little aid to farmers whose heirs want to continue operation of the family farm.

B. Specific Relief for Farm Estates¹⁶³

1. Extended payment provisions

Although prior law allowed installment payment of estate taxes attributable to farms and closely held businesses over a

159. See HOUSE REPORT, *supra* note 3, at 187, reprinted at 3438.

Computations based on the rates applicable to estates of persons dying in . . .	Estate tax on . . .		
	Class II farm	Class IB farm	Class IA farm
1976 (old law applicable)	\$47,786	\$88,903	\$233,351
1977 (\$30,000 credit; no use valuation)	40,897	85,915	242,586
1981 (\$47,000 credit; no use valuation)	23,897	68,915	225,586

For an explanation of the 1976 figures in this table, see notes 29-47 and accompanying text *supra*. The 1977 and 1981 figures are derived by applying the currently applicable tax rates, I.R.C. § 2001, the 40% credit for tax on previous transfers, *id.* § 2013, and the unified credit indicated above to the farm equity figures in note 43 *supra*. The calculations are all based on 1976 land values. Obviously, if farmland continues to appreciate at 15% per year, the taxes in 1981 will be much higher than those indicated here.

160. Farms other than those in classes IA, IB, and II account for only 11% of the nation's agricultural production. Note 43 and accompanying text *supra*.

161. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002, 90 Stat. 1854-56 (codified in I.R.C. § 2056).

162. I.R.C. § 2056(c)(1)(A).

163. The following provisions are also available to estates consisting primarily of closely held businesses, but this comment does not attempt to assess the value of these changes to nonfarm estates.

period of ten years¹⁶⁴ and discretionary extensions of up to ten years in cases of "undue hardship,"¹⁶⁵ Congress decided that additional opportunities for postponement of estate tax payment were needed.¹⁶⁶ The Tax Reform Act of 1976 created a new Internal Revenue Code section, section 6166, which permits qualifying estates to defer all payments of tax for five years, paying only 4 percent interest¹⁶⁷ during that period, and to pay the tax in equal installments over the next nine years following the five-year deferral period.¹⁶⁸ In addition, section 6161 was amended to allow discretionary extensions for "reasonable cause" rather than "undue hardship."¹⁶⁹ While the probable impact of this change in wording is difficult to assess, the effect of the five-year deferral of taxes at 4 percent rather than 7 percent interest is equivalent to a 15 percent tax cut for the first \$1 million worth of farm or closely held business property in the estate.¹⁷⁰ If the tax is then paid in ten annual installments, the 4 percent interest rate, as compared to a 7 percent rate, allows an additional savings of 13.5 percent—a total savings of 28.5 percent.¹⁷¹

2. *Use valuation of real property used in farms and closely held businesses*

Perhaps the most imaginative change wrought in the estate tax law by the Tax Reform Act of 1976 was introduction of section 2032A, which provides that qualifying real property, under certain circumstances, can be valued for estate tax purposes at "its value for the use under which it qualifies"¹⁷² rather than its fair market value. Since Congress intended to restrict the benefits of

164. I.R.C. § 6166A (formerly § 6166).

165. Small Business Tax Revision Act of 1958, Pub. L. No. 85-866, § 206(c), 72 Stat. 1684 (current version at I.R.C. § 6161).

166. HOUSE REPORT, *supra* note 3, at 30-31, reprinted at 3384-85.

167. The 4% interest rate is applicable only to the tax attributable to the first \$1 million of farm or closely held business property. *Id.* § 6601(j); HOUSE REPORT, *supra* note 3, at 31, reprinted at 3385.

168. I.R.C. § 6166(a). The 4% interest rate also applies to the installment payment period following the five-year deferral.

169. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2004(c)(1), 90 Stat. 1867-68 (codified in I.R.C. § 6161(a)).

170. This percentage is derived by computing the interest on a given sum for five years at 3% simple interest—the amount that is forgiven by the five-year deferral at 4% interest. The 7% interest rate has been effective since February 1, 1976. Rev. Rul. 75-487, 1975-2 C.B. 488.

171. When the interest rate under I.R.C. § 6621 is 9%, as was recently the case, the "tax savings" possible under § 6166 is 47.5%.

172. I.R.C. § 2032A(a)(1)(B).

section 2032A to estates consisting primarily of farms and small businesses that will continue to be operated by close relatives of the decedent after his death,¹⁷³ the circumstances under which use valuation is permitted are very limited. The remainder of this comment will examine the probable impact of section 2032A on farm estates, describe and evaluate the various features of the new section in light of public policy, and briefly consider its relationship to other provisions of the Internal Revenue Code.

V. IMPACT OF SECTION 2032A

The central feature of section 2032A is its formula for computing the use value of farm real property.¹⁷⁴ Although the statute also provides an alternative "multiple factor" valuation method for determining the use value of closely held business interests and of farmland in some cases,¹⁷⁵ the codified factors do not differ dramatically from those prescribed for determining fair market value.¹⁷⁶ Thus, the impact of this multiple factor valuation method, which is impossible to quantify, will probably not be spectacular.¹⁷⁷ On the other hand, section 2032A's use valuation formula allows relatively simple and precise calculation of use value.¹⁷⁸

In areas where urban development pressure on farmland prices is strong, the formula permits a drastic reduction in the value of farmland for estate tax purposes. In Maryland, for example, the formula yields a value of \$174 per acre¹⁷⁹ for cropland

173. HOUSE REPORT, *supra* note 3, at 21-22, *reprinted* at 3375-76.

174. This formula for use value (V) is $V = \frac{R - T}{i}$ where R = average annual gross cash rent for comparable land in the same locality in agricultural use; T = average real estate taxes; and i = average annual effective interest rate for all new Federal Land Bank loans. Each of these three elements of the formula is based on averages for the last five calendar years ending before the decedent's death. I.R.C. § 2032A(e)(7)(A). For detailed discussion of this formula, see notes 327-73 and accompanying text *infra*.

175. I.R.C. § 2032A(e)(8). For a listing of these factors, see text accompanying note 379 *infra*.

176. Compare *id.* with *Audit Technique Handbook for Estate Tax Examiners*, [1977] 1 INT. REV. MAN.—AUDIT (CCH) ¶¶ 551-54.

177. The benefit of multiple factor valuation will be inherently limited to businesses that are land-intensive. See generally note 237.

178. HOUSE REPORT, *supra* note 3, at 24, *reprinted* at 3378.

179. This figure was derived from cash rent data in FARM REAL ESTATE MARKET DEVELOPMENTS—1976, *supra* note 24, at 36; real estate tax information in ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, FARM REAL ESTATE TAXES—1975, at 14 (1977); ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, FARM REAL ESTATE TAXES—RECENT TRENDS AND DEVELOPMENTS 8 (1975); and Federal Land Bank interest rates in AGRICULTURAL STATISTICS, *supra* note 6, at 480. The interest rate for 1976 was estimated at 8.7% based on information in *Agriculture and Related Agencies Appropriations for*

worth \$1,138 to \$1,460 per acre,¹⁸⁰ eliminating 85 to 88 percent of the value of farmland from qualifying estates. Since an average farm in Maryland is 166 acres,¹⁸¹ use valuation allows a reduction of \$160,000 to \$213,000 in the average Maryland farmer's gross estate, largely shielding most qualifying farms of average size from estate taxes.¹⁸² In Pennsylvania, cropland that sells for \$870 to \$1,007 per acre¹⁸³ is valued at \$176 per acre¹⁸⁴ by section 2032A's formula, an 80 to 83 percent reduction in the value of farmland in qualifying estates. The average reduction in the value of pasture in Pennsylvania under section 2032A is about 81 percent—permitting pasture worth \$513 per acre to be valued at \$97 per acre.¹⁸⁵ The per acre reduction in the value of farmland in New Jersey is probably even greater than that in Maryland since the average value of New Jersey farmland in 1976 was \$2,852 per acre.¹⁸⁶ Obviously, the disparity between fair market value and use value as determined by the formula will generally be greatest in cases where farmland adjoins expanding suburban areas. In Wisconsin, for example, farmland in 1974 sold for as much as \$25,425 per acre.¹⁸⁷ Section 2032A would probably allow such property to be valued at about \$200 per acre—a reduction of over 99 percent.

In purely agricultural areas, the use valuation formula also produces striking reductions in the value of farmland for estate tax purposes, although not generally of the same magnitude as

1977: *Hearings Before the Subcomm. on Agriculture and Related Agencies of the House Comm. on Appropriations*, 94th Cong., 2d Sess. 379 (1976) (statement of Farm Credit Admin.). Estimates of cash rent and property taxes were employed in the few instances in which data was missing.

180. The lower of these values was derived from rents and rent-to-value ratios for 1976 in *FARM REAL ESTATE MARKET DEVELOPMENTS—1976*, *supra* note 24, at 36. The higher value is the average value of all farmland in Maryland. *FARM REAL ESTATE MARKET SUPPLEMENT*, *supra* note 24, at 4. Part of this discrepancy in values is probably due to the fact that the former information omits an entire crop district. See *FARM REAL ESTATE MARKET DEVELOPMENTS—1976*, *supra* note 24, at 36 n.2.

181. This figure was derived from *AGRICULTURAL STATISTICS*, *supra* note 6, at 418.

182. The average value of real estate per farm in Maryland was \$230,900 in 1976. *FARM REAL ESTATE MARKET DEVELOPMENTS—1976*, *supra* note 24, at 19.

183. These figures were derived as in note 180 *supra*.

184. This amount was calculated using the approach and sources cited in note 179 *supra*.

185. Notes 179-80 *supra*; *FARM REAL ESTATE MARKET DEVELOPMENTS—1976*, *supra* note 24, at 37. Property taxes on pasture were estimated by the author to be at one-half the level of taxes on cropland.

186. *FARM REAL ESTATE MARKET SUPPLEMENT*, *supra* note 24, at 4. The use value of farmland in New Jersey was not computed because of unavailability of cash rent data.

187. *House Estate Tax Hearings*, *supra* note 6, at 1497 (statement of Rep. Robert Kasten).

those in the Northeast. Kansas cropland worth an average of \$406 per acre is valued by the formula at \$235 per acre, a 42 percent reduction.¹⁸⁸ The formula appraises Kansas pasture at \$87 per acre, 66 percent less than its fair market value of \$254 per acre.¹⁸⁹ In North Dakota, cropland selling for \$325 per acre has a use value of \$194 per acre.¹⁹⁰ Iowa cropland, which yields the highest cash rent reported by the USDA, is valued under section 2032A at \$625 per acre, slightly over half its market value of \$1,233.¹⁹¹ The formula reduces the value for estate tax purposes of Wisconsin pastureland from \$254 to \$115 per acre.¹⁹² In Texas, pasture worth \$280 per acre is valued at only \$56 per acre, an 80 percent reduction.¹⁹³ Since average farms in most of these states utilize over \$200,000 worth of real property,¹⁹⁴ section 2032A permits a substantial reduction of estate taxes even in areas where development use plays no significant role in determining the value of farmland.¹⁹⁵

Unfortunately, the \$500,000 limitation¹⁹⁶ of section 2032A, which imposes a ceiling of \$500,000 on the amount by which the value of an estate can be reduced through use valuation, will severely curtail the benefit of use valuation to extremely large farms¹⁹⁷ and to farms near urban areas where relatively small farms with highly inflated real estate values will often collide with the \$500,000 limitation. If farmland prices continue to climb

188. This amount was derived from data in sources cited note 179 *supra*; ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, *FARM REAL ESTATE MARKET DEVELOPMENTS* 34 (1975).

189. This amount was derived from cash rent and rent-to-value ratio information in *FARM REAL ESTATE MARKET DEVELOPMENTS—1976*, *supra* note 24, at 37; note 179 *supra*. Real estate taxes were assumed to be 50% less than taxes for all farmland.

190. Note 179 *supra*.

191. *Id.*

192. Note 189 *supra*.

193. *Id.*

194. See *FARM REAL ESTATE MARKET DEVELOPMENTS—1976*, *supra* note 24, at 19.

195. Thus, contrary to the advice of some commentators, e.g., Case & Phillips, *Death and Taxes—The 1976 Estate and Gift Tax Changes*, 1976 ARIZ. ST. L.J. 321, 371 (asserting that § 2032A should not be used to value land whose highest and best use is for farming), § 2032A allows a reduction of 40 to 80% in the valuation of land whose highest and best use is for farming. For a brief discussion of reasons for this wide disparity between market value and use value in purely agricultural areas, see notes 9-11 and accompanying text *supra*.

196. I.R.C. § 2032A(a)(2). For a discussion of this provision, see notes 436-41 and accompanying text *infra*.

197. Since the average equity of class IA farms is over \$900,000, note 43 *supra*, it is likely that the \$500,000 limitation will adversely affect many such farms in the near future, especially as farmland values rise.

at a rate of 15 percent annually, this limitation will increasingly handicap section 2032A and frustrate its purposes.

VI. EVALUATION OF SECTION 2032A

A. General Evaluation

The basic criteria for evaluating section 2032A are the policies of revenue generation, wealth redistribution, equity, neutrality, preservation of the productive capacity of agriculture, simplicity, and administrative convenience.

Although solicitude for the protection of tax revenue often assumes a dominant position in the evaluation of tax laws, that concern fades into insignificance in evaluating section 2032A, whose projected revenue loss for fiscal 1978 is \$14 million, only 0.0037 percent of the federal budget.¹⁹⁸ Since the estate tax accounts for a relatively small proportion of federal revenues,¹⁹⁹ many have sought to justify its existence on grounds other than revenue generation. Chief among these grounds is the established national policy of redistributing wealth and income in favor of persons lacking such blessings.²⁰⁰ Since section 2032A will benefit only a small proportion of estates subject to transfer taxes, its macroeconomic impact on the goal of wealth redistribution will be negligible. Even in the relatively few instances where section 2032A is employed, the \$500,000 limitation²⁰¹ precludes a tax savings of more than \$350,000.²⁰² Moreover, an estate that avoids \$350,000 in taxes by virtue of section 2032A will still owe over \$2.5

198. See HOUSE REPORT, *supra* note 3, at 8, *reprinted* at 3362 (estimated revenue loss); BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, *supra* note 31, at 229 (1976 budget of \$373.5 billion). Fourteen million dollars is also an insignificant percentage (0.23%) of the total estate tax revenue of \$6 billion projected for fiscal 1977 (before the Tax Reform Act of 1976). See *House Estate Tax Hearings*, *supra* note 6, at 521 (statement of John Davidson). The revenue loss from use valuation is expected to increase by about \$1 million per year through 1981. HOUSE REPORT, *supra* note 3, at 8, *reprinted* at 3362. This expected rate of increase is well below that of the federal budget; thus, the revenue effect of use valuation of farmland for estate tax purposes will become even more insignificant in future years.

199. Immediately prior to the Tax Reform Act of 1976, the estate tax generated about 1.5% of federal revenues. *House Estate Tax Hearings*, *supra* note 6, at 351 (statement of Robert Brandon), 521 (statement of John Davidson).

200. *Id.* at 28 (statement of Rep. Omar Burleson), 1176 (statement of Charles Walker), 1646-48 (article by Allen Larson). *Contra, id.* at 743 (statement of Gerald Moran).

201. I.R.C. § 2032A(a)(2); notes 436-41 and accompanying text *supra*.

202. See I.R.C. § 2001(c) (maximum tax rate of 70%).

million in estate taxes²⁰³—hardly escaping the pangs of wealth redistribution.

Probably the strongest objection to section 2032A is its inherently unequal treatment of estates that are equal in size but consist of different types of assets.²⁰⁴ For example, application of the section results in a lower tax on a qualifying estate composed primarily of farmland than on an estate of equal value that is composed largely of marketable securities. Although section 2032A appears at first glance to violate the policy of equity,²⁰⁵ *i.e.*, equal treatment of persons similarly situated, such a conclusion must assume that an estate consisting of \$500,000 worth of farm assets is and ought to be treated as equal to an estate consisting of \$500,000 worth of stocks and bonds. These two estates are essentially equal if the heirs in both cases promptly liquidate the property they inherit.²⁰⁶

If, on the other hand, one who inherits a farm estate continues to operate the farm rather than liquidate it, there seems to be ample justification for the conclusion that the farm estate is not equivalent to the estate consisting of long-term bonds or General Motors stock, for example, and consequently should not be obligated to pay the same amount of tax as the nonfarm estate.²⁰⁷ The rate of return realized on farm assets is 2 to 3 percent, assuming a trivial wage for labor expended by the farm operator and no compensation for his entrepreneurial effort and risk-taking.²⁰⁸

203. In order for an estate to avoid \$350,000 in taxes under section 2032A, it would have to be in a 70% marginal tax bracket. Estates in the 70% bracket will generally have a tax liability of \$2.5 million or more. *See id.*

204. *See House Estate Tax Hearings, supra* note 6, at 1213 (statement of Richard Covey), 1703 (statement of Robert Branch).

205. Another relevant aspect of equity is equality of opportunity to enter agriculture for persons who desire to do so. Some fear that special tax treatment of farm estates will lead to the monopolization of agriculture by a hereditary landowning class. *See Small Business Tax Reform: Joint Hearings Before the Senate Select Comm. on Small Business and the Subcomm. on Financial Markets of the Senate Comm. on Finance*, 94th Cong., 1st Sess. 1590-93 (1976) (article by Harold Breimyer and Michael Boehlje). However, this problem is unlikely to materialize because the circumstances in which § 2032A may be used are quite limited and because many farm heirs have no desire to continue operating the family farm after the owner's death.

206. This raises questions as to the appropriate treatment of farm estates when several heirs sell their shares of the farm to another heir who continues to operate the farm. Section 2032A permits use valuation of an entire farm even though part or all of it may be sold by the heirs to other family members. Notes 303-09 and accompanying text *infra*.

207. This sort of reasoning should not be extended into other areas to allow special tax treatment of other types of assets (*e.g.*, art works, antiques, etc.) unless there are compelling policy reasons for doing so.

208. Notes 152-53 *supra*.

One who inherits liquid assets, however, can easily realize a 6 percent rate of return with no risk and receive substantial additional income as compensation for his services.²⁰⁹ This stark contrast between estates that are nominally equal in value provides reasonable justification for regarding these two types of estates as being unequal in value to their heirs. Therefore, the goal of equity, as defined above,²¹⁰ is not violated by taxing the farm estate at a lower rate than the other estate.

Even if one rejects the conclusion that a farm estate is not equivalent to an estate consisting of liquid assets, the policy of preserving family farms and promoting the efficiency of agricultural production may outweigh the goal of equity. That Congress seems to hold this view is evidenced by the existence of tax deferral and extended payment provisions for farms and closely held businesses.²¹¹ Similarly, Congress created section 2032A primarily because it wanted to lessen the tendency of the estate tax to handicap, fragment, and destroy family farms and to accelerate the sale of farmland for development use.²¹²

Although the goal of preserving family farms and agricultural use of land owes a substantial share of its popularity in Congress to an emotional, nostalgic feeling that the family farm symbolizes America's heritage and the free enterprise system,²¹³ it also rests on the policy of enhancing the productive capacity of American agriculture.²¹⁴ Efforts to preserve individual family farms, however, exert conflicting pressures on the efficiency of the agricultural industry as a whole. On the one hand, reduction of estate taxes on farms may increase economic efficiency by diminishing the burden of the tax on efficient, productive farms.²¹⁵ On the other hand, diminution of estate taxes may impair efficiency in many cases by insulating small, inefficient farms from the pressure that estate taxes apply in favor of the transfer of land to more efficient farm operations.

209. See also note 11 *supra*. One could readily convert liquid assets into savings accounts, certificates of deposit, bonds, or other risk-free investments commonly yielding a return of 6% or more.

210. Text accompanying note 205 *supra*.

211. I.R.C. §§ 6166, 6166A; HOUSE REPORT, *supra* note 3, at 30-31, reprinted at 3384-85.

212. See HOUSE REPORT, *supra* note 3, at 5, 21-22, reprinted at 3359, 3375-76.

213. Note 144 and accompanying text *supra*.

214. See *House Estate Tax Hearings*, *supra* note 6, at 588 (statements of E. H. Shoemaker and Samuel Guyton), 775 (statement of Joseph Hubenak), 1493 (statement of Rep. Tom Hagedorn), 1681 (article by Donald Kelley), 1705-07 (statement of L. E. Lohman).

215. Notes 108-43 and accompanying text *supra*.

A substantial amount of congressional concern about the desirability of use valuation of farmland was focused on "neutrality"—the goal of minimizing tax-induced distortion of behavior and its adverse effects.²¹⁶ Congress justifiably feared that a substantial tax reduction for estates consisting largely of farmland would induce wealthy persons to invest heavily in farmland in order to reduce estate taxes and thereby drive the price of land to an artificially high level.²¹⁷ Most of the numerous restrictions and qualifications of section 2032A are intended to avert both this problem and the inequity of reducing taxes on farm estates in cases where the family of the decedent does not continue the farm operation. Although Congress succeeded to a large extent in achieving neutrality, it left several loopholes in section 2032A that may lead to perverse consequences. These loopholes and other defects of the statute will be discussed subsequently.²¹⁸

Finally, section 2032A should also be judged against the criteria of simplicity, clarity, and ease of administration. While some have argued that use valuation is a deceptive method of reducing taxes on farm estates,²¹⁹ there is little merit to such a

216. See, e.g., *House Estate Tax Hearings*, *supra* note 6, at 773 (statement of William Cantwell) ("[T]he best tax law is a law which tends to conform with classic and typical patterns of action on the part of taxpayers rather than one which either shapes those actions or is seriously at odds with them."), 1290-91 (statements of Richard Covey and Prof. Carl Shoup).

217. *Id.* at 450-51 (statements of Rep. Al Ullman and Sen. Charles Mathias), 883 (statement of Rep. Floyd Fithian); *Revision of Federal Estate Tax Law: Hearing Before the Senate Comm. on Finance*, 94th Cong., 2d Sess. 29-30 (1976) (statement of Sen. Edward Kennedy); see *House Estate Tax Hearings*, *supra* note 6, at 723, 728-29 (statement of Edward McGinty). This fear was justified in view of England's experience with artificially high land prices that were partially due to deathbed purchases of farmland made solely to take advantage of preferential estate tax rates on farmland. *Id.* at 1291 (statement of Prof. Carl Shoup); *Small Business Tax Reform: Joint Hearings Before the Senate Select Comm. on Small Business and the Subcomm. on Financial Markets of the Senate Comm. on Finance*, 94th Cong., 1st Sess. 1587 (1976) (paper by Profs. Allen Bock, Ralph Hepp, and Gerald Harrison). For a brief outline of England's statutory scheme for taxing farm property at 55% of the normal estate tax rate (as of 1975), see I. STEPHENSON, *THE LAW RELATING TO AGRICULTURE* 163-64 (1975). Recent legislative reforms have attempted to curb these problems. See Finance Act of 1975, c. 7, §§ 35, 49(2); Finance Act of 1976, c. 40, § 74; *Small Business Tax Reform: Joint Hearings Before the Senate Select Comm. on Small Business and the Subcomm. on Financial Markets of the Senate Comm. on Finance*, 94th Cong., 1st Sess. 1587 (1976) (paper by Profs. Allen Bock, Ralph Hepp, and Gerald Harrison).

218. Text accompanying notes 239-45, 250-57, 274-83, 303-10, 320-26, 333-34, 345-52, 394-95, 402-06, 436-41 *infra*.

219. *House Estate Tax Hearings*, *supra* note 6, at 1290, 1302-03 (statements of Richard Covey). Mr. Covey apparently feels that any means of reducing taxes on a certain type of estate is deceptive if it is not a simple, direct percentage reduction from the taxes paid by other estates. See *id.*

contention. Use valuation is probably much less deceptive than certain extended payment provisions that permit five-year deferral and nine-year installment payment of estate taxes.²²⁰ This deferral at an artificially low interest rate of 4 percent results in a tax savings of over 28 percent.²²¹ The charge of deceptiveness also fails to appreciate the valuable flexibility of the use valuation formula²²² in adjusting to changes in interest rates, farm income, and property taxes, as well as ironing out much of the disparity in taxes on farm estates that is due to geographical variations in land prices.

Other critics predict that use valuation will substantially complicate estate planning and result in even more litigation of valuation disputes than when valuation is based on fair market value.²²³ The accuracy of this prediction will be tested largely by the passage of time, but it seems reasonable to assume that section 2032A will generally reduce the magnitude of the interests of taxpayers and the IRS that hinge on a determination of market value. Although use valuation will inevitably lead to some litigation, the formula of section 2032A, despite certain ambiguities,²²⁴ is sufficiently precise that it will probably be the subject of litigation far less often than is market value. Moreover, it is difficult to estimate whether use valuation will complicate estate planning. Since it offers substantial tax reduction in many cases,²²⁵ the benefits of use valuation may more than compensate for its complicating effects. Section 2032A also makes an invaluable contribution by reducing the wide disparity in tax burdens between well-planned and unplanned farm estates. Another factor mitigating the criticism of undue complexity is the fact that section 2032A, although formidably long and complex at first glance, does not seriously tax the faculties of persons familiar with estate planning or the Internal Revenue Code. The typical family farm estate will comfortably fit within its provisions with little or no estate planning effort.

Obviously, many of the policies relevant to section 2032A clash in varying ways. The policy of preserving the productive capacity of agriculture may conflict with the goals of revenue

220. I.R.C. § 6166.

221. Note 170 and accompanying text *supra*.

222. Notes 370-73 and accompanying text *infra*.

223. *E.g.*, Lecture by Luther Avery, ABA Nat'l Inst. on Est. & Gift Tax Provisions of the Tax Reform Act of 1976 (Oct. 14 & 28, 1976).

224. Text accompanying notes 333-34, 343-49, 358-62 *infra*.

225. Notes 179-95 and accompanying text *supra*.

generation,²²⁶ wealth redistribution, and equity. However, the statutory scheme Congress devised for use valuation of farmland implements the policy of protecting agriculture in a manner that seeks to minimize the adverse effects on competing policies. In devising this tax benefit for farm estates, Congress endeavored to restrict the benefit narrowly to avoid creating an unnecessarily large loophole, but did so at the expense of the goal of avoiding complexity in the law. Despite certain defects in its design and drafting, section 2032A achieves a respectable balance of these competing policies.

B. Qualifications for Use Valuation

1. At decedent's death

In order for real property²²⁷ in a decedent's estate to be valued at its use value for estate tax purposes, the decedent, at the time of his death, must have been a citizen or resident of the United States.²²⁸ In addition, the real property owned by the decedent must be situated within the United States²²⁹ and must have been in a qualified use on the date of his death.²³⁰ Qualified use means devotion of the property to "use as a farm for farming purposes"²³¹ or "use in a trade or business other than . . . farming."²³² While this definition of qualified use covers virtually any active²³³ commercial use of property, the use valuation formula is available

226. It is possible, however, that the overall effect of use valuation may be an increase in tax revenues because it will allow more farms to continue to operate at efficient levels, see notes 95-141 and accompanying text *supra*, thereby increasing income tax revenues. This increase in income tax revenue could conceivably offset the \$14 million per year revenue loss due to use valuation.

227. Section 2032A does not permit use valuation of any assets other than real property. However, the statute provides that certain improvements on real property are also eligible for use valuation:

[R]esidential buildings and related improvements on such real property occupied on a regular basis by the owner or lessee of such real property or by persons employed by such owner or lessee for the purpose of operating or maintaining such real property, and roads, buildings, and other structures and improvements functionally related to the qualified use shall be treated as real property devoted to the qualified use.

I.R.C. § 2032A(e)(3). For further explanation of this provision, see HOUSE REPORT, *supra* note 3, at 23-24, reprinted at 3377-78.

228. I.R.C. § 2032A(a)(1)(A).

229. *Id.* § 2032A(b)(1).

230. *Id.*

231. *Id.* § 2032A(b)(2)(A).

232. *Id.* § 2032A(b)(2)(B).

233. Notes 258-64 and accompanying text *infra*.

only for farm property.²³⁴ Nonfarm property is eligible for use valuation only on the basis of the alternative multiple factor valuation method,²³⁵ which is apt to be much less attractive to executors than the relatively precise use valuation *formula* because of the multiple factor method's uncertainty of application.²³⁶ Since section 2032A applies only to real property, it will probably be of little value to estates consisting mainly of nonfarm businesses except those that are land intensive.²³⁷ Fortunately, Congress included a broad definition of the terms "farm" and "farming purposes" in section 2032A.²³⁸ By so doing, a considerable amount of litigation may have been avoided because the use valuation formula is clearly made available for almost any conceivable agricultural or horticultural business.

Although most estates containing real property used in a farm or other business easily satisfy the foregoing conditions re-

234. I.R.C. § 2032A(e)(7)(A).

235. *Id.* § 2032A(e)(8). For a discussion of this valuation method, see notes 374-81 and accompanying text *infra*.

236. This uncertainty may be reduced somewhat in the course of time as regulations are promulgated and case law develops. These interpretations of the multiple factor valuation approach should be consistent with the legislative intent—to value qualifying real property at its value in its *current* use and to disregard its value in other uses as well as its speculative value. See HOUSE REPORT, *supra* note 3, at 22, *reprinted* at 3376.

237. Nonfarm land-intensive businesses might include quarries, sand and gravel excavating operations, junkyards, auto speedways, drive-in theaters, zoos, game preserves, dude ranches, amusement parks, golf courses, athletic fields, airports, and ski resorts. Obviously, several of these enterprises are nearly always publicly owned.

238. I.R.C. § 2032A(e)(4)-(5):

(e) Definitions; special rules. For purposes of this section—

...
(4) Farm. The term "farm" includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands.

(5) Farming purposes. The term "farming purposes" means—

(A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;

(B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and

(C) (i) the planting, cultivating, caring for, or cutting of trees, or

(ii) the preparation (other than milling) of trees for market.

garding citizenship or residence of the decedent and location and qualified use of property, the 50-percent and 25-percent tests of section 2032A(b)(1) will probably deny many of those estates the benefit of use valuation. The 50-percent test requires that at least 50 percent of the adjusted value of the gross estate, meaning the gross estate less deductions allowable under section 2053(a)(4),²³⁹ consist of the adjusted value²⁴⁰ of *real or personal* property that was employed in a qualified use on the date of the decedent's death and "was acquired from or passed from the decedent to a qualified heir of the decedent."²⁴¹ The obvious purpose of this requirement is to restrict use valuation to estates that consist primarily of farm or small business assets. Congress apparently believed that other estates have sufficient liquidity to cope with estate taxes without destroying the family farm or business or that the policy of protecting family enterprises should not extend to cases where the farm or business does not account for a major share of the decedent's property.

The difficulty with this approach, however, is illustrated by the fact that the dominance of farm or business property in the decedent's estate is not a consistent measure of either liquidity or the significance of the farm or business to the decedent or his heirs. Through ordinary estate planning practices, liquid (or non-liquid) assets can be removed from the decedent's estate, increasing the proportion of his estate that is attributable to the farm or business. Although such estate planning distorts the gross estate as a basis for qualification under section 2032A, it would be extremely difficult to devise a workable alternative basis that would accurately reflect the overall liquidity picture²⁴² and the impor-

239. *Id.* § 2032A(b)(3)(A). The term "adjusted value of the gross estate" should not be confused with the adjusted gross estate, a quantity that is relevant to the marital deduction and certain extended payment provisions. *Id.* § 2056(c), 6166(a), (b)(6). The deductions allowed by § 2053(a)(4) are "for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate."

240. The phrase "adjusted value" here means fair market value of the property less any deductions allowable under § 2053(a)(4) in respect of such property. *Id.* § 2032A(b)(3)(B).

241. *Id.* § 2032A(b)(1)(A). The meaning of the phrase "was acquired from" is obscure. It may have been intended to refer to gifts within three years of the decedent's death, notes 461-64 and accompanying text *infra*, but there is no evidence that such a meaning was intended. The committee report merely says that the real property "must pass to a qualified heir." HOUSE REPORT, *supra* note 3, at 22, reprinted at 3376. For definition and discussion of the term "qualified heir," see notes 295-97 and accompanying text *infra*.

242. It would be particularly difficult to devise a qualification scheme based on liquidity of the heirs—the only relevant aspect of liquidity according to at least one

tance of the farm or business as a source of family income. In this regard, Congress, because of the need for simplicity and ease of administration of the tax law, was probably forced to allow the benefit of use valuation to some undeserving estates that have been manipulated to fit within section 2032A.

The foregoing critique also applies to the 25-percent test. This test requires that at least 25 percent of the adjusted value of the gross estate consist of the adjusted value of *real* property that passes to a qualified heir of the decedent and satisfies the eligibility requirements for the period preceding the decedent's death.²⁴³ This test can often be met by planning the decedent's estate so that nonfarm assets are excluded in order to make the farm real property represent a disproportionately large share of the gross estate. If this device is carried to the extreme, an estate that includes a trivial amount of farmland with a very wide disparity between its market value and use value can be planned so that enough of the other assets are removed from the estate to ensure that the land with a high market value readily satisfies the 25-percent test, which is based on fair market value. By virtue of the use valuation formula, this land could then largely or even completely escape estate taxation even though it may not be operated on a serious commercial basis.

Despite the difficulties involved with these percentage requirements, it would not be desirable to increase the percentages substantially in an effort to ward off abuse. To do so would disqualify many unplanned farm or business estates that deserve and need the benefit of use valuation.²⁴⁴ In short, the policy of preserving family enterprises probably outweighs the policies of equity and neutrality in this instance. It is important to observe that the most productive family farms could generally satisfy the percentage tests comfortably even with no estate planning.²⁴⁵

scholar. See *House Estate Tax Hearings*, *supra* note 6, at 1322 (statement of Prof. James Smith).

This defect of § 2032A could perhaps be remedied in part by expanding the "grossing up" approach to include *all* lifetime gifts, by requiring inclusion of insurance on the decedent's life in his estate, and by adopting a test that takes into consideration the proportion of the family's income that is generated by the farm or other business. Such a complex solution is unlikely to materialize in the near future. This approach would bear some resemblance to that employed in UNIFORM PROBATE CODE § 2-202 (augmented estate concept used for computing elective share of surviving spouse).

243. I.R.C. § 2032A(b)(1)(B). For a discussion of these eligibility requirements, see notes 246-83 and accompanying text *infra*.

244. See *House Estate Tax Hearings*, *supra* note 6, at 1685 (article by Donald Kelley).

245. See BALANCE SHEET, *supra* note 4, at 3, 43.

2. *Prior to the decedent's death*

Three conditions must be satisfied for at least five of the eight years preceding the decedent's death in order to qualify for use valuation of real property in his estate.²⁴⁶ First, the property must have been owned by the decedent or a member of his family.²⁴⁷ Second, the property must have been devoted to use for farming or some other business.²⁴⁸ Third, there must have been "material participation by the decedent or a member of the decedent's family in the operation of the farm or other business."²⁴⁹

a. *Ownership.* The requirement of ownership of the land by the decedent or a member of his family for five of the eight years immediately preceding the decedent's death is clear and straightforward in most situations. For purposes of section 2032A, the term "member of the family" is liberally defined to include all of one's ancestors, lineal descendants, lineal descendants of one's grandparents, spouses of any of the above, and the individual's spouse.²⁵⁰ The statute further provides that "a legally adopted child of an individual shall be treated as a child of such individual by blood."²⁵¹

The definition of family members needs to be reasonably broad to allow flexibility in estate planning, adaptability to varying situations, and equitable treatment of farm estates in cases where the decedent leaves no children but has other close relatives who want to operate his farm. Congress, however, may have been overly liberal in defining family members so broadly. The spouse of the decedent's first cousin twice removed, for example, qualifies as a family member.²⁵² In the typical family farm situation, it would probably be desirable to include ancestors, descendants, siblings (and their descendants), and spouses in the definition, but it is questionable whether the same status should be extended to cousins and their spouses. In addition to possible problems resulting from this rather broad definition of family

246. I.R.C. § 2032A(b)(1)(C). No more than five years is required to avoid recapture. See *id.* § 2032A(c)(7)(B).

247. *Id.* § 2032A(b)(1)(C)(i).

248. *Id.*

249. *Id.* § 2032A(b)(1)(C)(ii).

250. *Id.* § 2032A(e)(2).

251. *Id.*

252. The spouse of the decedent's first cousin twice removed would qualify as a family member because the statute includes spouses of all lineal descendants of the decedent's grandparents as members of the decedent's family. *Id.* An example of one who is a first cousin twice removed is a grandchild of a first cousin.

members, the statute's treatment of adopted children as equivalent to natural children may permit abuse or cause confusion. By unqualifiedly equating adopted children with natural children, Congress may have opened the door to the inclusion of blood relatives of adopted persons as qualifying family members. This concern applies especially to cases in which the decedent was an adopted child; he may have as members of his family two complete sets of ancestors, lineal descendants of his grandparents, and spouses of the foregoing. Another difficulty may arise because of the occasional adoption of adults. Neither the statute nor its legislative history expressly disqualifies adoptions motivated by tax avoidance purposes. Thus, a wealthy person contemplating death could obtain the benefit of use valuation of farmland in his estate by adopting a farmer and purchasing his land if the buyer lives at least five years thereafter and the farmer continues farming the land during that time. Presumably, Treasury regulations, IRS procedures, and court decisions will promptly make it clear that such maneuvers will not be sanctioned for purposes of section 2032A.²⁵³

The apparent purpose behind the requirement of family ownership for at least five years before the decedent's death is to discourage acquisitions of farmland for the primary purpose of reducing estate taxes.²⁵⁴ The assumption underlying this approach is that nonfarmers are unlikely to commit a large portion of their wealth to a relatively low-yield form for a period long enough to ensure that the five-year holding period is satisfied.²⁵⁵ Critics of this holding period requirement maintain that it is not essential to the purpose of special tax rules for farms—to permit the family to continue operating the farm *after* the owner's death. They also point out that the holding period defeats the purpose of the law in situations where a bona fide farmer purchases land

253. Although § 2032A and its legislative history are silent on this point, the generally restrictive tenor of the statute strongly suggests that Congress did not intend § 2032A to benefit estates in cases where ownership of the decedent's farmland does not pass to a genuine family member. This view is further strengthened by the fact that Congress expressly disqualified tax-avoidance motivated adoptions for purposes of the orphans' exclusion. HOUSE REPORT, *supra* note 3, at 60, reprinted at 3414. See also Rev. Rul. 76-255, 1976-2 C.B. 40 (couple that obtains a foreign divorce solely for tax avoidance with intent to remarry after the end of the tax year will be considered married for tax purposes).

254. See *House Estate Tax Hearings*, *supra* note 6, at 723, 728 (statement of Edward McGinty).

255. *Id.* This assumption may be erroneous in view of the fact that farmland has become attractive as an investment because of its rapid rate of appreciation. Note 148 and accompanying text *supra*.

to expand his operation but dies within five years after the purchase.²⁵⁶ In this general clash between the goal of neutrality, *i.e.*, preventing nonfarmers from acquiring farmland in order to reduce estate taxes, and the policies of equity and preservation of family farms, Congress apparently believed that neutrality was of greater importance. Although such a judgment is difficult to evaluate, it appears to be reasonable except for the occasionally serious problem of premature death of genuine farmers who did not satisfy the holding period.²⁵⁷

b. Use. The statute's requirement that real property must have been devoted to use for farming purposes or in another trade or business for five of the eight years before the decedent's death in order to qualify for use valuation²⁵⁸ will probably create little difficulty in most cases where the corresponding ownership requirement is met. Nevertheless, disputes may arise occasionally as to whether a certain type or level of activity constitutes "use" for farming or other trade or business purposes. Both the statutory language defining "farming purposes"²⁵⁹ and the committee report²⁶⁰ suggest that Congress intended that the benefit of use valuation be limited to property in *active* use.²⁶¹ Thus, property that is idle or in disuse, such as woodlands, orchards, or fields that are not systematically grazed, planted, cultivated, or harvested, should not qualify for use valuation.²⁶² Such an interpretation of "use" seems to be in harmony with section 2032A's purpose "to encourage the continued *use* of property for farming and other small business purposes."²⁶³ In this regard it is also signifi-

256. *House Estate Tax Hearings*, *supra* note 6, at 1685 (article by Donald Kelley); *Senate Tax Reform Hearings*, *supra* note 9, at 1955 (statement of Richard Covey).

257. This problem may not be serious enough to justify the complexity involved in devising and administering a rule that requires a bona fide business purpose for an acquisition of land by the decedent less than five years before his death. Even if recently acquired land is not eligible for use valuation, the bulk of the decedent's farmland would still qualify in most cases. Moreover, there are probably few instances in which decedents, whose average age is about 70 years, have purchased land within five years before their deaths.

258. I.R.C. § 2032A(b)(1)(C)(i).

259. *Id.* § 2032A(e)(5). This provision is quoted in note 238 *supra*.

260. HOUSE REPORT, *supra* note 3, at 21, reprinted at 3375 ("actually used for farming purposes"); *id.* at 23, reprinted at 3377 ("mere passive rental of property will not qualify"). But see *id.* at 22, reprinted at 3376 ("used or held for use as a farm or closely held business") (emphasis added).

261. Support for this view can be found in the material participation test, whose key word is "production." See Treas. Reg. § 1.1402(a)-4(b)(1) to 4(b)(4) (1963). For quoted portions of this regulation, see text accompanying notes 270-72 *infra*.

262. See I.R.C. § 2032A(e)(5).

263. HOUSE REPORT, *supra* note 3, at 22, reprinted at 3376.

cant that Congress rejected Senate versions of use valuation legislation that would have allowed use valuation of "open space" and historical sites, with no requirement of active use.²⁶⁴

c. *Material participation.* The third requirement of section 2032A pertaining to the period before the decedent's death is that the decedent or a member of his family²⁶⁵ materially participate in the operation of the farm or other business for five of the eight years prior to the decedent's death.²⁶⁶ The statute dictates that material participation is to be determined "in a manner similar to the manner used for purposes of paragraph (1) of section 1402(a)."²⁶⁷ The pertinent portion of section 1402(a), which defines net earnings from self-employment, is section 1402(a)(1)(B).²⁶⁸ This clause provides that one of the requirements for the inclusion of real estate rentals in self-employment income is "material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity."²⁶⁹

The Treasury regulations under section 1402(a)(1) describe in considerable detail the types of activities that amount to material participation.²⁷⁰ They indicate that material participation means actual participation "to a material degree in the production or in the management of the production of . . . commodities" or participation in both production and management of production to an extent that both types of activities combined constitute participation to a material degree.²⁷¹ The regulations further provide:

264. H.R. REP. NO. 94-1515, 94th Cong., 2d Sess., 610, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 4249. For analysis of various bills that contained such provisions, see STAFF OF HOUSE COMM. ON WAYS AND MEANS, 94TH CONG., 2D SESS., BACKGROUND MATERIALS ON FEDERAL ESTATE AND GIFT TAXATION 55-56 (Comm. Print 1976).

265. For definition and discussion of the term "family member," see notes 247-53 and accompanying text *supra*.

266. I.R.C. § 2032A(b)(1)(C)(ii).

267. *Id.* § 2032A(e)(6).

268. Section 1402(a)(1)(A) is not relevant to use valuation because it concerns an oral or written "arrangement" that includes provisions requiring material participation. Treas. Reg. § 1.1402(a)-4(b)(3)(i) (1963). For purposes of § 2032A, such an agreement is not required—only the *existence* of material participation is required.

269. I.R.C. § 1402(a)(1)(B). The parenthetical phrase "as determined without regard to any activities of an agent of such owner or tenant" was added in 1974. Act of Aug. 7, 1974, Pub. L. No. 93-368, § 10(b), 88 Stat. 422. This amendment directly overrules Treas. Reg. § 1.1402(a)-4(b)(5) (1963), which has not yet been revoked.

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

271. *Id.* § 1.1402(a)-4(b)(4). For detailed definitions and descriptions of the terms "production" and "management of production," see *id.* § 1.1402(a)-4(b)(3)(ii) to 4(b)(3)(iii).

If the owner or tenant shows that he periodically advises or consults with the other person, who . . . produces the agricultural or horticultural commodities, as to the production of any of these commodities and also shows that he periodically inspects the production activities on the land, he will have presented strong evidence of the existence of the degree of participation contemplated by section 1402(a)(1). If, in addition to the foregoing, the owner or tenant shows that he furnishes a substantial portion of the machinery, implements, and livestock used in the production of the commodities or that he furnishes or advances funds, or assumes financial responsibility for a substantial part of the expense involved in the production of the commodities, he will have established the existence of the degree of participation contemplated by section 1402(a)(1) and this paragraph.²⁷²

Guidelines issued by the IRS for farmers are even more explicit in defining material participation as activity that meets any of the following tests:

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

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

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

Test No. 4. You do things which, considered in their total effect, show that you are materially and significantly involved in the production of the farm commodities.²⁷³

This borrowing of the material participation test from section 1402(a)(1) raises several difficulties. Since the regulations and IRS guidelines interpreting that section were drafted with farm production in mind,²⁷⁴ they are not directly applicable to

272. *Id.* § 1.1402(a)-4(b)(4). For a similar definition of material participation, see Rev. Rul. 57-58, 1957-1 C.B. 270.

273. INTERNAL REVENUE SERVICE, FARMER'S TAX GUIDE, INCOME AND SELF EMPLOYMENT TAX, IRS PUBLICATION 225, at 53-54 (1973) *paraphrased in* [1977] 1 FEDERAL TAX GUIDE (CCH) ¶ 796.

274. See text accompanying notes 272-73 *supra*.

nonfarm businesses. Although such factors as advising, consulting, inspecting production activities, furnishing equipment, and advancing funds provide useful guidance in determining participation in nonfarm businesses, they should be viewed as illustrative rather than prescriptive of the approach to be taken for non-farm businesses.

A more serious difficulty, however, is that since the regulations and IRS guidelines under section 1402(a)(1) focus on the degree of participation required to transform rental income into self-employment income, they may lead to undesirable results when applied in the context of section 2032A, where the focus should be on the degree of participation that ought to be required of a farm owner or his heirs to qualify for a reduction in estate taxes. In this respect, the policy of encouraging "the continued use of property for farming and other small business purposes"²⁷⁵ would be well served by the present broad definition of material participation, which may permit use valuation of a good deal of land that would not qualify under more restrictive standards. However, certain restrictive tests, such as a requirement that the owner or a member of his family provide the primary source of management of the farm or business and devote a substantial portion of his vocational activities thereto, would probably harmonize the policies of equity, neutrality, and preservation of family farms and businesses.²⁷⁶ Although this test may reduce the amount of land that qualifies for use valuation, it would do so primarily by screening out hobby farms and bad faith attempts to gain the benefit of use valuation. In short, from a policy standpoint, such a stricter participation test offers definite advantages over the section 1402(a)(1) material participation standard.²⁷⁷

275. HOUSE REPORT, *supra* note 3, at 22, reprinted at 3376.

276. Such a stricter test would improve neutrality by discouraging arrangements contrived solely to achieve a tax savings under § 2032A. At the same time, equity would be increased because farm heirs would not obtain the benefit of use valuation unless they or their family members were primarily responsible for the farm operation. The stricter test would achieve these benefits without violating the policy of preserving family farms because most family farms would easily satisfy the stricter test.

277. In addition, such a standard might avoid much of the administrative difficulty that the present material participation test is capable of creating. See notes 279-83 and accompanying text *infra*. Perhaps the chief advantage of adopting the material participation test of § 1402(a)(1) for purposes of use valuation is that its parameters have already been defined to some extent by regulations and IRS guidelines, but there is no case law dealing with the material participation test. However, this slight short-run advantage does not outweigh the benefits to be gained by employing a more appropriate standard. Even this slight advantage may prove to be illusory because of the substantial possibility that two different material participation tests (one for § 1402 and one for § 2032A) will evolve

Nevertheless, despite its deficiencies, the existing material participation standard is now law and will probably remain so for a long time. In the typical family farm situation, the existing requirement of material participation before the farm owner's death will be easily satisfied either by his personal involvement in the operation of the farm or by the activities of his children. Since section 2032A requires material participation for only five years of the eight-year period ending on the date of the decedent's death, Congress has made it possible for estates to qualify for use valuation even if there is no material participation by the decedent or any member of his family during the three years immediately prior to his death. The rule was probably drawn in this manner to avoid inequity in cases where serious illness precluded active involvement in the farm operation by the decedent.²⁷⁸ Such a precaution was probably unnecessary because it seems likely that if family members plan to operate a farm after the owner's death, at least one of them would also be able to satisfy the material participation requirement during the decedent's illness.

In many cases, however, the extent of involvement in a farm or business that is required to constitute material participation cannot easily be determined. While Congress has unambiguously declared its intention that "[t]he mere passive rental of property will not qualify,"²⁷⁹ the minimum level of participation required for section 2032A is far from definite. If the IRS guidelines are applied literally, material participation may be satisfied merely by 100 hours of work devoted to farm production activities during a five-week period.²⁸⁰ For example, one who desires to invest in farmland and obtain the benefit of section 2032A might attempt to satisfy the material participation requirement by hiring or otherwise inducing one of his children, grandchildren, or other family members to work on the farm part-time for a few weeks or months during the summer. This example illustrates the difficulty of applying the material participation test of section 1402(a)(1) to section 2032A situations. One hundred hours of work during a five-week period may provide an appropriate basis for inclusion of the owner's share of the crop for which he worked in his self-

over a period of time because of the fundamental differences between the purposes and policies underlying the two sections.

278. See *House Estate Tax Hearings*, *supra* note 6, at 873 (statement of Rep. Marvin Esch).

279. HOUSE REPORT, *supra* note 3, at 23, *reprinted* at 3377.

280. See text accompanying note 273 *supra*.

employment income, but that amount of labor may not even approach the level of participation that Congress envisioned as sufficient to qualify for use valuation of farmland. Even if Congress intended one hundred hours of labor during a five-week period to qualify as material participation, thorny problems will arise in determining the period of time for which that labor will satisfy the material participation requirement.²⁸¹ The problems may be even more treacherous where the labor is devoted, not to crop production, but to any of a wide range of other activities commonly conducted on farms.²⁸²

For purposes of estate planning, one would be well advised to ensure that the farm owner or a member of his family contribute much more than 100 hours a year to the farm operation, by way of either managerial involvement or farm labor. To avoid arguments by the IRS that such participation covers only a portion of the year,²⁸³ the efforts expended by the owner or family member should be spread over as much of the year as is feasible for the type of farm operation involved.

3. *After decedent's death*

a. *Election and agreement.* Within the time prescribed for filing the decedent's estate tax return, an election must be made in order to permit valuation of the decedent's farm or business real property at its use value.²⁸⁴ In conjunction with this election a written agreement must be filed, designating the property that is to be valued at its use value in the estate and evidencing by signature the consent of "each person in being who has an interest (whether or not in possession) in any property designated . . . to the application of subsection (c) with respect to such property."²⁸⁵

281. This period of time could be as little as five weeks or as long as an entire year, but a more reasonable period would perhaps be (1) the length of time during which labor is necessary to produce the crop involved or (2) the growing season of that crop. Because of the very large variety of crops and farming operations, material participation issues will generally be questions of fact necessarily resolved on a case-by-case basis.

282. Such other activities include livestock-related work, machinery repairs, fence-building, general maintenance or construction of farm buildings, etc.

283. If the IRS were to prevail with such an argument, the result might well be a recapture triggered by a failure to fulfill the material participation requirement for at least five years in every eight-year period.

284. I.R.C. § 2032A(a)(1)(B), (d)(1). The manner of making the election will be prescribed by regulations. *Id.* § 2032A(d)(1). Although the statute is silent on the issue of revocability of the election, it is probably safe to assume that the election is irrevocable. One can, however, achieve the practical equivalent of a revocation by triggering recapture (e.g., by selling the land or converting it to a nonqualifying use).

285. *Id.* § 2032A(d)(2), (a)(1)(B), (b)(1)(D). Subsection (c) sets out the recapture

The requirement of designation of the property for which use valuation is elected²⁸⁶ suggests that the executor is not forced to make an all-or-nothing decision with respect to use valuation. Instead, it appears that some real property that could qualify under section 2032A may be valued at its fair market value in the estate. Logic demands such a rule because the estate may be forced to sell part of the land to pay death taxes and because the family may not wish to retain all of the decedent's land or to continue using it in the farm or business. In addition, there may be sound tax reasons for selective application of section 2032A by an executor. Since the basis of property acquired from a decedent is affected by the property's value for estate tax purposes,²⁸⁷ the benefit of use valuation should be weighed against its adverse effect on depreciation deductions for buildings and other depreciable realty²⁸⁸ and its capacity to increase the amount of capital gain that is taxed if the property is sold.²⁸⁹ In some cases it may also be desirable to reduce the amount of land valued under section 2032A in an estate in order to qualify for the five-year deferral of tax under section 6166.²⁹⁰

Congress evidently chose to require the written consent of each person who has an interest in the property to ensure that if a recapture event occurs the additional tax will be collected and to avoid unfairness to an heir of the property who receives no tax benefit from the use valuation election, but who becomes personally liable for any recapture tax imposed with respect to his interest in the property.²⁹¹ In many cases, the agreement will require

provisions. The statute mentions no deadline for filing of the agreement, but the committee report says that "[o]ne of the requirements for making a *valid* election is the filing with the estate tax return a written agreement" HOUSE REPORT, *supra* note 3, at 27, reprinted at 3381 (emphasis added).

286. I.R.C. § 2032A(b)(1)(D).

287. *Id.* § 1023(h)(2); H.R. REP. NO. 94-1515, 94th Cong., 2d Sess., 613, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 4252. See also I.R.C. § 1023(g)(1).

288. As a practical matter, § 2032A may have little impact on depreciable real estate because of the probable lack of "comparable land" from which to determine the gross rent element of the formula. See I.R.C. § 2032A(e)(7)(B)(i). Under the alternative multiple factor valuation method, *id.* § 2032A(e)(8), the use value of depreciable farm real property will often be very near its market value because of the frequent unsuitability of such property for nonfarm use.

289. If sale of the property (or another event) triggers recapture, however, it would seem reasonable to adjust the basis of the property to what it would have been if use valuation had not been elected.

290. Notes 450-54 and accompanying text *infra*.

291. HOUSE REPORT, *supra* note 3, at 27, reprinted at 3381. Congress also stated that "such a consent also amounts to a consent to be personally liable for any recapture tax imposed with respect to the qualified heir's interest in the qualified property." *Id.*

the consent of a small number of persons, generally adults.²⁹² Where the decedent's testamentary scheme is more complex, such as in the case of a generation-skipping trust, the consent of a larger number of persons may often be required. Since some of these persons may be children, appointment of guardians may be necessary to obtain the children's consent.²⁹³ In cases where the persons whose consent is required have potentially conflicting interests, it may even be necessary for each of them to be represented by separate counsel.²⁹⁴

b. *Transfer to qualified heir.* Another postmortem condition for eligibility under section 2032A is that the qualifying real property pass to a qualified heir of the decedent.²⁹⁵ The statute defines a qualified heir as "a member of the decedent's family who acquired such property (or to whom such property passed) from the decedent."²⁹⁶ In view of the broad statutory definition of family members discussed above,²⁹⁷ most farm estates will easily satisfy this condition.

c. *Fifteen-year restrictions.* Once the qualified property has passed to a qualified heir, three additional conditions must be met for the next fifteen years in order to maintain eligibility for use valuation. First, the qualified heir must not dispose of any interest in the property to anyone other than a member of his family.²⁹⁸ Second, the qualified heir must continue to devote the property to farming or other business use.²⁹⁹ Finally, there must be material participation by the decedent, the qualified heir, or members of their families in the operation of the farm or business for more than five years of every eight-year period *ending* after the decedent's death.³⁰⁰ It should be noted that the first of these

292. Since most persons die at an advanced age, their children, to whom their property typically passes if there is no surviving spouse, will generally be adults.

293. *But see* Treas. Reg. § 1.1373-2(a), T.D. 7012, 1969-2 C.B. 246 (for purposes of a Subchapter S election, consent of a minor shareholder "shall be made by the *minor* or by his legal guardian, or his *natural guardian* if no legal guardian has been appointed") (emphasis added).

294. ABA CODE OF PROFESSIONAL RESPONSIBILITY Disciplinary Rule 5-105, Ethical Considerations 5-14 to 20 (1974); Avery, *supra* note 223.

295. I.R.C. § 2032A(b)(1)(A)(ii)-(B), (c)(1); HOUSE REPORT, *supra* note 3, at 22, reprinted at 3376.

296. I.R.C. § 2032A(e)(1).

297. The definition of the term "members of the decedent's family," *id.* § 2032A(e)(2), is discussed in notes 250-53 and accompanying text *supra*.

298. I.R.C. § 2032A(c)(1)(A).

299. *Id.* § 2032A(c)(1)(B), (c)(7)(A), (b)(2).

300. *Id.* § 2032A(c)(1)(B), (c)(7)(B). The rule is actually somewhat more complicated than this summary suggests. For a more complete explanation of the rule, see notes 317-23 and accompanying text *infra*.

continuously floating eight-year periods *begins* seven years and 364 days prior to the decedent's death. If any of these conditions is not met, an additional tax becomes due six months after the date of disposition of the property or cessation of qualified use.³⁰¹ If the qualified heir dies during the fifteen-year period, all of these conditions are waived for the period subsequent to his death without incurring liability for any additional tax.³⁰² If an election under section 2032A is made by the deceased qualified heir's estate, a new fifteen-year recapture period begins to run at that time.

Disposition. The requirement that the qualified heir refrain from disposing of any interest in the qualified property to anyone other than a member of his family³⁰³ was intended to avoid the windfall to the decedent's beneficiaries that could result from valuing his property at its use value for estate tax purposes and then selling it at full market value.³⁰⁴ At the same time, the rule was intended to allow use valuation of land passing from the decedent to heirs who sell the land to another family member because they have no desire to be involved in the farm or business operation.³⁰⁵ While the latter of these desirable aims is achieved by section 2032A, the former may be frustrated to a considerable degree because of improvident drafting of the statute, which provides that "[i]f a qualified heir disposes of any interest in qualified real property to any member of *his* family, such member shall thereafter be treated as the qualified heir with respect to such interest."³⁰⁶

This provision permits the qualified heir (whose relationship to the decedent may be as remote as spouse of the decedent's first cousin several times removed³⁰⁷) to sell the land at full value to

301. I.R.C. § 2032A(c)(5). "Cessation of qualified use" refers both to termination of farm or other business use and to the failure to satisfy the material participation requirement for the requisite period of time. *Id.* § 2032A(c)(7).

302. *Id.* § 2032A(c)(1). This provision was included to avoid the problems of overlapping recapture periods.

303. *Id.* § 2032A(c)(1)(A).

304. HOUSE REPORT, *supra* note 3, at 22, *reprinted* at 3376.

305. Although it is reasonable to permit such sales without recapture where the land is sold to close family members (*e.g.*, sister selling to brother), it is more difficult to justify a special tax reduction where the land is sold to distant relatives (*e.g.*, spouse of first cousin twice removed). See notes 250-53 and accompanying text *supra*.

306. I.R.C. § 2032A(e)(1) (emphasis added). Similar language is used in § 2032A(c)(1)(A). It is doubtful that Congress intended that the statute be drafted in this manner. See HOUSE REPORT, *supra* note 3, at 26-27, *reprinted* at 3380-81 (referring to sales or other dispositions "by one qualified heir to another *qualified heir*") (emphasis added).

307. Notes 250-52 and accompanying text *supra*.

any member of *his* family without triggering the additional tax. Since *his* family includes all of his ancestors and descendants, the descendants of his grandparents, the spouses of any of the above, and his own spouse,³⁰⁸ he can sell the land to persons who are not even remotely related to the decedent without losing the tax benefit of section 2032A. This potential for abuse is compounded by the statute's treatment of the family member-purchaser as a qualified heir, freeing that person to sell the land to any member of *his* family without causing recapture. If he does so, the new purchaser becomes a qualified heir, and the pattern can repeat itself ad infinitum, continuously avoiding recapture of the additional tax. By allowing the tax-free sale of farmland to persons unrelated to the decedent, the statute violates the legislative intent expressed by Congress:

However, your committee recognizes that it would be a windfall to the beneficiaries of an estate to allow real property used for farming or closely held business purposes to be valued for estate tax purposes at its farm or business value unless the beneficiaries continue to use the property for farm or business purposes, at least for a reasonable period of time after the decedent's death. Also, your committee believes that it would be inequitable to discount speculative values if the heirs of the decedent realize these speculative values by selling the property within a short time after the decedent's death.³⁰⁹

A possible legal impediment to the use of this totally unjustifiable loophole is the "substance-over-form" doctrine, which dictates that the incidence of taxation is controlled by the economic substance of a transaction rather than its form.³¹⁰ In the context of successive transfers of land described above, the IRS would probably argue that in substance this series of transactions amounts to the direct transfer of the land by the original qualified heir to the ultimate purchaser. If this reasoning prevails, the additional tax will be recaptured. Although this doctrine often involves difficulties of proof and persuasion, it will probably succeed in some cases in thwarting tax avoidance through transfers to persons who are not members of the original qualified heir's

308. I.R.C. § 2032A(e)(2).

309. HOUSE REPORT, *supra* note 3, at 22, reprinted at 3376.

310. See, e.g., *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). For discussion of this doctrine, see Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440 (1968). Certain elaborations of the substance-over-form doctrine, such as the step transaction doctrine and the business purpose test, may occasionally be useful in this context.

family. This result would be consistent with the purposes of section 2032A. Because the IRS may occasionally fail to thwart this species of tax avoidance, however, the only satisfactory remedy for this defective legislation is another act of Congress.

Section 2032A is silent as to the intended scope of the term "disposition." The committee report, however, indicates that the word is meant to include gifts,³¹¹ sales, taxable exchanges, exchanges that are tax-free under section 1031, involuntary conversions,³¹² rollovers, and similar transactions that are nontaxable by reason of sections 1033 or 1034.³¹³ The statute provides for partial recapture of the additional tax on a pro rata basis when a partial disposition occurs.³¹⁴

Use. The requirement of continued use of the property valued under section 2032A for farming or other business purposes for fifteen years after the decedent's death³¹⁵ is nearly identical, except for the difference in time periods, to the corresponding requirement for the period prior to the decedent's death.³¹⁶

Material participation. The third fifteen-year condition for use valuation eligibility after the decedent's death is the requirement of material participation.³¹⁷ More specifically, the statute provides that the qualified use ceases if

during any period of 8 years ending after the date of the decedent's death and before the date of the death of the qualified heir, there had been periods aggregating 3 years or more during which—

(i) in the case of periods during which the property was

311. HOUSE REPORT, *supra* note 3, at 26, *reprinted* at 3380.

312. An involuntary conversion or condemnation is *not* intended to be a disposition for recapture purposes "if the proceeds are reinvested in the real property which originally qualified for special use valuation." *Id.* at 25, *reprinted* at 3379. Since it is improbable that one would reinvest the proceeds of an involuntary conversion in the original property that was converted or condemned, Congress must have meant to say "if the proceeds are reinvested in similar real property to be used for a qualifying use."

313. *Id.* The tax-free transfer of property pursuant to I.R.C. §§ 351 or 721, however, is not to be treated as a disposition if the qualified heir retains the same equitable interest in the property, the transferee corporation or partnership is a closely held business as defined in § 6166(b)(1), and the transferee consents to personal liability for recapture under § 2032A(c). HOUSE REPORT, *supra* note 3, at 25 n.3, *reprinted* at 3379. The report also includes cessation of qualified use as a disposition, *id.* at 27, *reprinted* at 3381, but this use of terminology is inconsistent with the statute. See I.R.C. § 2032A(c)(7).

314. I.R.C. § 2032A(c)(2)(D).

315. *Id.* § 2032A(c)(1)(B), (c)(7)(A), (b)(2).

316. *Id.* § 2032A(b)(1)(C)(i). For discussion of this requirement, see notes 258-64 and accompanying text *supra*.

317. For discussion of the material participation requirement, see notes 265-83 and accompanying text *supra*.

held by the *decedent*, there was no material participation by the decedent or any member of *his* family in the operation of the farm or other business, and

(ii) in the case of periods during which the property was held by any *qualified heir*, there was no material participation by such qualified heir or any member of *his* family in the operation of the farm or other business.³¹⁸

This material participation requirement is more complicated than Congress apparently thought it to be because the committee report states that the qualified use ceases if for any eight-year period specified in the statute "there have been periods aggregating 3 years or more during which there was no material participation by the *qualified heir* or a member of his family."³¹⁹ The actual statutory language, however, reiterates the material participation requirement for the period preceding the decedent's death and imposes a similar requirement for the period subsequent to his death *with the variation* that the point of reference for defining family membership shifts from the decedent to the qualified heir.³²⁰ The complication arises during eight-year periods that include time both before and after the death of the decedent. During such periods the persons whose activities may satisfy the material participation requirement are the decedent or his family members prior to his death and the qualified heir or his family members subsequent to the decedent's death.

This shifting of reference points³²¹ for determining whose material participation is required to qualify for use valuation may occasionally prove to be another of the tax law's famous traps for the unwary. For example, the requisite material participation prior to the decedent's death can be supplied by the decedent's first cousin, but if the land passes to the decedent's son (the qualified heir), the tax savings under section 2032A will be recaptured unless the necessary participation is furnished by a member of the *son's* family, which does not include the decedent's first

318. I.R.C. § 2032A(c)(7)(B) (emphasis added).

319. HOUSE REPORT, *supra* note 3, at 27, reprinted at 3381.

320. Other more subtle differences are the waiver of recapture if the qualified heir dies during the fifteen-year period after the decedent's death, I.R.C. § 2032A(c)(1), and the addition of one day to the requisite duration of material participation during periods after the decedent's death, *compare id.* § 2032A(b)(1)(C) *with id.* § 2032A(c)(7)(B).

321. Another illustration of the evil of § 2032A's shifting reference point for defining family members is the possibility of tax avoidance through successive sales of land by "qualified heirs" to members of their families. Notes 306-11 and accompanying text *supra*.

cousin.³²² Not only is this legislative scheme a potential trap, but it is also bad policy in some cases. In this example it may disrupt continuity in the operation of the decedent's farmland. In order to avoid recapture, the heir or a member of his family is forced to assume a material degree of participation in the farm operation, and the decedent's first cousin will probably be forced to discontinue the use of the land. Such an economic dislocation violates the policy of neutrality and will often result in inefficiency.³²³

Another defect of the postmortem material participation rule is illustrated by the common case of farmland as to which there is continuous material participation and ownership by the decedent during the five years immediately preceding his death. If the executor values the land in the decedent's estate at its use value and the land passes to a qualified heir and remains in farm use, the additional tax can be postponed until three and one-half years after the decedent's death³²⁴ even if there is no attempt whatever to satisfy the material participation requirement after the decedent's death. Since section 2032A does not impose an interest charge on the additional tax,³²⁵ it allows a tax savings of 19 percent³²⁶ of the additional tax even though no effort is made to follow the postmortem eligibility rules. This sort of loophole does not encourage the preservation of family farms. Moreover, it violates the policies of revenue protection, wealth redistribution, and equity. While it may be somewhat easier to administer than a rule imposing interest charges only in cases of abuse, administrative convenience does not excuse a tax windfall of this magnitude.

C. Use Valuation Methods

1. Capitalization formula

The heart of section 2032A is its formula for computing the use value of farmland that meets the foregoing eligibility require-

322. The decedent's first cousin is a second cousin vis-a-vis the son. The statutory definition of family members does not include second cousins. See I.R.C. § 2032A(e)(2).

323. See notes 116-17 and accompanying text *supra*.

324. See I.R.C. § 2032A(c)(5), (c)(7)(B).

325. Notes 401-05 and accompanying text *infra*.

326. This percentage represents the amount of interest on the additional tax that the Treasury could have accrued during the two years and nine months after the date of filing of the estate tax return if a 7% interest rate were imposed. At 9% interest the savings would be 25% of the additional tax.

ments. The formula can be expressed:

$$V = \frac{R - T}{i}$$

where V is the use value of land; R is the average annual gross cash rent for comparable land over a five-year period;³²⁷ T is the average annual state and local real estate taxes for such comparable land for the same period; and i is the average annual effective interest rate for all new Federal Land Bank loans for the same five-year period. This portion of this comment will examine each element of this formula and evaluate the formula in the light of relevant policy considerations.

a. Cash rent. The most variable component of the formula is the "average annual gross cash rental for comparable land used for farming purposes and located in the locality" of the farmland whose value is to be determined under the formula.³²⁸ If there is no comparable land from which the cash rent may be determined, the statute dictates that the formula may not be used to value the property.³²⁹ However, about 38 percent of all farmland in the United States is rented,³³⁰ and over 55 percent of the rented land is operated under a cash rental arrangement.³³¹ Thus, over 20 percent of all farmland in the United States is rented for cash, and this percentage is expected to grow steadily in future years.³³² In most cases, then, there will be comparable farmland from which cash rent may be determined.³³³

This conclusion depends, however, on the definitions of the

327. The appropriate five-year period is the five most recent calendar years ending prior to the decedent's death. I.R.C. § 2032A(e)(7)(A).

328. *Id.* § 2032A(e)(7)(A)(i).

329. *Id.* § 2032A(e)(7)(B)(i). The use of comparable land for determining cash rent is based on the assumption that the material participation requirement will rarely be satisfied where the decedent's land is operated under a cash rent arrangement for five years preceding his death. There may be occasional instances where this assumption proves to be false, *e.g.*, where the decedent's land is operated by a family member under a cash rental arrangement. In such cases, cash rent based on an arm's-length bargain between the decedent and the family member ought to be used for valuing the land, rather than rent determined by reference to other land.

330. B. JOHNSON, *supra* note 114, at 3 (1969 data). This proportion has grown steadily since 1954. FARM TENURE AND CASH RENTS, *supra* note 146, at 2.

331. FARM TENURE AND CASH RENTS, *supra* note 146, at 7-8.

332. *Id.* at 17. The percentage of farmland that is rented for cash ranges from 9% in the Corn Belt to 30% in the Southern Plains. *Id.* at 9.

333. A likely source for such information is the USDA's Statistical Reporting Service, which periodically and systematically compiles cash rent data. See FARM REAL ESTATE MARKET DEVELOPMENTS—1976, *supra* note 24, at 36-37.

terms "comparable" and "locality," neither of which are defined in the statute. Since comparable land is to be used for determining cash rent, the focus should be on the *economic* comparability of the land, *i.e.*, on its income-producing capability in farm use. Although location and physical, chemical, and climatic similarity are factors relevant to economic comparability, they should not be determinative in themselves. Unfortunately, Congress dictated that only comparable land *in the same locality* as the land being valued may be used for determining cash rent. This locality restriction is probably unnecessary because economically comparable land would yield an appropriate cash rent whether or not it is in the same locality as the land being valued. Hopefully, the IRS and the courts will recognize this fact and avoid an unreasonably narrow definition of locality, which would be inconsistent with the policies of equity, preservation of family farms, and encouragement of the continued agricultural use of land.

A formula based on cash rent is superior to alternative use valuation formulae based on operating income,³³⁴ taxable income,³³⁵ or the present value of the income stream plus the projected market value of the property at the end of a selected time horizon.³³⁶ Net cash rent accurately reflects the agricultural productivity of farmland³³⁷ and consequently provides a sound basis for computing the value of land in agricultural use.³³⁸ Use of operating income, however, is unsuitable for several reasons. First, it is difficult accurately to identify the share of farm income that is attributable to the land rather than to capital, labor, or managerial effort.³³⁹ Second, since it yields the lowest valuation when

334. *E.g.*, *House Estate Tax Hearings*, *supra* note 6, at 1683-84 (article by Donald Kelley).

335. *E.g.*, *id.* at 1683 (article by Donald Kelley).

336. *E.g.*, *id.* at 605 (paper by Prof. John Hopkin).

337. FARM TENURE AND CASH RENTS, *supra* note 146, at 15; *House Estate Tax Hearings*, *supra* note 6, at 605 (paper by Prof. John Hopkin). Section 2032A's use valuation formula providing for the deduction of real property taxes from gross cash rent approximates a net cash rent, but does not attempt to arrive at a true cash rent, which would require deduction of *all* landlord expenditures (such as insurance, depreciation, repairs, damage on improvements, etc.). Since most of these expenses other than taxes are not involved in the rental of unimproved farmland, the formula approaches a net cash rent as closely as is necessary or feasible for purposes of § 2032A.

338. FARM TENURE AND CASH RENTS, *supra* note 146, at 15; *House Estate Tax Hearings*, *supra* note 6, at 589 (statement of Samuel Guyton), 1454 (statement of Sen. George McGovern), 1455 (paper by Dr. Calvin Kent).

339. *House Estate Tax Hearings*, *supra* note 6, at 1684 (article by Donald Kelley). In addition, the operating income approach to valuation is often unsuitable for valuing grassland. *Id.*

farm income is minimized, the operating income approach would reward inefficient farm operation, adversely affecting economic efficiency. Valuation based on taxable income partakes of the same defects in addition to the distortion introduced by income tax deductions, accounting methods, and other tax rules.³⁴⁰ Use of the present value of the operating income stream plus the projected value of the land at a time in the distant future combines the disadvantages of the operating income approach with the obvious impracticability of estimating the market value of a tract of land many years in the future.³⁴¹ Thus, although a cash rent approach has its own flaws,³⁴² it seems to be clearly superior to the available alternatives.

Since section 2032A does not include a definition of cash rent, occasional disputes may arise as to whether land operated under various crop share rental arrangements can be used to determine cash rent. One common type of crop share rental agreement requires the tenant to pay the landlord a fixed fraction of any crops harvested from the land.³⁴³ Averaged over a period of five years, the rents paid under such an agreement should often be regarded as identical to a cash rent. In other situations, the parties may agree that the landlord will pay a fixed share of certain production expenses and receive a fixed share of the harvested crop.³⁴⁴ Even in such cases, there seems to be good reason to regard the *net* rent to the landlord as a cash rent, especially when it is averaged over a five-year period. Unfortunately, absent statutory authorization, it is doubtful that the IRS will permit the executor to derive cash rent data from land operated under share rental arrangements, however reasonable it may be to do so.

b. Real estate taxes. In order to arrive at a rough approximation of net rent, section 2032A provides that "the excess of the average annual gross cash rental for comparable land . . . over the average annual State and local real estate taxes for such comparable land" is to be computed.³⁴⁵ While the principle underlying such a deduction from cash rent for property taxes is

340. *Id.* at 1683 (article by Donald Kelley).

341. This approach is fundamentally unsound because the future market value of land is irrelevant to *use* valuation if the land is not sold and it remains in its present use.

342. *House Estate Tax Hearings*, *supra* note 6, at 1683 (article by Donald Kelley).

343. This arrangement imposes an implied obligation on the tenant to expend his best efforts to produce crops.

344. OFFICE OF COMMUNICATION, U.S. DEP'T OF AGRICULTURE, *supra* note 110, at 30.

345. I.R.C. § 2032A(e)(7)(A)(i).

sound,³⁴⁶ this statutory scheme approaches absurdity. The difficulty lurks behind the phrase "real estate taxes *for such comparable land*."³⁴⁷ There is no rational justification for computing the use value of a tract of land by reference to the property taxes on *another* tract of land, and there are persuasive reasons for adjusting the cash rent to reflect the *actual* property taxes on the land being valued. The amount of property taxes for the past five years on the land being valued is more readily available to the executor than the taxes on some other land. Furthermore, the approach used in section 2032A invites shopping for "comparable land" that is subjected to relatively heavy property taxation because it is located in a jurisdiction that imposes higher taxes than other jurisdictions in the same locality.³⁴⁸ If the regulations or judicial decisions should curb such shopping by insisting that comparable land includes only land that is subjected to the same level of property taxation as the land being valued, then the pool of available land for determining cash rent will shrink, further reducing the availability of the formula to many deserving estates.³⁴⁹ Finally, the actual amount of property taxes on the land being valued is more relevant to the use value of that land than the taxes on any other tract of land. In order to estimate the net cash rent that could be derived from a tract of land, the taxes on *that land* should be subtracted from the gross cash rent.³⁵⁰ If this approach were adopted, it would enhance the validity and equity of use valuation under section 2032A³⁵¹ and the estate tax on farmland would automatically adjust to differences in the use value of land that is attributable to property tax variations both within a given locality and between different regions of the country.³⁵²

346. Notes 337-38 and accompanying text *supra*.

347. I.R.C. § 2032A(e)(7)(A)(i) (emphasis added).

348. The incentive for such shopping is the possibility of reducing the valuation under the formula by increasing the property tax variable. See text accompanying note 327 *supra*.

349. See also notes 328-37 and accompanying text *supra*.

350. See *House Estate Tax Hearings*, *supra* note 6, at 1457-58, 1460 (paper by Dr. Calvin Kent) (advocating incorporation of the property tax rate into the capitalization (interest) rate). Dr. Kent's approach arrives at valuations quite similar to those computed under the § 2032A formula.

351. The concept of valuing land by taking into consideration the property taxes on that land is analogous to the natural tendency of the market to capitalize changes in property taxes into farm real estate values. See Pasour, *The Capitalization of Real Property Taxes Levied on Farm Real Estate*, 57 AM. J. AGRICULTURAL ECON. 539, 542-43, 547 (1975).

352. Average taxes on farmland vary from \$0.25 per acre in New Mexico to \$20.13 in Rhode Island. ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, FARM REAL ES-

c. *Interest rate.* The statutory formula for use valuation solves the difficult problem of determining an appropriate capitalization rate³⁵³ by providing for the use of "the average annual effective interest rate for all new Federal Land Bank loans" for the five most recent calendar years ending before the decedent's death.³⁵⁴ The Federal Land Bank interest rate is an excellent capitalization rate for valuing farmland because it is uniform and readily ascertainable and because it reflects risk and a safe yield.³⁵⁵ It accurately reflects currently prevailing interest rates because the Federal Land Bank is the largest single source of farm real estate credit, accounting for over 31 percent of all loan funds for farmland, and its market share is steadily growing.³⁵⁶ The relevance of the Land Bank interest rate is even greater than its market share indicates because other lenders often follow the lead of the Federal Land Bank and other arms of the Farm Credit Administration in establishing the terms of loans.³⁵⁷

The method to be used in computing the average annual effective interest rate for all new Federal Land Bank loans is subject to ambiguity as to whether a simple average of the published interest rates for each of the five years or an average weighted according to the number of loans made each year is required.³⁵⁸ The former approach enjoys the obvious advantage of

TATE TAXES—1975, at 14-15 (1977). Since these figures are statewide averages, the actual variation in taxes from one area to another is often much greater than the difference between these two figures.

353. Kirby, *How to Plan for New Special Rules of Valuing Farm and Close Corporation Real Estate*, 4 EST. PLAN. 94, 98 (1977) (determining proper capitalization rate is perhaps the most difficult problem in farm valuation); *House Estate Tax Hearings*, *supra* note 6, at 1457-58 (paper by Dr. Calvin Kent).

354. I.R.C. § 2032A(e)(7)(A).

355. *House Estate Tax Hearings*, *supra* note 6, at 1460 (paper by Dr. Calvin Kent). Dr. Kent's approach uses a composite capitalization rate that incorporates the real return on investment in marketable stocks, partly because the local Federal Land Bank generally had required one-third equity of their typical borrowers. *Id.* The Federal Land Bank, however, recently made a major reduction in equity requirements for loans, BALANCE SHEET, *supra* note 4, at 17, so that only 15% equity is now required. *Agriculture and Related Agencies Appropriations for 1977: Hearings Before the Subcomm. on Agriculture and Related Agencies of the House Comm. on Appropriations*, 94th Cong., 2d Sess. 381 (1976) (statement of Farm Credit Admin.); [1974-1975] FARM CREDIT ADMIN. ANN. REP. 9. This fact and the need for simplicity and administrative convenience suggest that the incorporation of stock market returns into the capitalization rate would be unnecessary and undesirable for purposes of § 2032A.

356. BALANCE SHEET, *supra* note 4, at 16. The catch-all group of lenders supplies 36% of such loan funds. *Id.*

357. OFFICE OF COMMUNICATION, U.S. DEP'T OF AGRICULTURE, *supra* note 110, at 43-44.

358. Although weighting the average according to dollar volume of loans in each of the five years would also be reasonable, the statutory language seems to rule out this

simplicity, but the weighted average is technically the proper method of arriving at the average interest rate for all new loans over a five-year period.³⁵⁹ For estates of decedents who die during 1977, the simple average yields a capitalization rate of 8.086 percent.³⁶⁰ For the same estates, the weighted average yields a capitalization rate of 8.19 percent.³⁶¹ Since the difference between these two rates is slight, the difference in use valuations derived from them is not spectacular, but the weighted average rate consistently reduces the per acre use value of land by 1.27 percent from the value computed with a simple average rate.³⁶²

d. Merits of the formula. The type of valuation formula used in section 2032A is familiar to many appraisers and is accepted by the academic community.³⁶³ The committee report proclaims the chief virtues of the formula to be its tendency to reduce subjectivity and controversy in farm valuation, its elimination of nonagricultural use as a determinant of the value of farmland, and its elimination of the premium on agricultural land that is attributable to speculation in cases where nonfarm use is not a relevant factor.³⁶⁴

Congress is probably justified in its belief that the formula will be valuable because of its capacity to yield reasonably certain values. Depending somewhat on the procedure used in auditing returns that have employed use valuation, however, it is not

approach. If this method were used, it would place greater weight on the most recent interest rates because the dollar volume of Land Bank loans is steadily increasing. AGRICULTURAL STATISTICS, *supra* note 6, at 487. As of 1977, this approach would result in a higher interest rate and consequently lower use values than under the other approaches.

359. In other words, the simple average is actually weighted in favor of the earlier years of the five-year period in which fewer loans were made than in more recent years. See [1974-1975] FARM CREDIT ADMIN. ANN. REP. 72. Weighting is not a difficult computation—anyone qualified to make out an estate tax return should have no difficulty with it.

360. This rate is based on the following interest rates for new loans: 7.42% (1972), 7.48% (1973), 8.14% (1974), 8.69% (1975), and 8.7% (1976). All but the 1976 rate appear in AGRICULTURAL STATISTICS, *supra* note 6, at 480. The 1976 rate is an estimate based on information in *Agriculture and Related Agencies Appropriations for 1977: Hearings Before the Subcomm. on Agriculture and Related Agencies of the House Comm. on Appropriations*, 94th Cong., 2d Sess. 379 (1976) (statement of Farm Credit Admin.).

361. The number of Land Bank loans for 1972-75 appear in [1974-1975] FARM CREDIT ADMIN. ANN. REP. 72. The number for 1976 was estimated conservatively at 82,391, based on a 10% increase from 1975. Increases in the four prior years varied from 12.2% to 31.9%. *Id.*

362. In Iowa, for example, this capitalization rate lowers the use value of land from \$625, note 191 and accompanying text *supra*, to \$617 per acre, reducing the valuation of 800 acres of farmland by \$6,400.

363. *House Estate Tax Hearings*, *supra* note 6, at 1683 (article by Donald Kelley), 1454 (statement of Sen. George McGovern); see Pasour, *supra* note 351, at 542.

364. HOUSE REPORT, *supra* note 3, at 24-25, reprinted at 3378-79.

likely that section 2032A will eliminate a great deal of litigation concerning valuation.³⁶⁵ If the IRS, in order to defeat eligibility under the 50-percent or 25-percent tests, to inflate the additional tax in case of recapture, or to reduce the amount of land that can be included at use value by reason of the \$500,000 limitation,³⁶⁶ appraises the property at a market value different from that reported by the estate, then the issue of market value may need to be resolved by litigation. In cases where the \$500,000 limitation or eligibility under the percentage tests is at issue,³⁶⁷ market value will clearly be a justiciable issue after a deficiency assessment has been made.³⁶⁸ In other cases involving disputes as to market value, it is probable that the amount of the lien imposed under section 6324B will also provide a basis for justiciability of market value at the time of the audit even though no deficiency assessment is involved.³⁶⁹ Thus, section 2032A may often lead to more litigation than arose previously because *both* market value and use value may be subjects of litigation. This result would needlessly waste farmers' money and the judiciary's time in cases where eligibility under the percentage tests is obvious, the \$500,000 limitation is clearly irrelevant, and no need for determination of market value exists because of continued compliance with the postmortem eligibility rules.

Congress is clearly correct in asserting that the formula will eliminate speculation and other nonagricultural influences from the valuation of farmland for estate tax purposes.³⁷⁰ Moreover, use valuation has unique advantages over most other methods of providing tax relief for farm estates. Since the values derived by the formula depend on cash rents, those values will automatically adjust to increases in farmland productivity.³⁷¹ Thus, the estate tax on qualifying farmland will vary in direct proportion to the land's ability to generate income.

365. *But see House Estate Tax Hearings, supra* note 6, at 727 (statement of Edward McGinty); notes 223-24 and accompanying text *supra*. See also Kelley, *Farmland Values for Estate Tax Purposes*, PRAC. LAW., Jan. 15, 1976, at 71, 80 (unusually large number of farmland valuation cases pending).

366. For a discussion of this limitation, see notes 436-41 and accompanying text *infra*.

367. At present farmland values, relatively few farm estates will be affected by the \$500,000 limitation. Compare notes 5, 43 and accompanying text *supra* with notes 179-96 and accompanying text *supra*. In addition, eligibility under the percentage tests will often be so obvious that no dispute will arise as to that issue.

368. See I.R.C. § 6501(a). See also *id.* § 6503(d).

369. The IRS is likely to contest a market value it regards as too low in order to avoid the possibility of being bound by that value if recapture occurs after the running of the three-year statute of limitations subsequent to the filing of the return.

370. See text accompanying notes 179-96, 337-38 *supra*.

371. Notes 337-38 and accompanying text *supra*.

Finally, the five-year averaging approach adopted by Congress³⁷² is desirable³⁷³ because it tends to iron out short-run variations in estate tax that might otherwise depend largely on fortuitous circumstances such as the year of the farm owner's death. A five-year period is long enough to achieve these aims without the practical difficulties of collecting data for a substantially longer period of time when such information may be so old as to bear little relevance to present agricultural values.

2. *Multiple factor valuation*

The statute also provides a multiple factor method for determining use value. This method is to be used whenever (1) non-farm business property is being valued,³⁷⁴ (2) there is no comparable land from which to determine cash rent for farmland valuation,³⁷⁵ or (3) the executor elects to use it to value farmland.³⁷⁶ The statute styles the multiple factor approach "[m]ethod of valuing closely held business interests,"³⁷⁷ yet several of the factors specified in the statute are directed primarily at valuing farmland.³⁷⁸ The statute provides that

the following factors shall apply in determining the value of any qualified real property:

(A) The capitalization of income which the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and similar factors,

(B) The capitalization of the fair rental value of the land for farmland or closely held business purposes,

(C) Assessed land values in a State which provides a differential or use value assessment law for farmland or closely held business,

(D) Comparable sales of other farm or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price, and

372. I.R.C. § 2032A(e)(7)(A).

373. *House Estate Tax Hearings*, *supra* note 6, at 369 (statement of William Pietz), 1458 (paper by Dr. Calvin Kent).

374. I.R.C. § 2032A(e)(7)(A), (e)(8).

375. *Id.* § 2032A(e)(7)(B)(i).

376. *Id.* § 2032A(e)(7)(B)(ii).

377. *Id.* § 2032A(e)(8).

378. *See id.* § 2032A(e)(8)(A), (e)(8)(D).

(E) Any other factor which fairly values the farm or closely held business value of the property.³⁷⁹

In the absence of interpretive regulations and guidance as to the relative weight to be assigned these factors, it is practically impossible to evaluate this approach or assess its probable impact on the value of farm or business real property. For example, if the income or rent capitalization factors are heavily weighted, the valuation will be lower than if comparable sales are given special emphasis in the valuation. Comparable sales in areas where non-agricultural use is not significant will reflect fair market value while income or rent capitalization will yield a substantially lower valuation.³⁸⁰ Particular emphasis on the income and rent capitalization factors, however, would be consistent with the legislative intent of reducing farmland valuations.³⁸¹

D. Recapture³⁸² of Additional Tax

1. Events that trigger recapture

The failure to satisfy *all* of the postmortem eligibility requirements of section 2032A results in recapture of the tax that was saved by virtue of use valuation.³⁸³ Those requirements pertain to land ownership,³⁸⁴ land use,³⁸⁵ and material participation in the farm or business that is using the land.³⁸⁶

2. Amount of tax recaptured

During the first ten years subsequent to the decedent's

379. *Id.* § 2032A(e)(8).

380. See notes 188-95 and accompanying text *supra*.

381. Although the factors under the multiple factor valuation method do not differ greatly from those used for determining market value, note 176 *supra*, the entire thrust and purpose of § 2032A is to value qualifying property according to its current use and to eliminate speculative premiums from such valuations. See HOUSE REPORT, *supra* note 3, at 22, reprinted at 3376.

382. Although § 2032A never employs the term "recapture" in reference to the imposition of the "additional estate tax" upon a breach of the postmortem eligibility requirements for use valuation, the committee report repeatedly refers to the additional tax as a "recapture." *E.g., id.* at 22, 25-27, reprinted at 3376, 3379-81. These terms are therefore used interchangeably in this comment.

383. I.R.C. § 2032A(c)(1).

384. For a discussion of the ownership requirement, see notes 247-57 and accompanying text *supra*.

385. For a discussion of the use restrictions, see notes 258-64 and accompanying text *supra*.

386. For a discussion of the material participation test, see notes 265-83 and accompanying text *supra*.

death, the amount of tax imposed in the event of recapture as to all property valued at use value in the estate is the *lesser* of (1) the estate tax savings attributable to the use of section 2032A³⁸⁷ or (2) the excess of the fair market value of the property over its use value.³⁸⁸ For the same period, the amount of tax imposed upon recapture as to an interest in a portion of the assets included in the estate at use value is the lesser of (1) the ratable share of the tax savings attributable to that interest³⁸⁹ or (2) the excess of the fair market value of the interest over its use value.³⁹⁰

The apparent purpose for selecting the lesser of these two amounts in either of the above situations is to avoid an unreasonable tax burden in the event of recapture as to land whose market value has declined substantially after the decedent's death.³⁹¹ In view of the pattern of steadily rising farm real estate prices over the past 40 years,³⁹² it is likely that the additional tax in the vast majority of section 2032A recapture situations will be based on the tax savings attributable to use valuation rather than the difference between market value at the time of recapture and use value. Nevertheless, for the occasional instances in which the value of real estate declines substantially after the decedent's death, it seems desirable to provide a means of softening the blow of recapture.³⁹³ The means employed in section 2032A, however, may prove to have been an unfortunate choice. Most of its bene-

387. Instead of tax savings, the statute uses the term "adjusted tax difference" attributable to the interest as to which recapture occurs. I.R.C. § 2032A(c)(2)(A)(i). If recapture occurs as to all property valued under section 2032A in an estate, this amount will be the "adjusted tax difference with respect to the estate," *see id.* § 2032A(c)(2)(B), which is defined as the "excess of what would have been the estate tax liability but for subsection (a) [allowing use valuation] over the estate tax liability" determined by use of § 2032A. *Id.* § 2032A(c)(2)(C).

388. *Id.* § 2032A(c)(2)(A)(ii) ("the excess of the amount realized . . . (or, in any case other than a sale or exchange at arm's length, the fair market value . . .) over the value . . . determined under subsection (a)."). Since a sale or exchange at arm's length is by definition at fair market value, the amount referred to in § 2032A(c)(2)(A)(ii) will always be fair market value less use value. The committee report makes it clear that the additional tax is *always* the lesser of the two amounts in § 2032A(c)(2)(A), even where no disposition of the property has occurred. HOUSE REPORT, *supra* note 3, at 26, *reprinted at* 3380.

389. I.R.C. § 2032A(c)(2)(A)(i), (c)(2)(B); HOUSE REPORT, *supra* note 3, at 26, *reprinted at* 3380; *see note 387 supra*.

390. Note 388 *supra*.

391. This is essentially the same philosophy that underlies the alternate valuation date, I.R.C. § 2032.

392. FARM REAL ESTATE MARKET DEVELOPMENTS—1976, *supra* note 24, at 6.

393. Equity considerations, however, may militate against such relief. If securities, for example, decline in value after the alternate valuation date, I.R.C. § 2032, no reduction in estate tax on those securities is permitted.

fits will probably accrue to estates in the higher tax brackets.³⁹⁴ More importantly, in some cases the land as to which recapture occurs will have depreciated after the decedent's death as a result of soil depletion caused by overutilization, excessive cutting of timber, overgrazing, accelerated depletion of underground water reservoirs, avoidable erosion, or the ordinary deterioration of certain structures or improvements on real estate that have a relatively short useful life. Since many of these potential causes of depreciation in land values are associated with income advantages to the owner of the property,³⁹⁵ it is probably inequitable to allow an estate tax savings upon recapture in such cases. In order to avoid this inequity, section 2032A should be amended to require the entire tax savings attributable to use valuation of the property to be recaptured in such cases.

During the eleventh through fifteenth years after the decedent's death, the amount recaptured is determined in the same manner as it is during the first ten years except that the amount is phased out on a ratable monthly basis.³⁹⁶ Both the concept of phasing out the additional tax over an extended period and the specific recapture periods prescribed by section 2032A are eminently reasonable. The policies of equity, neutrality, and preservation of family farms are best served by a fairly long recapture period because a long period encourages prolonged farm or business use of land and discourages investment in farmland for the primary purpose of reducing estate taxes.³⁹⁷ On the other hand,

394. This principle is perhaps best explained by an example: Assuming that the market value of farmland qualifying for use valuation in a decedent's estate is \$100,000 at his death and \$75,000 five years later when a recapture event occurs and that the land was valued at \$60,000 (under § 2032A) in the decedent's estate, the amount recaptured will be the tax savings due to use valuation for estates whose marginal tax rate was less than about 40%, but for an estate whose marginal rate exceeds 40%, the amount recaptured will be \$15,000 (the spread between use value (\$60,000) and market value at recapture (\$75,000)). An estate whose marginal rate was 70% will have enjoyed a tax savings of \$28,000 by virtue of use valuation, yet only \$15,000 of that amount will be recaptured. Thus, the effect of § 2032A(c)(2)(A) is to reduce the recapture amount for high-bracket estates where there has been a *relatively slight* decline in market value after the decedent's death, but not to allow such a reduction in the case of low-bracket estates unless the decline in market value is relatively large.

395. For example, the owner may realize greater profits in the short run by overusing the soil, excessive timber harvesting, or overgrazing. He may also reduce his income taxes by rapid depreciation of structures with a short useful life.

396. I.R.C. § 2032A(c)(3).

397. *Joint Hearing on Impact of Estate Taxes*, *supra* note 10, at 17-18 (analysis by Joint Economic Comm. Staff); *House Estate Tax Hearings*, *supra* note 6, at 414 (statement of Horace Hildreth), 448 (statement of Sen. Charles Mathias), 453 (statement of Sen. Floyd Haskell), 723, 728 (statement of Edward McGinty), 1685 (article by Donald Kelley); *Senate Tax Reform Hearings*, *supra* note 10, at 316 (statement of Sen. Richard Stone).

the goals of administrative convenience and promotion of efficient use of agricultural resources require a finite recapture period, contrary to the views of those who advocate recapture in perpetuity.³⁹⁸ A ten- to fifteen-year recapture period strikes a reasonable balance between these conflicting policies. The phaseout of the additional tax over a five-year period is desirable because it enhances the equity of use valuation by reducing the impact of fortuitous events and minimizes adverse effects on neutrality by avoiding an abrupt termination of recapture liability, which would probably lead to irrational straining to prolong eligibility until the end of the period.³⁹⁹

The statute magnanimously provides that only one additional tax will be imposed with respect to any portion of an interest in property that was included in the decedent's estate at its use value, even if two or more recapture events occur with respect to that portion.⁴⁰⁰ Probably the only thing worth saying about this provision is that it would be totally unnecessary if the IRS were not known occasionally to argue in favor of legal positions that prove to be unreasonable.

3. *Miscellaneous recapture provisions*

a. *Due date.* If a recapture event occurs, the additional tax becomes due and payable six months after the date of disposition of the property or cessation of its qualified use.⁴⁰¹ Since the framers of section 2032A heard testimony regarding the question of whether or not an interest charge on the recaptured tax should be imposed and considered bills that proposed such an interest charge,⁴⁰² the absence of such a provision, in addition to the treat-

398. See *Joint Hearing on Impact of Estate Taxes*, *supra* note 10, at 127 (statement of Minn. Farm Bureau Federation); *House Estate Tax Hearings*, *supra* note 6, at 10 (statement of Allan Grant), 727-28 (statement of Edward McGinty).

399. See *House Estate Tax Hearings*, *supra* note 6, at 1221 (statement of Richard Covey).

400. I.R.C. § 2032A(c)(4); HOUSE REPORT, *supra* note 3, at 26, reprinted at 3380. An example of multiple recapture events is the case in which the heirs first fail to satisfy the material participation requirement, later discontinue farm use of the land, and finally dispose of the land to someone other than family members.

401. I.R.C. § 2032A(c)(5).

402. STAFF OF HOUSE COMM. ON WAYS AND MEANS, 94TH CONG., 2D SESS., BACKGROUND MATERIALS ON FEDERAL ESTATE AND GIFT TAXATION 55-56 (Comm. Print 1976) (analysis of pending bills); *Joint Hearing on Impact of Estate Taxes*, *supra* note 10, at 18 (analysis by Joint Economic Comm. Staff); *House Estate Tax Hearings*, *supra* note 6, at 448 (statement of Sen. Charles Mathias), 1433-34 (statement of Edward Halbach), 1685-86 (article by Donald Kelley).

ment of the additional tax as a separate estate tax,⁴⁰³ the fact that the lien amount is limited to the tax savings realized under section 2032A,⁴⁰⁴ and the due date six months after a breach of eligibility occurs, indicate a legislative intent not to charge interest on the additional tax. This failure to impose an interest charge is inconsistent with the express policy of section 2032A—to encourage the continued use of land for farming and to preserve family farms. Although an interest charge might be undesirable in a few instances,⁴⁰⁵ such cases will probably be rare in comparison to the relatively large number of cases in which section 2032A will be abused by those who elect it merely to obtain a temporary interest-free “loan” from the Treasury.⁴⁰⁶

b. *Personal liability.* As a device for ensuring that the additional tax is collected, the statute provides that “[t]he qualified heir shall be personally liable for the additional tax imposed by this subsection with respect to his interest.”⁴⁰⁷ This liability may be terminated by compliance with the eligibility requirements for a period of fifteen years after the decedent’s death,⁴⁰⁸ by the death of the qualified heir before the end of the fifteen year period,⁴⁰⁹ by the transfer of the interest to a member of his family,⁴¹⁰ or by the running of the three year statute of limitations.⁴¹¹ If the interest is transferred to another qualified heir, the personal liability shifts to that person, whether or not he has paid full value for the interest.⁴¹²

c. *Lien.* The provision for personal liability of the qualified

403. HOUSE REPORT, *supra* note 3, at 27, *reprinted* at 3381. The fact that the tax is “a separate estate tax” suggests that it is regarded as one that is first imposed six months after recapture—thus, it would be inconsistent with its status as a separate tax to impose an interest charge as if the tax had been due nine months after the decedent’s death.

404. I.R.C. § 6324B(a).

405. For example, where the qualified heir becomes disabled and cannot continue material participation but has young children who would like to continue the farm operation when they are grown, it is conceivable that the added burden of interest upon recapture could make it impossible to keep the farmland in the family.

406. See notes 324-25 and accompanying text *supra*.

407. I.R.C. § 2032A(c)(6).

408. For a discussion of these postmortem eligibility requirements, see notes 284-326 and accompanying text *supra*.

409. I.R.C. § 2032A(c)(1); HOUSE REPORT, *supra* note 3, at 26, *reprinted* at 3380.

410. I.R.C. § 2032A(c)(1)(A), (e)(1); HOUSE REPORT, *supra* note 3, at 26-27, *reprinted* at 3380-81. For a discussion of this provision, see notes 303-16 and accompanying text *supra*.

411. I.R.C. § 2032A(f). For a discussion of this statute of limitations, see notes 446-48 and accompanying text *infra*.

412. HOUSE REPORT, *supra* note 3, at 26-27, *reprinted* at 3380-81; see I.R.C. § 2032A(c)(1)(A), (e)(1).

heir is probably unnecessary in many section 2032A recapture cases because the lien imposed by section 6324B⁴¹³ on real property valued at use value is likely to be more than adequate to cover the additional tax.⁴¹⁴ The amount of this lien is the "adjusted tax difference" attributable to the property valued under section 2032A,⁴¹⁵ or, in other words, the estate tax savings realized by virtue of use valuation,⁴¹⁶ even in the relatively few cases in which the additional tax is the difference between the property's market value at the time of recapture and its use value at the time of the decedent's death.⁴¹⁷ A lien imposed under section 6324B continues until the liability for the additional tax is satisfied or becomes "unenforceable by reason of lapse of time"⁴¹⁸ or "until it is established to the satisfaction of the Secretary that no further tax liability may arise under section 2032A(c) with respect to such interest."⁴¹⁹

The Code further provides that such a lien is not "valid as against any purchaser, holder of a security interest, mechanic's lien, or judgment lien creditor" until proper notice of the lien has been filed.⁴²⁰ Even if such notice has been filed, the lien is not valid as against certain "superpriorities,"⁴²¹ including real property tax liens,⁴²² mechanic's liens for repairs and improvements,⁴²³

413. I.R.C. § 6324B.

414. The fact that farmland values are steadily rising, *FARM REAL ESTATE MARKET DEVELOPMENTS*—1976, *supra* note 24, at 6; *FARM REAL ESTATE MARKET SUPPLEMENT*, *supra* note 24, at 4-5, supports the conclusion that the lien will generally be adequate. In addition, the recapture tax can not exceed 70% (highest marginal tax rate) of the difference between market value and use value. This tax will generally be less than 30% of the land's market value at the time of the decedent's death. *See* notes 179-95 and accompanying text *supra* (reduction in value by virtue of use valuation generally less than 80%); note 43 and accompanying text *supra* (equity of most farms less than \$800,000); I.R.C. § 2001 (39% marginal tax rate on estate of \$800,000). *But see* notes 420-27 and accompanying text *infra* (numerous types of security interests have priority over the § 6324B lien).

415. I.R.C. § 6324B(a).

416. Note 387 and accompanying text *supra*.

417. Note 388 and accompanying text *supra*. The reason for imposing a lien equal to the tax savings is because it is generally impossible to determine in advance whether or not the additional tax will be the lesser quantity that is recaptured when market value declines substantially after the decedent's death.

418. I.R.C. § 6324B(b)(1).

419. *Id.* § 6324B(b)(2). The legislative history of § 2032A contains no hint as to what state of facts is intended to be sufficient to satisfy "the Secretary" that no further tax liability may arise. This clause is likely to be of virtually no use to taxpayers.

420. I.R.C. § 6324B(c), 6324A(d)(1). The requirements of I.R.C. § 6323(f) govern the procedure for filing of notice, except that § 6324A(d)(1) provides that notice need not be refiled.

421. *Id.* §§ 6324B(c), 6324A(d)(3); *HOUSE REPORT*, *supra* note 3, at 34, *reprinted at* 3388.

422. I.R.C. §§ 6324A(d)(3)(A), 6323(b)(6).

and security interests for financing the construction or improvement of real property or "the raising or harvesting of a farm crop or the raising of livestock or other animals,"⁴²⁴ "whether such security interest came into existence *before or after* tax lien filing."⁴²⁵ Thus, contrary to the assertions of many who opposed a long recapture period for section 2032A because of the tendency of a lien on farmland to impede financing of farm operations,⁴²⁶ the lien that Congress has created for use valuation should not create a serious obstacle to farm financing because it is *inferior* to security interests for the financing of farm improvements or operations, even if they arise after the filing of the estate tax lien.⁴²⁷ In addition to the benefit of this superpriority of security interests for farm financing, there are other reasons for discounting the argument that a lien in connection with use valuation will significantly reduce the availability of farm credit. The Code provides that a section 6324B lien on property is in lieu of any lien on the same property under section 6324⁴²⁸ and that other security may be substituted for the lien imposed under section 6324B to the extent allowed by forthcoming regulations.⁴²⁹ Moreover, section 6325 provides for the discharge of part of the property subject to a tax lien where the market value of the part of the property "remaining subject to the lien is at least double the amount of the unsatisfied liability secured by such lien and the amount of all other liens upon such property which have priority over such lien."⁴³⁰ This provision may prove to be highly useful in connec-

423. *Id.* § 6324A(d)(3)(B) (tax lien is not valid "[i]n the case of any real property subject to a lien for repair or improvement, as against a mechanic's lienor").

424. *Id.* §§ 6324A(d)(3)(C), 6323(c)(3)(A).

425. *Id.* § 6324A(d)(3)(C) (emphasis added).

426. *Joint Hearing on Impact of Estate Taxes*, *supra* note 10, at 127 (statement of Minn. Farm Bureau Federation); *House Estate Tax Hearings*, *supra* note 6, at 10 (statement of Allan Grant), 727 (statement of Edward McGinty).

427. Note that the last sentence of § 6324A(d)(3) refers *only* to notice of *accelerations* of deferred tax payments—not to notice of the ordinary lien for deferred payments. By analogy, it seems reasonable to conclude that in cases of § 6324B liens, this sentence would apply only to notice of an additional tax obligation after recapture has been triggered—not to notice of the lien itself. Thus, a security interest for a farm production loan that comes into existence either before or after the filing of a § 6324B lien has priority over the § 6324B lien.

It is conceivable, however, that lending institutions may fail to appreciate the priority of various security interests over the § 6324B lien. If so, the lien may result in some impairment of farm credit availability.

428. I.R.C. §§ 6324B(c), 6324A(d)(4).

429. *Id.* § 6324B(d); *HOUSE REPORT*, *supra* note 3, at 27, *reprinted* at 3381.

430. I.R.C. § 6325(b)(1); *see* *Treas. Reg.* § 301.6325-1(b)(1), -1(b)(4), T.D. 6700, 1964-1 (pt. 1) C.B. 467-68.

tion with section 6324B liens because of the anticipated persistent and substantial increase in farm real estate values.

d. *Credit for tax on previous transfers.* Another Code provision relevant to section 2032A recapture situations is section 2013,⁴³¹ which provides a credit for tax on prior transfers. Section 2013 was amended by the Tax Reform Act of 1976 in order to provide for the treatment of additional tax recaptured under section 2032A.⁴³² The amendment dictates that any additional tax imposed "before the date which is 2 years after the date of decedent's death . . . shall be treated as a Federal estate tax payable with respect to the estate of the transferor."⁴³³ It also provides that the value of property as to which a recapture occurs and the taxable estate are to be determined according to fair market value rather than use value.⁴³⁴ The committee report gives the following explanation of these provisions:

If the qualified heir dies within 10 years of the time of the death of the decedent but after a recapture event has occurred, this recapture tax would be utilized in computing the previously taxed property credit. However, it would be treated as having been imposed as of the date of the decedent's death, rather than at the time the actual recapture event occurred.⁴³⁵

E. Miscellaneous Provisions of Section 2032A

1. \$500,000 maximum reduction in value per estate

Congress imposed an arbitrary limit of \$500,000 on the amount by which any decedent's gross estate can be reduced by virtue of section 2032A.⁴³⁶ Although it is desirable from the standpoint of equity, wealth redistribution, and revenue protection to impose a limit on the tax benefit of use valuation, this limitation, based on the reduction in the gross estate, shares the same defects that plagued the old \$60,000 exemption and ultimately led to its demise.⁴³⁷ This \$500,000 ceiling confers the greatest tax savings on

431. I.R.C. § 2013 (allowing decedent's estate a credit of 100% of estate or gift tax paid on transfers to the decedent within two years of his death, 80% during the third and fourth years prior to the decedent's death, 60% during the fifth and sixth years, etc.).

432. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003(c), 90 Stat. 1862 (codified in I.R.C. § 2013(f)).

433. I.R.C. § 2013(f)(1). The term "decedent" in this section refers to a person who receives property that was valued under § 2032A in the transferor's estate.

434. *Id.* § 2013(f)(2).

435. HOUSE REPORT, *supra* note 3, at 27, reprinted at 3381. The term "decedent" here refers to the transferor whose property was valued under § 2032A in his estate.

436. I.R.C. § 2032A(a)(2); HOUSE REPORT, *supra* note 3, at 22, reprinted at 3376.

437. See HOUSE REPORT, *supra* note 3, at 15, reprinted at 3369.

a very large estate (which can save up to 70 percent of the reduction in value because of its high marginal tax rate) while allowing a relatively small savings by smaller estates (as little as 18 percent of the reduction in value).⁴³⁸ This disproportionate benefit to large estates violates the very policies of wealth redistribution and revenue generation that it was intended to promote. This defect could be largely remedied by basing the limitation on the amount of taxes that can be avoided through use valuation.⁴³⁹ A far more serious defect of the \$500,000 limitation is its rapid obsolescence during periods of substantial inflation of land values.⁴⁴⁰ Congress should either construct the limitation in such a way that it adjusts automatically on an annual basis to the nationwide farm real estate price index⁴⁴¹ or otherwise ensure that it is adjusted legislatively on a frequent and regular basis to reflect inflation of farmland prices.

2. *Application to interests in partnerships, corporations, and trusts*

Probably the most complex aspect of sections 2032A and 6324B will be their application to a decedent's interest in a partnership, corporation, or trust that includes qualifying real property. The Code merely directs "the Secretary" to prescribe regulations governing application of these sections in cases where such an interest, "with respect to the decedent, is an interest in a closely held business."⁴⁴² The term "interest in a closely held business" is defined as

- (A) an interest as a proprietor in a trade or business carried on as a proprietorship;
- (B) an interest as a partner in a partnership carrying on a trade or business, if—
 - (i) 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or
 - (ii) such partnership had 15 or fewer partners; or

438. See I.R.C. § 2001.

439. For example, a limitation restricting the maximum tax reduction to \$200,000 could be imposed instead of the present \$500,000 limitation on the allowable reduction in value.

440. This defect, however, is common to the entire federal tax structure.

441. This index is readily available in AGRICULTURAL STATISTICS, *supra* note 6, at 423; FARM REAL ESTATE MARKET DEVELOPMENTS—1976, *supra* note 24, at 6.

442. I.R.C. § 2032A(g).

- (C) stock in a corporation carrying on a trade or business if—
 - (i) 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or
 - (ii) such corporation had 15 or fewer shareholders.⁴⁴³

Other than these meager directions furnished by the Code, there are few indications of legislative intent in this area. A passage in the committee report states that "a decedent's estate generally should be able to utilize the benefits of special use valuation where he holds the qualifying real property indirectly, that is, through his interest in a partnership, corporation, or trust" if the property is used in a closely held business and the property would be eligible for use valuation "if it were held directly by the decedent."⁴⁴⁴ Additional insight is provided by the following statement in the conference report:

The conferees intend to make it clear that the rules for special valuation apply to property which passes in trust. Trust property shall be deemed to have passed from the decedent to a qualified heir to the extent that the qualified heir has a present interest in that trust property.⁴⁴⁵

Although it is clear that applicability of use valuation to property held by trusts, corporations, and partnerships is desirable to avoid inequitable treatment of the many family farms organized as corporations or partnerships, the extent and nature of this applicability will remain uncertain until regulations are promulgated.

3. *Statute of limitations*

Section 2032A provides that if a breach of the postmortem eligibility requirements⁴⁴⁶ occurs, the three-year statute of limitations begins to run at "the date the Secretary is notified (in such manner as the Secretary may by regulations prescribe)" of the disposition or cessation of use that triggers recapture.⁴⁴⁷ This statute of limitations is intended to supersede "any other law or rule

443. *Id.* § 6166(b)(1). This provision gives no guidance as to the type of trust that will be regarded as an "interest in a closely held business."

444. HOUSE REPORT, *supra* note 3, at 24, reprinted at 3378. See also *House Estate Tax Hearings*, *supra* note 6, at 727, 763 (statements of Edward McGinty).

445. H.R. REP. NO. 94-1515, 94th Cong., 2d Sess. 610, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 4249.

446. Notes 284-325 and accompanying text *supra*.

447. I.R.C. § 2032A(f)(1).

of law which would otherwise prevent . . . assessment" of the additional tax.⁴⁴⁸ Since the IRS is likely to respond to the required notice within three years by taking action to collect the additional tax, this statute of limitations will probably benefit very few taxpayers. Indeed, this statute of limitations apparently allows the IRS an unlimited amount of time to seek to collect the additional tax in cases where notice is either not given or is given improperly.

VII. INTERSECTIONS BETWEEN USE VALUATION AND OTHER CODE PROVISIONS⁴⁴⁹

A. *Extended Payment Provisions*

In general, if an estate makes use of section 2032A, it may also utilize the Code's provisions for extended payment of estate taxes if the appropriate requirements are met.⁴⁵⁰ An estate that achieves substantial tax savings by electing to value real property at its use value may realize further important tax benefits by use of the five-year deferral of taxes under section 6166.⁴⁵¹ In some cases, however, the reduction in the value of a farm or business due to use valuation may prevent the estate from qualifying for this deferral because the value of the business may be reduced to the point that it does not satisfy the requirement that the decedent's interest in a closely held business exceed 65 percent of the adjusted gross estate.⁴⁵² In many of these cases, eligibility for section 6166 can probably be maintained without completely sacrificing the benefits of use valuation if the decedent's real property is selectively designated in the section 2032A agreement⁴⁵³ so that the value of the farm or business in the estate slightly exceeds the 65 percent requirement. Similarly, an election under section 6166A may be frustrated if use valuation reduces the value of the decedent's interest in a closely held business below

448. *Id.* § 2032A(f)(2).

449. Obviously, section 2032A will intersect with provisions of the tax law other than those discussed below, but they are too numerous to examine for purposes of this comment. See, e.g., *id.* §§ 2204, 7403. Some of the more significant of these intersections have been discussed earlier in this comment, including the effect of use valuation on the basis of property so valued, notes 287-89 and accompanying text *supra*, and the relationship between section 2032A recaptures and the credit for previously taxed transfers, notes 431-35 and accompanying text *supra*.

450. I.R.C. §§ 6161, 6166, 6166A; notes 164-71 and accompanying text *supra*.

451. Notes 170-71 and accompanying text *supra*.

452. I.R.C. § 6166(a)(1), (b)(4); HOUSE REPORT, *supra* note 3, at 31-33, reprinted at 3385-87.

453. Notes 284-90 and accompanying text *supra*.

the 35 percent (of the gross estate) and 50 percent (of the taxable estate) requirements of section 6166A.⁴⁵⁴ This result, too, can often be avoided by selective use of section 2032A for only part of the decedent's land that could qualify for use valuation.

B. Alternate Valuation Date

Although it is conceivable that the alternate valuation date six months after the decedent's death⁴⁵⁵ could be employed in conjunction with use valuation, it seems more likely that joint use of these two valuation sections will not be allowed.⁴⁵⁶ An election to value property as of the alternate valuation date requires *all* of the property in the estate to be valued as of that date,⁴⁵⁷ but the use valuation formula expressly requires that the computation be based on rent, taxes, and interest rates for the five most recent calendar years ending before the date of the decedent's death.⁴⁵⁸ Thus, even if the alternate valuation date were used in conjunction with section 2032A, it would not change the use value under the formula.⁴⁵⁹ There would appear to be less difficulty, however, in using the multiple factor valuation method jointly with the alternate valuation date. Since the alternate valuation date is seldom elected⁴⁶⁰ and use valuation will be employed only by relatively few estates, the number of estates that could benefit from joint use of these provisions is probably extremely small.

C. Gifts Within Three Years of Decedent's Death

Another area as to which the Code and the legislative history of section 2032A are silent is the possibility of use valuation of real property that is included in the decedent's estate by virtue of section 2035.⁴⁶¹ Since section 2032A does not require ownership of

454. I.R.C. § 6166A(a).

455. *Id.* § 2032.

456. Avery, *supra* note 223; Case & Phillips, *supra* note 195, at 366.

457. I.R.C. § 2032(a).

458. *Id.* § 2032A(e)(7)(A).

459. This conclusion would be indisputable if the decedent died in the first six months of the calendar year. If the decedent died in the last six months of the year, however, it might be argued that the alternate valuation date would shift the five-year base period ahead one year. Such an argument would fail because § 2032A expressly requires the computation to be based on the five most recent calendar years ending before the date of the decedent's death.

460. See INTERNAL REVENUE SERVICE, *supra* note 33, at 23.

461. I.R.C. § 2035 (providing that property, other than that transferred in bona fide sales for full consideration and gifts within the annual exclusion of I.R.C. § 2503(b), transferred by the decedent within three years of his death is included in his gross estate).

property by the decedent at the time of his death in order to qualify for use valuation, the literal requirements for eligibility under section 2032A could be satisfied if the decedent makes a gift of farmland, for example, to a "family member"⁴⁶² within three years before his death and the other requirements of location, citizenship or residence, ownership, use, material participation, and the 50-percent and 25-percent tests⁴⁶³ are met. Indeed, certain language used in section 2032A even suggests (for the lack of any other explanation for it) that such gifts were intended to be eligible for use valuation.⁴⁶⁴ If qualifying real property is included in the decedent's estate despite the fact that he gave it to a member of his family within three years of his death, it seems eminently reasonable to permit such property to be valued at its use value if the other eligibility requirements are complied with. This result would be equitable and consistent with the basic policy of section 2032A—preservation of family farms and businesses.

VIII. CONCLUSION

The potential burden of estate taxes on farms under prior law constituted a serious threat to the survival of many family farms and to the efficient use of agricultural land, especially in view of the gross illiquidity of large farm estates and the lack of adequate estate planning by farmers. In addition, the valuation of farmland at fair market value based on its highest and best use contributed materially to the irreversible conversion of farmland to nonagricultural uses. The Internal Revenue Code's new provision for use valuation of farmland and certain other real estate constitutes a substantial step toward the resolution of these problems. Despite its defects, section 2032A achieves a respectable balance between complex and competing policies. Nevertheless, the section can and should be improved substantially through appropriate action by Congress. Although the IRS and the courts can improve the new law to a limited extent through intelligent interpretation in the light of public policy and legislative intent, the primary responsibility for correcting the defects of section 2032A rests squarely on Congress.

462. Notes 250-53 and accompanying text *supra*.

463. For a discussion of these various requirements, see notes 227-325 and accompanying text *supra*.

464. Note 241 and accompanying text *supra*; see I.R.C. § 2032A(e)(1) (defining "qualified heir" as a member of decedent's family "who acquired such property (or to whom such property passed) from the decedent").