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## **Agriculture Estate Planning and The Economic Recovery Tax Act of 1981**

by

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# AGRICULTURE ESTATE PLANNING AND THE ECONOMIC RECOVERY TAX ACT OF 1981

D.L. UCHTMANN\* and T. FISCHER\*\*

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## INTRODUCTION

The Economic Recovery Tax Act of 1981<sup>1</sup> contains significant changes in federal estate and gift tax law which have an impact on agricultural estate planning. Many of these changes, such as amendments to I.R.C. section 2032A, relating to special use valuation, and I.R.C. section 6166, relating to extension of time for payment of estate taxes, are modifications of sections originally introduced by the Tax Reform Act of 1976<sup>2</sup> specifically to assist the family farm and closely held businesses. It is important to examine the 1981 Act in relation to the previous law and determine whether the 1981 Act corrects perceived agricultural estate planning problems, fails to deal with any of these problems, exacerbates these problems, or creates new problems. It is also important to analyze whether the new provisions' actual effect on agricultural estate planning and agriculture in general matches the policy rationale behind their enactment.

This article begins with an extensive technical analysis of the 1981 Act as it relates to agriculture. This technical analysis is divided into the first section which focuses on the lengthy and complex I.R.C. section 2032A and the second section which focuses on other changes. In the third section the article addresses various ways in which agricultural estate planners must change their strategies. This section also considers why agricultural estate planning is still important to farmers and illustrates some of the practical effects of the 1981 Act. The fourth section concludes with a policy analysis of the 1981 Act's effect on agriculture and agricultural estate planning. This section deals with broad policy issues, such as whether certain provisions of the estate tax law might encourage creation of a landholding elite or investment by non-traditional farmers seeking tax shelters. This section also in-

1. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981).

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

investigates I.R.C. sections 2032A, 6166, and 2042A, relating to the fractional interest rule for joint tenancies.

### PROVISIONS OF I.R.C. SECTION 2032A SPECIAL USE VALUATION

The Tax Reform Act of 1976<sup>3</sup> originally introduced the special use valuation provisions. Prior to the 1976 Act, I.R.C. section 2031(a) provided that the gross estate of the decedent include all farmland at its fair market value. Fair market value includes not only expected future returns from producing crops or livestock, but also potential returns from conversion to non-farm uses or other speculative returns. Thus, the fair market value of farmland often exceeded its value for producing crops and livestock. The special use valuation provisions were designed to include qualified farmland in the gross estate at its value as farmland.<sup>4</sup> To obtain this goal Congress enacted I.R.C. section 2032A which provided that under certain circumstances an executor of an estate could elect to have qualifying real property included in a decedent's gross estate at a value less than fair market value.

#### *Method of Valuing Farms and Increase in Aggregate Reduction*

Previous law calculated special use valuation by dividing the excess of average annual gross *cash* rentals for comparable farmland in the locality of decedent's farm over the average annual state and local real estate taxes for such comparable land by the average annual interest rate for new federal land bank loans.<sup>5</sup> The 1981 Act extends use of this formula method by authorizing the use of *net share* rentals.<sup>6</sup> This provision will be available for

3. *Id.*

4. H.R. REP. NO. 1380, 94th Cong., 2d Sess. 21, 22, reprinted in 1976 U.S. CODE CONG. & AD. NEWS 3375, 3376.

5. I.R.C. § 2032A(e)(7)(A)(i), (ii) (1981) (amended 1981). For example, assume that over the past five years average annual gross cash rent for comparable property has averaged \$140 per acre, that average real estate taxes for comparable property have averaged \$20 per acre, and that the interest rate on new Federal Land Bank loans has averaged 10%. The special valuation per acre would be as follows:  $\$140 - \$20/.10 = \$1200$ . If there were no comparable land from which an average annual gross cash rental could be determined, I.R.C. § 2032A(e)(8) (1981) provides for an alternative multi-factor approach. Among the factors which should be applied are

(A) [T]he capitalization of income which the property can be expected to yield for farming or closely held business purposes . . . ,

(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 . . . ,

(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 non-agricultural use is not a significant factor in the sales price, and

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

It is the author's observation that the multiple factor approach was rarely used in valuing farmland, as a practical matter.

6. I.R.C. § 2032A(e)(7)(B)(i), (ii) (1981) (amended 1981). If there is no comparable land from which an average annual gross cash rental may be determined, but there is comparable land from which an average net share rental may be determined, "average annual net share rental" may be substituted for "average annual gross cash rental" in the valuation formula. *Id.* Net share rental means the excess of the value of the produce received by the lessor of the land on which such

the estates of decedents dying after 1981. The House of Representatives Committee Report explains that this change generally ensures the availability of the formula method to farms in areas which traditionally use share rather than cash rentals.<sup>7</sup>

The practical application of this change may result in a lower valuation of farmland than would be calculated if average cash rental information had been available. In theory average crop share rentals should be higher than cash rentals because the lessee undertakes a much greater element of risk in the case of crop share rentals. The uncertainties of weather and price can drastically affect the dollar value of the rent received. In practice, however, cash rentals tend to be higher because so little farmland is available for rent. If net share rentals are lower than cash rentals, a formula value based on net share rentals will be lower than one based on crop share rentals. The 1981 Act, therefore, may result in still lower valuations for farms located in areas where no cash rental information is available—farms which, but for the new rule, would not have been able to use the formula at all. Any inequity resulting from this opportunity is outweighed by the fact that estates which otherwise meet the qualification rules will now for the first time be able to make use of the formula valuation method.

Previous law limited the aggregate reduction resulting from special use valuation to \$500,000.<sup>8</sup> The new rule in I.R.C. section 2032A(a)(2) raises the limit to \$600,000 in 1981, \$700,000 in 1982, and \$750,000 thereafter.<sup>9</sup>

### *Extension of Qualified Use, Measurement of Material Participation, and "Tacking" of Requirements for Qualified Exchange Property*

Only qualified real property as defined by I.R.C. section 2032A is eligible to be included at its special use valuation in the decedent's estate. The 1981 Act makes important changes in the definition of qualified real property.<sup>10</sup> I.R.C. section 2032A(b) now provides that the qualified use can be

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produce is grown over the cash operating expenses of growing such produce, not including real estate taxes, which under the lease are paid by the lessor.

7. H.R. REP. NO. 4242, 97th Cong., 1st Sess. — (1981).

8. I.R.C. § 2032A(a)(2) (1981) (amended 1981).

9. *Id.*

10. Under previous law qualified real property was defined as real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and which, on the date of the decedent's death, was used for a qualified use. In addition, at least 50% of the adjusted value of the decedent's gross estate had to consist of the adjusted value of real or personal property which, on the date of the decedent's death, was being used for a qualified use. *Id.* at (b)(1)(A). Finally, at least 25% of the adjusted value of the decedent's gross estate had to consist of the adjusted value of real property for which during the eight year period ending on the date of the decedent's death there had been periods aggregating five years or more during which the real property was owned by the decedent or a member of the decedent's family and used for a qualified use. *Id.* at (b)(1)(B). There also had to be material participation by the decedent or a member of the decedent's family in the operation of the farm or other business during the periods aggregating five years or more.

The treasury regulations for the previous law made it clear that the decedent had to be "at risk" to meet the requirement. They provided that the "qualified use" of I.R.C. § 2032A (1981) applied "only to an active business such as a manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities, as distinguished from mere passive invest-

implemented by the decedent or a member of the decedent's family. This change was made retroactive to the estates of decedents dying after 1976. For farm families this means the decedent can have a cash lease with a member of his family and still fulfill the requirements of I.R.C. section 2032A(b) because now either the decedent or a member of his family must be at risk. A cash lease to a non-family member, however, would still preclude qualification.

The 1981 Act allows the decedent's material participation to be measured from the date of the decedent's retirement or permanent disability instead of from the date of the decedent's death.<sup>11</sup> For older farmers this change, which takes effect for the estates of decedents dying after 1981, is important. One determines the material participation required of the decedent by referring to I.R.C. section 1402(a)(1), which relates to net earnings from self-employment. Income derived from the farm could reduce retired farmers' social security benefits. A farmer, therefore, could have had to choose between planning for a special use valuation election and receiving social security benefits.<sup>12</sup> With the change in I.R.C. section 2032A(b)(4), retired farmers will no longer have to make this choice.

I.R.C. section 2032A(e)(14) of the 1981 Act permits the "tacking" of ownership, qualified use, and material participation requirements for qualified replacement property. Such property is defined as real property acquired under an I.R.C. section 1033 involuntary conversion or an I.R.C. section 1031 like-kind exchange. The tacking is permitted only to the extent that the value of the qualified replacement property does not exceed the value of the replaced property.

### *"Active Management" for Surviving Spouses*

In certain cases, the 1981 Act permits satisfaction of the material participation requirement of a surviving spouse if there is "active management"

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ment activities" and flatly prohibited "the mere passive rental of property," i.e., cash leases. Treas. Reg. § 20.2032A-3(b)(1) (1981). If the decedent were not at risk for five of the eight years ending at the date of the decedent's death then the decedent's estate would not have qualified for I.R.C. § 2032A (1981). A cash lease between the decedent and a member of the decedent's family during those five years would have been fatal to qualification since the decedent would not be at risk as to production. A crop share lease would not have been fatal, however, because the decedent would thereby be at risk.

11. If on the date of the decedent's death the decedent's material participation requirement is not met and if the decedent was receiving old-age social security benefits until the decedent's death or was permanently disabled until the decedent's death, then the decedent's material participation requirement will be measured from the date the decedent began to receive old-age benefits or was permanently disabled. I.R.C. § 2032A(b)(4) (1982).

12. According to the House Committee Report:

Under present law, the decedent or a member of his family must materially participate in the farm for periods aggregating five years of the eight years before the decedent's death. On the other hand, if the decedent materially participates in the farm any income derived from the farm is treated as earned income for social security purposes and, therefore, may reduce social security benefits. Because of the interaction of these two rules, some older citizens are forced to choose between receiving social security benefits and securing the benefits of current use valuation for their estates. H.R. Rep. No. 4242, 97th Cong., 1st Sess. — (1981).

by the surviving spouse.<sup>13</sup> Active management of a business is defined as the making of management decisions other than daily operating decisions.<sup>14</sup> If a decedent does not pay self-employment tax under I.R.C. section 1402(a)(1), material participation is ordinarily presumed not to occur.<sup>15</sup> But active management can be assumed to occur even if the decedent does not pay self-employment tax under I.R.C. section 1402(a)(1).<sup>16</sup> The House of Representatives Committee Report further explains:

Among the farming activities, various combinations of which constitute active management are inspecting growing crops, reviewing and approving annual crop plans in advance of planting, making a substantial number of the management decisions of the business operation, and approving expenditures for other than nominal operating expenses in advance of the time the amounts are expended. Examples of management decisions are decisions such as what crops to plant or how many cattle to raise, what fields to leave fallow, where and when to market crops and other business products, how to finance business operations, and what capital expenditures the trade or business should make.<sup>17</sup>

The active management provision is meant as a recognition on the part of Congress that many surviving spouses, particularly surviving farm wives, cannot satisfy the strict requirement of material participation even though they play a leading role in directing the operations of their farms. The Treasury Regulations define material participation as actual employment of the decedent on a substantially fulltime basis or to any lesser extent necessary personally to manage fully the farm or business. The Regulations also specify what particular activities on the part of the decedent might constitute material participation.<sup>18</sup>

Although I.R.C. section 2032A(b)(5) was meant as a relief provision for surviving spouses, the difference between qualification for active management and qualification for material participation may be insignificant. The owner or the owner's family members who furnish a substantial portion of the machinery, implements, and livestock used in the farm production activities may meet the material participation requirement. Factors such as actual physical work, regular inspection of growing crops, direct control of the financial operations of the farm, and the making of a substantial portion of the management decisions are relevant, but none of these factors is abso-

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13. I.R.C. § 2032A(b)(5) (1982). If property is qualified real property for a decedent and the property is acquired from or passed from that decedent to the decedent's surviving spouse, active management by the surviving spouse will be treated as material participation by that spouse in the operation of the farm or business for the purposes of the recapture provision and qualification in the estate of the surviving spouse. *Id.*

14. I.R.C. § 2032A(e)(12) (1982).

15. Treas. Reg. § 20.2032A-3(c) (1981).

16. H.R. REP. NO. 4242, 97th Cong., 1st Sess. — (1981).

17. *Id.*

18. Treas. Reg. § 20.2032A-3(e)(1) (1981).

lutely dispositive.<sup>19</sup> Thus certain kinds of crop share leases with accompanying management activity can fulfill the material participation requirement. Similarly, inspection of growing crops, decisions concerning the financing of the farming operations and the making of capital expenditures, as well as other management decisions, are all factors relevant in determining *active management*, but none is absolutely dispositive. Presumably certain kinds of crop share lease arrangements with accompanying management activity will also fulfill the active management requirement. The crucial difference between material participation and active management may then be that material participation is ordinarily presumed not to occur if the decedent did not pay self-employment tax. Active management, however, can be presumed to occur even if the decedent did not pay the self-employment tax, regardless of whether such tax should have been paid.

There is one other important difference between active management and material participation. One may fail to meet the material participation requirement because of the terms of the crop share lease. Either a written or oral lease must include an agreement that the dependent or a member of the decedent's family will materially participate. Failure to include the agreement prevents the fulfillment of the material participation requirement regardless of the necessary material participation. At this time, active management demands no similar requirement.

### *Eligibility of Property Transferred to Certain Discretionary Trusts and Property Purchased from Decedent's Estate*

The 1981 Act provides that for application of I.R.C. section 2032A, an interest in a discretionary trust, all the beneficiaries of which are qualified heirs, will be treated as a present interest.<sup>20</sup> This provision is retroactive to the estates of decedents dying after 1976.

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19. (2) Factors considered. No single factor is determinative of the presence of material participation, but physical work and participation in management decisions are the principal factors to be considered. As a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and/or family members must participate in making a substantial number of these decisions. Additionally, production activities on the land should be inspected regularly by the family participant, and funds should be advanced and financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, the furnishing by the owner or other family members of a substantial portion of the machinery, implements, and livestock used in the production activities is an important factor to consider in finding material participation. With farms, hotels, or apartment buildings, the operation of which qualifies as a trade or business, the participating decedent or heir's maintaining his or her principal place of residence on the premises is a factor to consider in determining whether the overall participation is material. Retention of a professional farm manager will not by itself prevent satisfaction of the material participation requirement by the decedent and family members. However, the decedent and/or a family member must personally materially participate under the terms of arrangement with the professional farm manager to satisfy this requirement.

Treas. Reg. § 20.2032A-3(3)(2) (1981).

20. I.R.C. § 2032A(g) (1982).

Under I.R.C. section 2032A(e)(9) of the previous law, property was considered to have been acquired from or to have passed from the decedent only if the property was so characterized under I.R.C. section 1014(b), that is, only through inheritance, bequest, or devise, or if a person acquires the property from the estate in satisfaction of the right of the person to a pecuniary bequest. The 1981 Act amends I.R.C. section 2032A(e)(9) so that it includes property acquired by a person from the estate in satisfaction of the right of the person to a pecuniary bequest. The 1981 Act amends I.R.C. section 2032A(e)(9) to include property acquired by a person from the estate, that is, property purchased from the decedent's estate by a qualified heir. This provision also applies retroactively to the estates of decedents dying after 1976. These changes in the property eligibility requirements increase the planning flexibility of farm families interested in an I.R.C. section 2032A election.

### *Definition of Family Member*

The 1981 Act amends I.R.C. section 2032A(e)(2) to define "member of the family," for purposes of special use valuation, as an individual's ancestor, an individual's spouse, a lineal descendent of the individual, the individual's *spouse*, or the individual's *parent*, and the spouses of these lineal descendants.<sup>21</sup> The new definition of "member of the family," which takes effect for estates of decedents dying after 1981, is important both in terms of qualification for I.R.C. section 2032A and that section's recapture provisions.<sup>22</sup> The qualified heir who acquires the qualified real property from the decedent must be a member of the decedent's family; the decedent or a member of the decedent's family must be at risk for five of the eight years preceding the decedent's death; and there must be material participation by the decedent or a member of the decedent's family for five of the eight years preceding the date of the decedent's death, retirement, or permanent disability. Previous law received criticism because its broad definition of "member of the family" included persons even remotely related to the decedent.<sup>23</sup> The new definition eliminates aunts and uncles and the descendants of aunts and uncles, but it adds stepchildren, their spouses, and their descendants. For farm families planning to utilize special use valuation in the estates of post-1981 decedents, a cash lease between the decedent and the decedent's brother, nephew, or stepson, who was at risk and who materially partici-

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21. *Id.* Under previous law "member of the family" was defined as an individual's ancestor, an individual's spouse, a lineal descendent of the individual or the individual's *grandparents*, and the spouses of these lineal descendants. I.R.C. § 2032A(e)(2) (1981) (amended 1981).

22. See *infra* text accompanying notes 24-27 for the effects of this change in definition on the recapture provisions.

23. Comment, *The Family Farm and Use Valuation—Section 2032A of the Internal Revenue Code*, 1977 B.Y.U.L. REV. 353, 404. This comment points out that under the 1976 Act the qualified heir who received the benefit of I.R.C. § 2032A might be as remotely related to the decedent as the spouse of the decedent's first cousin several times removed.

pated in the operation of the farm, would be satisfactory, while the same lease with the decedent's uncle or cousin would not be.

*Reduction of Recapture Period to Ten Years and Institution of Two Year Grace Period*

Before the 1981 Act recapture of the estate tax saved by special use valuation could occur if the qualified real property were disposed of within fifteen years of the decedent's death.<sup>24</sup> The 1981 Act amends I.R.C. section 2032A so that recapture takes place only if the prescribed conditions occur within ten (or in some cases twelve) years after the decedent's death. This provision applies to the estates of decedents dying after 1981.<sup>25</sup>

Under the 1981 Act if the date on which the qualified heir begins to use qualified real property is prior to two years after decedent's death, extra estate tax will not be imposed.<sup>26</sup> This provision is made retroactive to the estates of decedents dying after 1976. This two year grace period is necessitated by the provision in I.R.C. section 2032A(b)(4) that material participation can be measured from the date of the decedent's retirement or permanent disability. If the decedent was retired or permanently disabled and was renting his land out, the qualified heir might need the grace period to satisfy leasing arrangements into which the decedent had entered, for example, a non-material participation crop share lease. Even if there were no difficulties with existing leases, a complex estate might still require the grace period to qualify for special use valuation.

The change in the definition of "member of the family" is important for the recapture provisions as well as for the qualification provisions because if the qualified heir disposes of any interest in the qualified real property to anyone but a member of the *qualified heir's family*, then recapture occurs. It is important to note that for purposes of the *recapture* provisions the inquiry concerns the *qualified heir's* members of the family, while for the purposes of the *qualification* provisions the inquiry concerns the *decedent's* members of the family.<sup>27</sup> The definition of the qualified heir's family members is both

24. I.R.C. § 2032A(c)(1) (1981) (amended 1981) of the previous law provided for an imposition of an additional estate tax if within fifteen years after the decedent's death and before the death of the qualified heir, the qualified heir disposed of any interest in the qualified real property (other than by disposition to his family), or the qualified heir ceased to use for the qualified use the qualified real property which was acquired or passed from the decedent. I.R.C. § 2032A(c)(3) (1981) (amended 1981) provided for a phaseout of additional taxes between the tenth and fifteenth years. Cessation of qualified use was defined by I.R.C. § 2032A(c)(7) (1981) (amended 1981) as when property ceased to be used for the qualified use under which the property qualified for the provisions of I.R.C. § 2032A or when during any period of eight 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 of three years or more during which there was no material participation by the decedent or any member of his family in the operation of the farm or other business or no material participation by a qualified heir or member of his family.

25. The 1981 Act only changes the recapture period for estates of decedents dying after 1981. Estates of decedents dying before 1982 will continue to be governed by the fifteen year recapture period. ERTA, Pub. L. No. 97-34, § 421(k), 95 Stat. 313 (1981).

26. I.R.C. § 2032A(c)(7) (1982).

27. Comment, *supra* note 23. This Comment points out that because I.R.C. § 2032A(e)(2) of

broadened and narrowed in the same way as is the definition of the decedent's family members. For estates of decedents dying after 1981, the qualified heir can dispose of the heir's interest in the qualified real property to the heir's sister, niece, or stepdaughter without triggering the recapture provisions. A disposition to the heir's aunt or cousin would retrigger recapture.

### *Basis Increase for Property Subject to Recapture Tax*

The 1981 Act creates an election in the qualified heir to increase the adjusted basis of the qualified real property by the amount of the recapture tax if the recapture tax were imposed.<sup>28</sup> Once made the election is irrevocable. An election is also provided for partial dispositions of property for which a special use valuation election has been made.<sup>29</sup> If the recapture tax is imposed on qualified replacement property or qualified exchange property, the increase in basis will be made by reference to the property involuntarily converted or exchanged.<sup>30</sup> If the qualified heir elects to have the recapture tax included in the basis, the heir must pay interest on the recapture tax from the date the decedent's estate taxes were due until the date the recapture tax is due.<sup>31</sup>

These provisions, which take effect for the estates of decedents dying after 1981, correct a major flaw in the previous law. The reduction in income tax basis in farmland as a result of the I.R.C. section 2032A election, and the failure to provide for an increase in basis of the farmland as to which an election has been made if the farmland is sold and a recapture tax is imposed, has been called the greatest detriment to the utilization of that section.<sup>32</sup> That is because if an estate makes an I.R.C. section 2032A election the basis of the real property acquired from the decedent is its value as determined by that section.<sup>33</sup> If the qualified heir wanted or had to sell the qualified real property acquired from the decedent, the heir would have had to pay not only the recapture tax, but also an increased federal income tax as a result of the lower basis, that is, the I.R.C. section 2032A value. Farm families might have hesitated to elect I.R.C. section 2032A because of the potentially disastrous tax consequences if for some reason they had to sell

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the previous law, which is unchanged by the 1981 Act, allows a qualified heir to sell the qualified property to any member of the qualified heir's family without having to pay the recapture tax, and because a member of the qualified heir's family might include anyone as remotely related to the heir as the heir was to the decedent, the qualified heir will be able to keep the benefits of I.R.C. § 2032A and still sell the land to persons in no way related to the decedent. The qualified heir will still be discouraged from selling the qualified real property because of the lower basis of the qualified real property.

28. I.R.C. § 1016(c)(1) (1982). Under previous law a qualified heir's income tax basis in property for which a special use valuation election had been made was its special use valuation. No adjustment in the basis could be made if the recapture tax were imposed.

29. I.R.C. § 1016(c)(2) (1982).

30. I.R.C. § 1016(c)(4) (1982).

31. I.R.C. § 1016(c)(5)(B) (1982).

32. Cox, *Estate Planning for Farmers After the Tax Reform Act of 1976*, 14 WAKE FOREST L. REV. 577, 612 (1978).

33. I.R.C. § 1014(a)(3) (1981).

some of their farmland. I.R.C. section 1016(c)(1) now removes the cause for that hesitation.

*Recapture and Involuntary Conversions or Exchanges of Qualified Real Property*

Under previous law, an involuntary conversion of an interest in qualified real property would allow the qualified heir to elect to have no recapture tax imposed if qualified replacement property were purchased.<sup>34</sup> The 1981 Act amends I.R.C. section 2032A(h)(1)(A) so that the qualified heir need no longer elect to have the benefit of this provision. In addition, the 1981 Act adds I.R.C. section 2032A(i) which provides that if an interest in qualified real property is exchanged solely for an interest in qualified exchange property in a transaction which qualifies under I.R.C. section 1031, no recapture tax will be imposed. The qualified exchange property or qualified replacement property must be used in the same qualified use as the property which was disposed of.<sup>35</sup>

These provisions apply to involuntary conversions and exchanges occurring after 1981. Taken in conjunction with the provisions of I.R.C. section 2032A(e)(14) relating to the tacking of requirements for qualified exchange property, these provisions mean that involuntary conversions and like-kind exchanges will neither prevent the decedent's estate from qualifying for special use valuation nor trigger the recapture tax for the qualifying heir.

*Active Management Requirements for Eligible Qualified Heirs*

The 1981 Act extends the provision that active management can be treated as material participation not only for surviving spouses, but also for qualified heirs who have not attained the age of twenty-one, who are disabled, or who are students.<sup>36</sup> If the qualified heir has not attained the age of twenty-one or is disabled, the active management may be by a fiduciary. The House of Representatives Committee Report explains that the fiduciary can be a guardian or a trustee but not an agent.<sup>37</sup> These provisions apply retroactively to the estates of decedents dying after 1976. They indicate a realization on the part of Congress that there are limited classes of qualified heirs besides surviving spouses that cannot satisfy the strict requirement of material participation even though they play a leading role in directing the operation of their farms.

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34. I.R.C. § 2032A(h)(1)(A)(i) (1981) (amended 1981).

35. I.R.C. §§ 2032A(i)(3), 2032A(h)(3)(B) (1982).

36. I.R.C. § 2032A(c)(7)(B) (1982).

37. H.R. REP. NO. 4242, 97th Cong., 1st Sess. — (1981).

## OTHER ESTATE AND GIFT TAX PROVISIONS OF THE 1981 ECONOMIC RECOVERY TAX ACT

### *Increase in the Unified Credit*

I.R.C. sections 2010(a) and 2505(a) increase the unified credit against estate and gift taxes from \$47,000 in 1981 to \$192,000 in 1987.<sup>38</sup> Beginning in 1987 there will be no federal taxes on estates or lifetime gifts totaling less than \$600,000. I.R.C. section 6018(a)(3) phases in the filing requirement for estates to coincide with the exemption equivalent amounts in I.R.C. sections 2010(b) and 2505(b).

The benefits of these sections to the farm family are obvious. Under the new law, by 1987 a much larger portion of farm property will be able to pass through the estate free of federal estate tax.<sup>39</sup> In some cases, depending upon the size of the farm and the region in which it is located, an entire farming operation will be transferable at death without generating federal estate taxes. This increase lessens the burden of estate taxes on almost all farm families and helps alleviate the potential problem of a forced sale of the family farm to pay decedent's taxes.

### *Reduction of Maximum Transfer Tax Rate*

I.R.C. section 2001(c) provides for reduction of the maximum transfer tax rate from 70% on transfers in excess of \$5,000,000 in 1981 to 50% on transfers in excess of \$2,500,000 by 1985. Reductions are in 5% increments over this four year period. This section will most benefit the owners of large farming operations.

### *Unlimited Marital Deduction*

Previous law, I.R.C. section 2056(c), limited the estate tax marital deduction to the greater of \$250,000 or 50% of the value of the adjusted gross estate. I.R.C. section 2523(a) limited the gift tax marital deduction to the first \$100,000 of gifts to a spouse and to 50% of gifts exceeding \$200,000. Under the 1981 Act, I.R.C. section 2056(a) allows determination of the value of a decedent's taxable estate by deducting from the value of a gross estate an amount equal to all the property passing to the surviving spouse. I.R.C. section 2523(a) allows a deduction in computing taxable gifts of an amount equal to any gift given to the donor's spouse.

These provisions, which take effect for the estates of decedents dying after 1981, have a profound effect on estate tax planning. Under previous law, property transferred from the estate of the first spouse to die to the surviving spouse could be taxed in the estates of both spouses. It will now

38. I.R.C. §§ 2010(b) and 2505(b) (1982) phase in the credit so that in 1982 it is \$62,800 (exemption equivalent = \$225,000), in 1983, \$79,300 (\$275,000), in 1984, \$96,300 (\$325,000), in 1985, \$121,800 (\$400,000), in 1986, \$155,000 (\$500,000), and in 1987, \$192,800 (\$600,000).

39. The \$47,000 unified credit under I.R.C. § 2010(a) (1981) (amended 1981) of the previous law had an exemption equivalent of \$175,000.

only be taxed in the estate of the surviving spouse. A husband and wife attempting to balance ownership of their assets so as to avoid additional estate taxes will no longer have to pay gift taxes when one spouse transfers assets to the other.<sup>40</sup> Similarly, couples who want to dissolve their joint tenancy ownership of farm property because of some of the accompanying adverse estate tax consequences will no longer have to worry about the adverse gift tax consequences of such a dissolution. Provided the optimum marital deduction is utilized, the unlimited marital deduction makes it easy for a couple to create two separate \$600,000 taxable estates so that \$1,200,000 can pass to the next generation free of federal estate tax. For many farmers this technique is the only tax planning step necessary to eliminate federal estate tax. It also creates the risk that many farm families will mistakenly believe estate tax planning is no longer important. This risk is discussed later in this article.

This new unlimited marital deduction does not apply to wills and trusts containing maximum marital deduction formula clauses which were created before an enactment of the 1981 Act.<sup>41</sup> The House of Representative Committee Report noted that many testators using marital deduction formula clauses might not have wanted to pass more than the greater of \$250,000 or one-half of the adjusted gross estate to the surviving spouse.<sup>42</sup> Estate planners should ask their clients whether they want the marital deduction formula clauses in their previously created wills and trusts to refer specifically to the unlimited marital deduction. This exception for marital deduction formula clauses in previously created wills and trusts, is permanent; it does not expire on some future date.

The new unlimited marital deduction also applies to certain *qualified terminable interest property*. Under the previous law, a life interest in which a decedent controlled the ultimate disposition of the property was not eligible for the marital deduction.<sup>43</sup> The 1981 Act allows an irrevocable election

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40. For example, if the husband owned farm property worth \$1,000,000, and the wife owned farm property worth \$200,000, the husband might want to transfer \$400,000 of property to his wife so that they could both make maximum use of their \$600,000 unified credit. Under previous law the husband would have had to pay some gift taxes on the \$400,000 transfer. Under the 1981 Act he has a marital deduction for the entire amount when computing his taxable gifts.

41. If a decedent executes a will or creates a trust before September 12, 1981 and that will or trust contains a marital deduction formula clause, the unlimited marital deduction does not apply to the estate of that decedent unless the formula clause was amended to refer specifically to the unlimited marital deduction or the state enacts a statute which construes the formal clause as referring to the unlimited marital deduction. I.R.C. § 2207A(e) (1982).

42. H.R. REP. NO. 4242, 97th Cong., 1st Sess. — (1981).

43. I.R.C. § 2056(b)(1) (1981) provides generally that no marital deduction will be allowed for a life interest passing to a surviving spouse when an interest in the life interest property passed from the decedent to anyone but the surviving spouse. I.R.C. § 2056(b)(5) (1981) does allow the marital deduction for life interests with a general power of appointment in the surviving spouse. The requirement that no interest in the life interest property can pass from the decedent to anyone but the surviving spouse is retained and the surviving spouse has to have the sole power of appointment for the life interest. I.R.C. § 2056(b)(5) (1981) was not changed by the 1981 Act, but it will now be used far less frequently. If testators want to ensure that the property in their estates qualifies for the marital deduction and that their spouses have total control of it, they can do so by bequeathing a fee simple interest in the property to their spouses. If testators want to control the

in the executor to have certain life interests qualify for the marital deduction.<sup>44</sup> It also allows an irrevocable election in a donor spouse to have inter vivos transfers creating certain life interests in the donee spouse qualify for the marital deduction.<sup>45</sup>

These provisions take effect for the estates of decedents dying and gifts made after 1981. They make a marital deduction possible even for property where the ultimate disposition is controlled by the decedent or donor. For example, a farming husband could leave all his property in trust to his wife for life, remainder to his children. If the executor so elected, this disposition would qualify for the marital deduction. The disposition would also qualify for the marital deduction if he left all his property in trust to his wife for life along with a power of appointment to be exercised only at her death.

### *Jointly Held Property*

Previous law, I.R.C. section 2040(a), provided that the entire value of a joint property should generally be included in the estate of the first joint tenant to die.<sup>46</sup> As amended by the 1981 Act, this section provides that where spouses hold property in joint tenancy with the right of survivorship, the value of the gross estate of the decedent is one-half the value of the joint interest. I.R.C. section 2040(c) and its material participation requirements are repealed.<sup>47</sup> These changes take effect for the estates of decedents dying after 1981.

The new 50% rule is meant to replace the "2% material participation" rule which did not offer a significant tax savings and created problems resulting from the material participation of the spouse.<sup>48</sup> But the need for this 50% rule is totally eliminated by the unlimited marital deduction. Even if the previous rule for joint tenancies still existed, the new unlimited marital deduction would allow the transfer of all joint tenancy property without the

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ultimate disposition of the property, ensure that the property may qualify for the marital deduction, and ensure that their spouses will have the use and benefit of the property, I.R.C. § 2056(b)(7) (1982) now makes that possible. As a result I.R.C. § 2056(b)(5) (1981) will probably have far less appeal for most testators.

44. I.R.C. § 2056(b)(7) (1982). Qualified terminable interest property is defined as property which passes from the decedent and in which the surviving spouse has a qualifying income interest for life. I.R.C. § 2056(b)(7)(B)(i) (1982). Qualifying income interest for life means the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, and no person has the power to appoint any part of the property to any person other than the surviving spouse. I.R.C. § 2056(b)(7)(B)(ii) (1982). The surviving spouse is permitted to retain a testamentary power of appointment.

45. The irrevocable election must be made by the executor on the estate tax return. I.R.C. § 2523(f) (1982). The requirements for the qualified terminable interest property under this section are the same as under I.R.C. § 2056(b)(7) (1982).

46. An exception was also made for certain qualified joint interests defined in I.R.C. § 2040(b) (1981) of the previous law. Also, where the spouse of the decedent materially participated in the farm or other joint interest a portion of the joint interest could be excluded from the decedent's estate under I.R.C. § 2040(c) (1982).

47. I.R.C. § 2040(b)(3)(A) (1982).

48. Material participation was determined in a manner similar to the manner used to determine earnings from self employment under I.R.C. § 1402(a)(1) (1981), so the surviving joint tenant should have paid self employment taxes during her years of material participation.

imposition of federal estate taxes. But the new 50% rule does have a negative impact on the basis of the property in the hands of the surviving spouse.<sup>49</sup> Also the new rule may create difficulty in qualifying for I.R.C. sections 2032A and 6166 in some estates, since both beneficial provisions require the decedent to meet certain property ownership tests.

*Coordination of Extensions of Time for Payment of Estate Taxes Where Estate Consists Largely of Interest in Closely Held Business*

The 1981 Act consolidates I.R.C. sections 6166 and 6166A, both which dealt with the extension of time for the payment of estate tax where the estate consisted largely of an interest in a closely held business.<sup>50</sup> It expressly repeals I.R.C. section 6166A and amends I.R.C. section 5155 so that if the value of an interest in a closely held business included in the decedent's gross estate exceeds 35% of the adjusted gross estate (the old rule was 65%), the executor may elect to pay all or part of the estate tax in up to ten installments. Formerly, the rule required the interest in a closely held business exceed 65% of the adjusted gross estate. The special interest rate on the estate tax attributable to the first \$1,000,000 of interest in the closely held business still applies. The rule in I.R.C. section 6166(c) regarding two or more closely held businesses is changed so that now the decedent's interest in the closely held business can be 20% or more of the total value of each business.<sup>51</sup> The 1981 Act modifies I.R.C. section 303(b) to correspond with I.R.C. section 6166 as amended.<sup>52</sup>

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49. Only the half of the joint tenancy transferred to the surviving spouse through the estate of the decedent is eligible for the increase in basis provided for in I.R.C. § 1014(a) (1981). The other half will keep the same basis. As a result if the surviving spouse decides to sell the property which was formerly held in joint tenancy, he or she will have to pay more federal income tax than if the entire joint tenancy had been transferred to the surviving spouse (full stepped-up basis) through the estate of the decedent.

50. I.R.C. § 6166(a) (1981) (amended 1981) provided that if the value of an interest in a closely held business included in the decedent's gross estate exceeded 65% of the adjusted gross estate, the executor could elect to pay all or part of the tax imposed by I.R.C. § 2001 in not more than ten equal installments. If an election were made the first installment had to be paid no later than five years after the date prescribed by I.R.C. § 6151(a) (1981), and thereafter installments were to be paid annually. Under I.R.C. § 6601(j) (1981) the interest on the estate tax attributable to the first \$1,000,000 of interest in the closely held business was payable at a special 4% rate. No election could be made under I.R.C. § 6166(a) (1981) (amended 1981) if an election under I.R.C. § 6166A (1981) (amended 1981) applied with respect to the estate of the decedent.

I.R.C. § 6166A (1981) (amended 1981) provided that if the value of an interest in a closely held business included in the decedent's gross estate exceeded either 35% of the value of the gross estate or 50% of the taxable estate, the executor could elect to pay all or part of the tax imposed by I.R.C. § 2001 in not more than ten equal installments. If an election were made, the first installment had to be paid on or before the day prescribed by I.R.C. § 6151, and thereafter installments were to be paid annually. This section did not provide for a special interest rate.

51. Under I.R.C. § 6166(c) (1981) (amended 1981) of the previous law the interests in two or more closely held businesses, with respect to each of which there was included in determining the value of the decedent's gross estate more than 20% of the total value of each business, were treated as an interest in a single closely held business.

52. I.R.C. § 303(b) (1981) (amended 1981) of the previous law allowed stock redemption to pay estate taxes and funeral and administration expenses if the decedent's interest in the closely held corporation constituted at least 50% of the adjusted gross estate. Under the 1981 Act the decedent's interest in the closely held corporation must constitute at least 35% of the adjusted gross estate. The stock of two or more corporations, with respect to each of which there is included in

The 1981 Act alters the tax acceleration provisions of I.R.C. section 6166. Under I.R.C. section 6166(g)(1)(A), if the aggregate of distributions, sales, exchanges, or other dispositions and withdrawals from the qualifying closely held business exceeds 50% of the value of the interest, the unpaid portion of the tax payable in installments is due.<sup>53</sup> Under the previous law, the unpaid portion of the tax payable in installments was due if a payment of principal or interest was not paid on or before the due date.<sup>54</sup> The 1981 Act amends I.R.C. section 6166(g)(3) so that if payment is made within six months of the due date the entire unpaid tax does not become due. The late payment, however, does not have the benefit of the special 4% interest rate; a penalty of 5% per month of late payment is imposed.

Under previous law the unpaid tax did not become due if the decedent's interest in the closely held business was transferred to a person entitled by reason of the decedent's death to receive the property by will, intestacy, or a trust created by the decedent.<sup>55</sup> The 1981 Act amends I.R.C. section 6166(g)(1)(D) so that the unpaid tax also does not become due if there is a series of subsequent transfers of the decedent's interest in the closely held business by reason of death provided each transfer is to a member of the family within the definition of I.R.C. section 267(c)(4).

These provisions all go into effect for the estates of decedents dying after 1981. Family farms frequently are closely held businesses.<sup>56</sup> Farm families need to be most concerned about the requirement that the value of

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determining the value of the decedent's gross estate 20% or more in value of the outstanding stock, will be treated as the stock of a single corporation.

53. I.R.S. § 6166(g)(1)(A) (1981) (amended 1981) provided that the aggregate of distributions, sales, or exchanges, or other dispositions and withdrawals from the closely held business had to exceed one-third of the value of the interest.

54. I.R.C. § 6166(g)(3) (1981) (amended 1981).

55. I.R.C. § 6166(g)(1)(D) (1981) (amended 1981).

56. Treas. Reg. § 20.6166A-2(a) defines interest in a closely held business as:

(a) In general. For purposes of §§ 20.6166-1, 20.6166-3, and 20.6166-4, the term "interest in a closely held business" means

(1) An interest as a proprietor in a trade or business carried on as a proprietorship.

(2) An interest as a partner in a partnership carrying on a trade or business if 20% or more of the total capital interest in the partnership is included in determining the decedent's gross estate or if the partnership had ten or less partners.

(3) Stock in a corporation carrying on a trade or business if 20% or more in value of the voting stock of the corporation is included in determining the decedent's gross estate or if the corporation had ten or less shareholders.

The regulations further provide that in the case of a proprietorship the interest in the closely held business includes only those assets of the decedent which were actually utilized by him in the trade or business. Treas. Reg. § 20.6166A-2(c)(2) (1981). The Service has maintained that a farmer proprietor is engaged in a closely held business for the purposes of I.R.C. § 6166A if he materially participates in the farming operation. The decedent must have cultivated or managed the farm himself or entered into a material participation crop share lease. Rev. Rul. 75-366, 1975-2 C.B. 472. Recently the Service indicated that it has relaxed this requirement somewhat. In a private letter ruling of April 28, 1981, the Service explained in reference to a crop share lease that:

In order for the rental of the property to constitute an active trade or business under section 6166, the executor must demonstrate that the decedent's employee or agent normally performed substantial personal services in managing, maintaining and leasing the property. The mere "management" of income producing assets from which a decedent obtained income largely through ownership of the property, rather than the performance of management activities does not constitute an active trade or business. Let. Rul. 8134009.

the interest in the farm property exceeds 35% of the decedent's adjusted gross estate. There had been some speculation, after the enactment of the 1976 Act, that the use valuation reduction in fair market value of farm property under I.R.C. section 2032A would cause estates to fail to meet the old 65% requirement of I.R.C. section 6166. Now that this threshold requirement has been reduced to 35%, the chance of an I.R.C. section 2032A election precluding an I.R.C. section 6166 election has been practically eliminated for most family farms. Indeed, the changes in I.R.C. section 6166 will open its benefits to farms which would previously only qualify for the less attractive benefits of I.R.C. section 6166A.

Although the benefits of I.R.C. section 6166 have become more available, they also have become less significant for the estates qualifying for them. I.R.C. section 6601(j) provides that the interests in the closely held business eligible for the special 4% interest rate is the lesser of the extended tax or the credit allowable under I.R.C. section 2010(a), subtracted from \$345,800. Previously, the maximum credit allowable under I.R.C. section 2010(a) was \$47,000; under the 1981 Act, it will be increased to \$192,000 in 1987. Therefore, in 1981, \$297,000 could be deferred at the special 4% rate, but in 1987 only \$153,800 can be deferred.<sup>57</sup> The increase in the maximum estate tax credit clearly makes I.R.C. section 6166 less significant.

#### *Gifts Made Within Three Years of Decedent's Death Not Included in Gross Estate*

Under previous law, the value of the gross estate included the value of all property interests which the decedent had transferred, by trust or otherwise, during the three year period ending on the date of the decedent's death.<sup>58</sup> New I.R.C. section 2035(d)(1) provides that I.R.C. section 2035(a) will not apply to the estates of decedents dying after 1981. There are some exceptions to this rule.<sup>59</sup> The gross estate will include gifts within three years of death for purposes of determining eligibility for I.R.C. section 303(b), relating to stock redemption, I.R.C. section 2032A, relating to special use valuation, I.R.C. section 6166, relating to the extension of time for the payment of estate taxes, and subchapter C of chapter 64, relating to estate tax liens.<sup>60</sup> From the taxpayers' viewpoint, the new rule in I.R.C. section 2035(d)(1) will have a positive impact on the decedent's estate tax burden, but a negative impact on the tax basis of the transferred property in the

57. If a farmer whose only property was a farm valued in his estate at \$1,000,000 died in 1981, the \$297,000 in estate tax could be paid in up to ten annual installments with the special 4% interest rate applicable. If the same farmer died in 1987, the more generous unified credit would reduce his estate tax to \$153,800, and only that amount would be payable at the special 4% rate.

58. I.R.C. § 2035(a) (1981).

59. I.R.C. § 2035(a) (1981) will still apply to the transfer of an interest in property included in the value of the gross estate under I.R.C. § 2036 (relating to transfers with a retained life estate), § 2038 (relating to revocable transfers), § 2041 (relating to powers of appointment), or § 2042 (relating to proceeds of life insurance), or which would have been included in one of these sections if the interest had been retained by the decedent. See I.R.C. § 2035(d)(2) (1982).

60. I.R.C. § 2035(d)(3) (1982).

hands of the donee.<sup>61</sup> The provision in I.R.C. section 2035(b)(2) that I.R.C. section 2035(a) applies to all gifts of life insurance remains in effect.<sup>62</sup>

I.R.C. section 2035(d) could provide substantial benefits to farmers who transfer farm property within the three year period ending at their death. Any post-gift appreciation of the property will not be subject to taxation in the estate of the decedent. The transferred property, however, can be included in the gross estate of the decedent to determine if the estate qualifies for I.R.C. section 303(b), stock redemption, I.R.C. section 2032A, special use valuation, and I.R.C. section 6166, extension of time for payment of estate taxes.

### *The Basis of Property Acquired from a Decedent*

The basis of property in the hands of a person acquiring the property from a decedent is the fair market value of the property at the date of the decedent's death.<sup>63</sup> The 1981 Act added I.R.C. section 1014(e) to prevent individuals from transferring property in contemplation of the donee's death merely to obtain the tax-free step-up in basis upon receipt of the property from the decedent's estate.<sup>64</sup> I.R.C. section 1014(e) is particularly important because of the 1981 Act's introduction of the unlimited marital gift tax deduction. But for its enactment, a taxpayer with a large amount of appreciated property could have married an individual with less than a year to live and given all the appreciated property to the new spouse without having to worry about gift tax. When the new spouse died bequeathing the property back to the original donor, that individual would have a stepped-up basis for the appreciated property.

Farmers who claim they are willing to do just about anything for a tax break should take note that I.R.C. section 1014(e) applies only to appreciated property acquired by the decedent by gift during the one year period ending on the date of the decedent's death. Taxpayers can still transfer property merely to obtain the tax-free step-up basis if they are fairly certain that the donee is going to live more than one year after acquiring the property. Because of the huge appreciation in the value of farmland since the end of World War II, a farmer's basis in land is often only a fraction of its current fair market value. If such a farmer wanted to sell the land, a tax-free

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61. The House Committee Report notes:

[G]ifts made within three years of death will not be included in the decedent's gross estate, and the post-gift appreciation will not be subject to transfer taxes. Accordingly, such property will not be considered to pass from the decedent and the step-up basis rules of section 1014 will not apply.

H.R. REP. NO. 4242, 97th Cong., 1st Sess. — (1981).

62. H.R. REP. NO. 4242, 97th Cong., 1st Sess. — (1981).

63. I.R.C. § 1014(a) (1981).

64. If the appreciated property was acquired by the decedent by gift during the one year period ending on the date of the decedent's death, and the property is acquired from the decedent by (or passes from the decedent to) the donor of the property (or the spouse of the donor), the basis of the property in the hands of the donor (or spouse) will be the adjusted basis of the property in the hands of the decedent immediately before the death of the decedent. I.R.C. § 1014(e) (1982). The provision takes effect for the estates of decedents dying after 1981.

step-up basis could prevent an income tax disaster. Marriage to one who will live slightly more than one year, coupled with transfer of the property to the new spouse, will provide the remedy and prevent the disaster. This is assuming, of course, that the new spouse does not recover and abscond!

### *Increase in Annual Gift Exclusion*

The annual gift exclusion in I.R.C. section 2503(b) rises from \$3000 to \$10,000 for transfers made after 1981. The 1981 Act also creates an unlimited gift tax exclusion for payments directly to educational institutions and health care providers.<sup>65</sup> A transitional rule, which is similar to the transitional rule for the unlimited marital deduction in I.R.C. section 2207A(e), exists for the increased annual gift exclusion.<sup>66</sup>

The increased annual gift exclusion is important to farm families who want to make inter vivos transfers of farm property. Together a farm couple can transfer property worth \$20,000 to each recipient before exceeding the exclusion.<sup>67</sup> Under the previous law they could only transfer \$6000. If the property was farmland, it was often very difficult to transfer parcels in fee which were worth \$600 or less. The couple had to set up a land trust or other mechanism to effectuate the transfers. With the new \$20,000 limit it will be much easier for farm couples to transfer farmland by simply deeding property directly to donees.

## IMPACT OF THE 1981 TAX ACT ON AGRICULTURAL ESTATE PLANNING

### *Impact of the 1981 Act on Planning for Special Use Valuation*

For purposes of I.R.C. section 2032A, the 1981 Act provides that the decedent's material participation can be measured from the date of the decedent's retirement or permanent disability as well as from the date of the decedent's death and that either a decedent *or* a member of the decedent's family must be at risk for five of the eight years preceding the decedent's death. The Act, however, does *not* allow fulfillment of the "at risk" requirement on the date of the decedent's retirement or permanent disability in lieu of the date of decedent's death. The date of the decedent's death is always the relevant date in deciding whether the decedent or a member of the decedent's family was at risk.

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65. The payment must be to an educational organization described in I.R.C. § 170(b)(1)(A)(ii) (1981) for the education or training of the donee or to a provider of medical care as defined in I.R.C. § 213(e) (1981) for medical care rendered to the donee.

66. For instruments executed before September 12, 1981 which provide for powers of appointment to be exercised after 1981, if the power of appointment is expressly defined in terms of, or by reference to, the amount of the annual gift tax exclusion under previous law, then the new gift exclusion will not apply to a gift made under the instrument. An exception is made if the instrument is amended after September 12, 1981, or the state enacts a statute under which the power of appointment is construed as being defined in terms of, or by reference to, the new \$10,000 annual gift exclusion. I.R.C. § 2503(c) (1982).

67. This is because of the split gift provision of I.R.C. § 2513(a) (1982) which provides that a gift made by one person to any person other than his spouse will be treated for the purposes of the annual gift exclusion as made one-half by him and one-half by his spouse.

As a result, a farmer who is hoping to use special use valuation must still be careful of his leasing arrangement after his retirement.<sup>68</sup> A non-material participation crop share lease will satisfy the requirement that the retired farmer be at risk. A cash lease to a member of the retired farmer's family will also be satisfactory as long as that family member is at risk. The retired or permanently disabled farmers should also be careful not to enter into any leases which last more than two years. This is so that the qualified heir will be able to satisfy any leasing arrangements the retired or disabled farmer has entered into without triggering the I.R.C. section 2032A recapture provisions.<sup>69</sup>

The off-farm qualified heir must also be very careful what leasing arrangements the heir enters into to avoid the recapture tax. A cash lease is always fatal to the qualified heir, regardless of whether it is with a family member who is at risk. An off-farm heir can easily overcome some of the disadvantages of not being able to enter into a cash lease with a member of the heir's family. The heir can enter into a crop share lease and appoint as agent an on-farm heir who must also be a member of the off-farm heir's family. The agent will keep all the accounts for the off-farm heir, pay out all expenses for the off-farm heir, and once a year send the off-farm heir a check for the profits. Such an arrangement will satisfy the off-farm heir's at risk requirement, that is, the off-farm heir is personally at risk, and material participation requirement, that is, a family member of the off-farm heir is materially participating. If the off-farm heir does not have a family member available to serve as manager, the off-farm heir must enter into a crop share lease in which the off-farm heir materially participates.

Because of the change in I.R.C. section 2032A's definition of "member of the family," both the farm families planning for a special use valuation election and the qualified heirs must be careful about to which family members they lease. A leasing arrangement with a person not included in the new definition could prevent qualification of the decedent's estate or result in imposition of the recapture tax. Farmers planning an election and qualified heirs should avoid leases with uncles, aunts, and cousins unless the farmer or heir will personally and materially participate. Leases with parents, brothers, sisters, nieces, nephews, and stepchildren will have adverse effects on the special use valuation election. To prevent possible problems, however, the lease should prohibit assignment without the consent of the landowner.

### *Impact of the 1981 Tax Act on Planning an I.R.C. Section 6166 Election*

The 1981 Act lowers the threshold requirement of I.R.C. section 6166.

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68. For example, a farmer who retired on March 1, 1978, entered into a cash lease with a non-family member, and died on March 1, 1983 will not qualify for an I.R.C. § 2032A election because neither the farmer nor a member of the farmer's family was at risk for at least five of the eight years preceding the farmer's death and on the date of decedent's death.

69. See *supra* text accompanying notes 24-27.

To qualify, the decedent's interest in the closely held business must exceed 35% of the decedent's adjusted gross estate as opposed to 65% of the adjusted gross estate required under previous law. This lower threshold requirement for I.R.C. section 6166 could encourage gifting of business property since the new qualification rule requires a smaller portion of decedent's estate to be comprised of closely held business assets.

Farm families planning for an I.R.C. section 6166 election need to be aware of the effects of post-death dispositions of an interest in the qualified business. Under I.R.C. section 6166, the unpaid taxes become due if the holder or holders of an interest in a closely held business for which estate taxes have been deferred dispose of more than 50% of that interest.<sup>70</sup> This rule does not apply if a transfer of the interest to a member of the family occurs because of the death of the holder.<sup>71</sup> This means that acceleration of taxes takes place only if a significant portion of a qualified business is gifted or sold. The fact that another family member received the property is irrelevant. In deciding whether or not to make an I.R.C. section 6166 election a farm family should weigh the benefits of the fifteen year deferral and the special 4% interest rate against not being able to sell or give away more than 50% of the qualified interest for fifteen years, even to a family member.

In this regard, farm families planning an election need to be particularly aware of the potential problems when an interest in the qualified business is transferred to more than one family member. Substantial family disharmony could result if the holder of 51% of the interest disposed of that interest and thus accelerated the unpaid tax. The 1981 Act lessens but by no means eliminates the chance for such disharmony.<sup>72</sup>

### *Impact of the 1981 Tax Act on Planning a Marital Deduction*

As noted previously, when agricultural estate planners review their clients' wills, the estate planners should point out that marital deduction formula clauses in previously created wills and trusts are exempt from the unlimited marital deduction. They should ask their clients if they should increase the marital deduction or if they should change the formula clause to refer to the unlimited marital deduction.

By subjecting life income interests classified as qualified terminable interest property to the unlimited marital estate and gift tax deduction, the 1981 Act provides surviving spouses with far greater flexibility in adjusting

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70. I.R.C. § 6166(g)(1)(A) (1982).

71. See *supra* text accompanying notes 50-57.

72. Under previous law the unpaid tax was accelerated if more than one-third of the decedent's interest in the qualified business was disposed of. That meant that the holder of 33.5% of the interest could trigger the acceleration of all the unpaid tax. Because the holder or holders of the rest of the interest would have to pay the bulk of the accelerated tax, holders so situated could be more easily tempted to dispose of their interests. Now a holder must own over 50% of the interest to trigger acceleration. Such a holder will have to pay a much larger portion of the accelerated tax and as a result will be less likely to dispose of the holder's interest to the detriment of the other holders.

the size of the decedent spouse's marital deduction. The only way for a surviving spouse to adjust the size of the marital deduction under previous law and still retain a life income interest in the property was for the decedent to include a provision in his will directing any property disclaimed by the surviving spouse to be placed in trust, the income of which would be paid to the surviving spouse.<sup>73</sup>

A will or an inter vivos transfer can create the qualified terminable interest; all that matters is that the surviving spouse receive a life income interest in the property.<sup>74</sup> Moreover, the executor can decide whether to have the life interest treated as a qualified terminable interest. Many wills contain two trusts, one of them with and another without a general power of appointment in the surviving spouse. Under the previous law the surviving spouse could only adjust the size of the decedent spouse's marital deduction by disclaiming the trust with the power of appointment. Property in the other trust would have been ineligible for the marital deduction anyway. Now the surviving spouse can decide whether to disclaim the trust with the general power of appointment as well as whether to classify the other trust as a qualified terminable interest property which is eligible for the marital deduction.

Farm couples must be careful that both spouses make full use of their unified credit against estate and gift taxes. To achieve this goal, the couple should balance ownership of assets between the two spouses. Although both spouses do not make full use of their uniform credit, there might not be any negative estate tax consequences at the death of the first spouse because of the unlimited estate tax marital deduction.<sup>75</sup> In that case the negative estate tax consequences will occur on the death of the surviving spouse. The unlimited marital gift tax deduction means there no longer is an impediment to balancing ownership of assets between spouses.

### *Impact of the 1981 Tax Act on Joint Tenancy Holdings*

In terms of agricultural estate planning, larger joint tenancy holdings can be tolerated after the 1981 Act because of the greater equivalent exemption. In 1981, assuming no other assets, an interspousal joint tenancy holding valued at more than \$175,000 was subject to federal estate taxes. In 1987, such a joint tenancy holding would require valuation at more than \$600,000 before federal estate taxes would apply. Even when the value of the joint tenancy exceeds the equivalent exemption, the 1981 Act reduces the tax costs of a joint tenancy because of the unlimited estate tax marital de-

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73. See I.R.C. § 2518(b)(4) (1981).

74. I.R.C. § 2056(b)(7) (1982).

75. For example, assume the husband owned \$800,000 in farm assets and his wife owned nothing. If the husband dies in 1986 leaving all his property to his wife, no estate tax would be due because of the unlimited marital deduction. If the wife died in 1987 leaving \$800,000 to an only child, estate taxes of \$75,000 would be due (\$267,800 tentative tax less \$192,800 unified credit). However, if the husband and the wife had balanced ownership of their assets and each transferred \$400,000 directly to the only child, no estate tax would be due on either estate.

duction.<sup>76</sup> The 1981 Act, however, does not change the fact that the inevitable result of every joint tenancy is the unnecessarily large gross estate of the last joint tenant to die. Every large joint tenancy can still present serious estate tax problems.<sup>77</sup>

The best possible solution for many large joint tenancies continues to be an inter vivos termination of the joint tenancy. The 1981 Act made this solution far more feasible. Previously, the termination of certain joint tenancies and the creation of balanced estates could result in serious gift tax implications. The unlimited marital gift tax deduction provided for in I.R.C. section 2523(a) eliminates any possibility of gift taxes resulting from the termination of a joint tenancy between spouses. There is now no real impediment to the termination of joint tenancies between spouses.

Unfortunately many farm couples will not terminate their joint tenancy ownership prior to the death of the first spouse. Section 2518(b), enacted in the Tax Reform Act of 1976, provides that when a person makes a qualified disclaimer with respect to any interest in property, that person will not have to pay any gift taxes on the property.<sup>78</sup> If the qualified disclaimer could be applied to disclaimers made by surviving joint tenancies, estate tax disasters could be avoided for many couples who did not terminate their large joint tenancy ownership before the death of the first spouse. The Internal Revenue Service, however, has indicated in private letter rulings that disclaimers by surviving joint tenants are not qualified.<sup>79</sup> Even though an increasing number of states provide for disclaimers by surviving joint tenants, the Service bases its rule on the property concept of the joint tenancy. Uchtmann and Hartnell argue that modern property law concepts and basic fairness require that such disclaimers be qualified.<sup>80</sup> The 1981 Act did not, however, provide for disclaimers by surviving joint tenants.<sup>81</sup> As a result, many farm

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76. Under prior law joint tenancies between spouses in excess of \$500,000 would be taxed in the following manner. As much as \$250,000 could be in the taxable estate of the first joint tenant to die since the marital deduction would be no more than \$250,000 in such a case. Also the entire \$500,000 property could be subject to tax at the death of the second joint tenant, assuming the surviving joint tenant did not remarry. Thus, the entire property could be taxed one and one-half times by the time it was received by the next generation. Under new law, the unlimited marital deduction will assure that the property is only taxed once before it is received by the next generation.

77. For example, suppose a farming couple's only asset is a farm worth \$1,000,000. If they held the property as joint tenants, upon the death of the first spouse, that spouse's one-half share of the property would pass to the surviving spouse. If the surviving spouse died in 1987, he or she would have to pay estate taxes of \$153,000 (\$345,800 tentative tax less \$192,000 unified credit). If both spouses owned approximately equal amounts of the property, and each transferred the property directly to children, the couple would be able to transfer their farm with no federal estate taxes.

78. A qualified disclaimer is defined as an irrevocable and unqualified refusal by a person to accept an interest in property made in writing within nine months of the date the interest was created. The person cannot have accepted the interest, and as a result of the disclaimer it must pass without any direction on the person's part. I.R.C. § 2518(b) (1981).

79. See Uchtmann and Hartnell, *Qualified Disclaimer of Joint Tenancies: A Policy and Property Law Analysis*, 22 ARIZ. L. REV. 987 (1980) for a thorough discussion of this issue.

80. *Id.* at 1009-10.

81. I.R.C. § 2518 (1981) was amended by the 1981 Act, but not in such a way as to affect this aspect of the section.

couples need to be advised of the enormous benefits of an inter vivos termination of a joint tenancy.

The new 50% rule of I.R.C. section 2040(a) does have one small practical benefit for joint tenancies. Because it decreases the size of the estate of the first spouse to die it will reduce the number of estates which are required to file estate tax returns. The executor must file estate tax returns only when the decedent's gross estate exceeds the equivalent exemption.<sup>82</sup> If the gross estate of the first spouse to die includes only half of a joint tenancy, the gross estate might not reach the filing requirement; whereas if, as often happened under previous law, the gross estate of the first spouse to die included the entire joint tenancy interests, the estate would surpass the filing requirements. This seems to be the only real benefit of the 50% rule.

### *Impact of the 1981 Tax Act on Gifting*

The 1981 Act has such a tremendous impact on gifting that the topic requires far less discussion than it would have under previous law. The increase in the equivalent exemption to \$600,000 in 1987 has vastly reduced the need for gifting. Where there is still a need for gifting, the increase in the annual gift exclusion from \$3000 to \$10,000 makes it easier particularly for farm families who want to deed farmland as gifts. Finally, there are no longer any gift tax consequences for inter vivos transfers between spouses. This includes terminations of joint tenancies.

### *The Significance of Agricultural Estate Tax Planning*

Undeniably, the 1981 Tax Act gives farm families far greater freedom from federal estate taxes than they enjoyed under previous law. That does not mean, however, that they can ignore federal estate tax considerations in their estate planning. First of all, taking advantage of this greater freedom from federal estate taxes will require basic estate tax planning. This estate tax planning will require a balancing of ownership of assets for each spouse to take maximum advantage of his or her unified credit. Such a balancing often occurs only by the dissolution of a joint tenancy and the inter vivos transfer of property. If such a balance occurs in 1987, a farm couple will be able to pass farm property worth \$1,200,000 to the next generation free of federal estate taxes. To many farm families this will seem like complete freedom from estate taxes, particularly in comparison to the amount of property which could pass free of federal estate taxes under previous law. For some families it will indeed turn out to be complete freedom from estate taxes.

Inflation and appreciation in land values, however, have dramatically increased the price of farmland over the last several decades and this trend may well continue. The significance of agricultural estate tax planning to a family farm may depend on the size and location of the farm. The average

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82. I.R.C. § 6018(a) (1982).

value per operating unit of farms varies significantly from one region of the country to another.<sup>83</sup> In the Northeast, the Lake states, the Appalachian region, and parts of the Southeast and Delta states, most farm families may well be free of federal estate tax worries for the foreseeable future because of the lower average value of the operating units in those areas.<sup>84</sup> Since \$1,200,000 in property can be transferred without any federal estate tax if a farm family engages in basic estate tax planning, most farm families in these

83. The point is illustrated in the following table:

States by Region	Average Value of Operating Unit by State, 1981	States by Region	Average Value of Operating Unit by State, 1981
<b>Northeast</b>		<b>Appalachian States</b>	
Maine	119,100	Virginia	182,500
New Hampshire	158,300	West Virginia	157,800
Vermont	165,300	North Carolina	167,400
Massachusetts	192,400	Kentucky	142,300
Rhode Island	235,100	Tennessee	145,000
Connecticut	302,700		
New York	143,600	<b>Southeast</b>	
New Jersey	329,400	South Carolina	175,000
Pennsylvania	210,000	Georgia	240,400
Delaware	358,600	Florida	514,000
Maryland	405,900	Alabama	203,000
<b>Lake States</b>		<b>Delta States</b>	
Michigan	216,200	Mississippi	278,000
Wisconsin	221,100	Arkansas	298,700
Minnesota	351,800	Louisiana	414,700
<b>Corn Belt</b>		<b>Mountain States</b>	
Ohio	299,400	Montana	620,500
Indiana	380,900	Idaho	458,500
Illinois	585,000	Wyoming	623,000
Iowa	555,900	Colorado	567,600
Missouri	249,000	New Mexico	696,400
		Arizona	1,542,200
<b>Northern Plains</b>		Utah	549,600
North Dakota	440,800	Nevada	839,700
South Dakota	343,500		
Nebraska	491,200	<b>Pacific States</b>	
Kansas	385,100	Washington	352,700
		Oregon	312,600
<b>Southern Plains</b>		California	733,000
Oklahoma	318,100		
Texas	387,500	<b>43 States</b>	<b>342,100</b>

U.S. DEPT. OF AGRICULTURE ECONOMIC RESEARCH SERVICE, FARM REAL ESTATE MARKET DEVELOPMENTS 19 (August 1981).

It should be stressed that these average values per operating unit include very small farms. The basis for these average values was data taken from the 1978 Census of Agriculture. *Id.* at 44. The 1978 Census defined farms as any place from which \$1000 or more of agricultural products were sold or normally would have been sold during the census year. U.S. DEPT. OF COMMERCE, 1978 CENSUS OF AGRICULTURE, PART 51, UNITED STATES VII (1981). In fact, 690,329 of the farms included in the census ranged from one to forty-nine acres. *Id.* at IX. It is clear that most of these farms could not be "family farms" in the sense that they provided the primary source of support for an entire family. The average value per operating unit of farms which actually provide the primary source of income for a family will be significantly greater than the average values in the 1981 data.

84. U.S. DEPT. OF COMMERCE, 1978 CENSUS OF AGRICULTURE, PART 5, UNITED STATES IX (1981).

areas may be able to concentrate on other estate planning goals. But in the Cornbelt, the Northern Plains, Florida, Louisiana, the Southern Plains, the Mountain states, and the Pacific states, many farm families will find that their farm property is worth far in excess of \$1,200,000, as inflation and appreciation in land values continue.<sup>85</sup>

These farm families should continue to regard minimization of federal estate taxes as one of their prime estate planning goals. Often, the I.R.C. section 2032A special use valuation and inter vivos transfers may be the means chosen to attain such minimization, and both methods require careful planning. Although the 1981 Tax Act provides farm families with greater freedom from federal estate tax, farm families should keep in mind that agricultural estate tax planning is still important.

#### POLICY ANALYSIS OF THE 1981 ECONOMIC RECOVERY TAX ACT

##### *Disparity of Treatment of Cash Leases for Pre-Death and Post-Death Situations Under I.R.C. Section 2032A*

Under the 1981 Act, either a decedent or a member of a decedent's family must be at risk for five of the eight years preceding the decedent's death for a decedent's estate to qualify for I.R.C. section 2032A.<sup>86</sup> Although a decedent can satisfy this requirement by entering into a cash lease with a member of the decedent's family, to avoid triggering the I.R.C. section 2032A recapture tax, the qualified heir must be at risk.<sup>87</sup> A cash lease between the heir and a member of the heir's family would trigger the recapture tax.

There is no justification for this disparity in treatment of pre-death and post-death cash leases for purposes of I.R.C. section 2032A. Any compelling reasons mandating there be no cash leases in the post-death period would also mandate there be no cash leases in the pre-death period. Qualified use by a member of the family should extend to the qualified heir during the recapture period.

##### *Post-Death Dispositions from One Family Member to Another Under I.R.C. Sections 2032A and 6166*

Under I.R.C. section 2032A, recapture does not occur if a qualified heir disposes of an interest in the qualified real property to a member of the heir's family.<sup>88</sup> This means that the recapture tax is not imposed if the heir sells the property to a member of the heir's family, gives the property to a member of the heir's family, or dies and passes the property to a member of the heir's family. Under I.R.C. section 6166, acceleration of the deferred tax occurs if a holder disposes of more than 50% of the qualified interest in the

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85. *Id.*

86. *See supra* text accompanying notes 10-12, and in particular *see supra* note 6.

87. I.R.C. § 2032A(c)(1) (1982).

88. *Id.*

closely held business to anyone unless there is a transfer of the interest to a family member because of the death of the holder.<sup>89</sup>

There is no reason why I.R.C. sections 2032A and 6166 should treat post-death dispositions within the family so differently. Family members holding interests in a closely held business commonly sell or give their interests to other family members. An I.R.C. section 6166 election should not preclude such a disposition because it does not defeat any of the purposes for which the section was enacted. The rule should be changed so that post-death dispositions to family members will not cause an acceleration of the unpaid tax.

*I.R.C. Sections 2032A and 6166 May Encourage Non-Traditional Farmers to Seek Agricultural Tax Shelters*

After the 1976 Act, concern existed that I.R.C. section 2032A could encourage non-traditional farmers to seek tax shelters in agriculture.<sup>90</sup> It was feared that investors could be attracted to farmland because of the benefits of special use valuation. The 1981 Act increased the attractiveness of I.R.C. section 2032A to investors in a variety of ways. The Act provided that either the decedent or a member of the decedent's family must be at risk. It increased the limit of the aggregate reduction in the value of the qualified real property to \$750,000. It allowed active management to be substituted for material participation by certain qualified heirs. It broadened the definition of "passing to" to include sale to the qualified heir. It included the two year grace period for the qualified heir to begin material participation or active management, and finally, it shortened the period when the recapture tax could be imposed. There are legitimate concerns which caused the introduction of each of these changes into the 1981 Act, but the changes also make it more likely that I.R.C. section 2032A will be implemented by non-traditional farmers seeking tax shelters in agriculture.

I.R.C. section 6166, as enacted in 1976, also provided potentially lucrative benefits that could encourage investment in farmland by non-traditional farmers. The 1981 Act makes this section much more accessible by requiring that the value of the closely held business must exceed only 35% of the

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89. I.R.C. § 6166(g)(1)(A) (1982).

90. See Comment, *supra* note 23, at 398. This Comment suggested I.R.C. § 2032A requires that the owner or a member of his family provide the primary source of management of the farm and devote a substantial portion of his vocational activities thereto. It recognized that it would reduce the amount of farmland that qualified, but thought it would do so primarily by screening out non-traditional farmers seeking tax shelters in agriculture and bad faith attempts. It is true that the primary source of management requirements could not be met by some decedents who now meet the material participation requirements, but with the change in the 1981 Act that the decedent's material participation can be measured from the date of retirement or permanent disability instead of only date of death, almost all family farmers should be able to meet the primary source of management requirements. Unfortunately, because the primary source of management could still be by a broadly defined group of the decedent's or qualified heir's family members, this proposed change alone would not prevent the situation outlined in *infra* note 93 because the qualified heir could enter into a lease with her brother-in-law as on-farm manager and many other situations where the heir holds the property only for investment purposes.

adjusted gross estate and not the 65% previously required. As this article has explained, the benefits of I.R.C. section 6166, while more accessible, are less significant because of the increased unified exemption. I.R.C. section 6166, particularly as amended by the 1981 Act, will not attract investment by non-traditional farmers to the degree that I.R.C. section 2032A does.

In the 1981 Act, Congress did not deal with the problem of non-traditional farmers seeking tax shelters in agriculture, although the protection of the non-traditional farmer does not seemingly fall within the purpose of either I.R.C. section 2032A or I.R.C. section 6166. Moreover, the encouragement of the non-traditional farmer can be detrimental to the family farm. It has been suggested that I.R.C. section 2032A could attract such increased outside investment in farmland that it would result in even more rapid increases in the price of farmland and, consequently, make it more inaccessible to family farmers trying to purchase land.<sup>91</sup> The effects of I.R.C. section 2032A and 6166 should be carefully monitored to ensure that the benefits of these sections flow only to those groups they were designed to protect.

#### *The 1976 and 1981 Tax Acts May Encourage a New Primogeniture*

Arguably, the 1976 Act did not help the family farm as an American institution, but helped only those families who happened to own farms at the time.<sup>92</sup> The provision most specifically designed to benefit the family farm with respect to estate taxes was I.R.C. section 2032A. The changes in this section in the 1981 Act were designed to further effectuate these benefits. I.R.C. section 2032A, as it first appeared in 1976 and as amended in 1981, requires that land for which the section has been elected continue to be used for the qualified use and that the land pass to a member of the family. The requirement that the land continue to be used for a certain period of time for the qualified use is essential. This section is based on the assumption that the value of land as farmland is often significantly less than its fair market value and that it is burdensome for families of decedents planning to continue to use the land as farmland to have to pay estate taxes on its fair market value. It would be grossly unfair to allow family members of the decedent to include the land in the estate at less than fair market value and then turn around and sell the same land at fair market value a short time later.

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91. See Hjorth, *Special Estate Tax Valuation of Farmland and the Emergence of a Landholding Elite Class*, 53 WASH. L. REV. 609, 613 (1978). See also BOEHLJE, ANALYSIS OF THE IMPLICATIONS OF SELECTED INCOME AND ESTATE TAX PROVISIONS ON THE STRUCTURE OF AGRICULTURE 151 (1981). Boehlje notes that the increased investment of non-traditional farmers in farmland will have significant implications with respect to the separation of ownership and control of farm assets.

92. See Bratt, *Material Participation and the Valuation of Farm Land for Estate Tax Purposes Under the Tax Reform Act of 1976*, 66 KY. L.J. 848, 878 (1978). Bratt argued that Congress had adopted a restrictive definition of the family farm for purposes of I.R.C. § 2032A by focusing on the destination of the transfer and asking whether the land remained in the family. He suggested that a definition more in harmony with the broad purposes of I.R.C. § 2032A would be to focus on the use of the land after the transfer and ask if the land is being used as a family farm. He stressed that a family farm in a broad institutional sense is no less a family farm because it has been transferred to a different family.

But for the purposes of the I.R.C. section 2032A recapture provisions, whether the qualified heir uses the qualified real property as part of the heir's family farm or merely holds it for investment purposes does not matter, as long as the property is used as farmland.<sup>93</sup> It is difficult to understand how offering benefits to individuals holding farmland strictly for investment purposes assists the family farm. Some have expressed fears that I.R.C. section 2032A so favors current owners of farmland and their relatives that it will cause the emergence of a landholding elite class.<sup>94</sup> Moreover, as explained previously, the benefits of special use valuation can potentially affect not only those who merely wish to hold the qualified property for investment purposes, but also who are not even remotely related to the decedent.<sup>95</sup>

Some have suggested, however, that one way to ensure that special use valuation will apply only to farmland used in family farms would be to make the qualification and recapture provisions of I.R.C. section 2032A more rigorous.<sup>96</sup> The increased unified exemption and the unlimited marital deduction have provided every farm family with significant relief from federal estate taxes. I.R.C. section 2032A offers important benefits to family farms, but does not successfully confine its benefits to family farms. In fact, there is a strong indication that I.R.C. section 2032A encourages forms of farmland ownership very different from the family farm. The increased protection from estate taxes provided by the increased exemption and unlimited marital deduction offers an excellent opportunity to re-examine and perhaps restructure I.R.C. section 2032A so that it better accomplishes its purpose.

### *The New I.R.C. Section 2040(a) 50% Rule*

It has already been explained that the need for the I.R.C. section 2040(a) 50% rule was eliminated by the expanded estate tax marital deduction, and that the 50% rule has a negative impact on the basis of the property

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93. For example, assume the qualified heir was the wife of the decedent's deceased grandnephew and a thirty year resident of the city of Chicago. Assume also that the qualified real property was in Champaign County, Illinois. A material participation crop share lease between the qualified heir and any independent farmer or corporation would satisfy the requirements of I.R.C. § 2032A in terms of not triggering the recapture tax, although meeting the material participation requirement while living approximately 140 miles away from the farm would take much effort. This qualified heir is by no stretch of the imagination a family farmer; she holds the qualified real property strictly for investment purposes.

94. See Hjorth, *supra* note 91, at 626. Hjorth feared that the 1976 Act would work to prevent those without land from acquiring family farms. His proposals were for the government to loan money for purposes of buying land. The loans would be made to fulltime farmers or farm workers who do not now own substantial amounts of land. The loans would be up to an amount equal to the benefits which can be received under I.R.C. §§ 2032A and 6166. The government could follow I.R.C. § 6166 with respect to payment of the loan requiring no principal payments for five years and payment of the loan balance in ten equal installments thereafter. See also BOEHLJE, *supra* note 91, at 148. According to Boehlje, the eventual result of I.R.C. § 2032A will be better opportunities for heirs who inherit property to continue family farms, but fewer opportunities for those who do not inherit property to obtain control of farmland through purchase or lease. He warns that the increased concentration of ownership and control of farm assets has implications for income and wealth distribution and for entry into agriculture.

95. For example, in *supra* note 93 the qualified heir could sell the qualified real property to her brother-in-law, a resident of Champaign County, without retriggering the recapture tax.

96. See *supra* note 90.

in the hands of the decedent's surviving spouse.<sup>97</sup> I.R.C. sections 2032A, 6166, and 303(b) may cause the 50% rule to have a negative impact on the qualification of the estate of the first spouse to die. The 50% rule can have a negative impact on the qualification for these sections for the same reason it always has a negative impact on the surviving spouse's tax basis; if a farm couple owns their farmland as joint tenants only one-half of the land will be included in the gross estate of the first spouse to die. For the purposes of I.R.C. section 2032A, if that spouse also had the sole ownership of a large amount of real or personal property not used for farming purposes, the estate might not meet the requirement that 50% or more of the adjusted value of the gross estate consist of the adjusted value of real or personal property used for farming purposes, and 25% or more of the adjusted value of the gross estate consist of the adjusted value of real property used for farming purposes. This problem would occur less frequently if the rule relating to joint tenancies had remained as it was before the 1981 Act; that rule was that the gross estate of the spouse who provided consideration would include the entire joint tenancy.<sup>98</sup>

The 50% rule can prevent qualification for I.R.C. sections 6166 and 303(b) in the same way. Congress has shown an intent to facilitate the qualification of estates for I.R.C. sections 2032A, 6166, and 303(b).<sup>99</sup> There is no indication that Congress wanted to prevent qualification with a provision intended to alleviate the estate tax problems of joint tenancies. As long as the rule continues to exist in its present form it will be a trap to the unwary.<sup>100</sup> But the rule does have the overriding advantage of simplicity. It eliminates the administrative and judicial proceedings common under the old rule to determine who furnished the consideration for the joint tenancy property.

The best solution is to provide that the 50% rule affects the gross estate only for purposes of calculating estate taxes, but that 100% of the jointly owned property would be included for purposes of determining whether the decedent's estate qualifies for I.R.C. sections 2032A, 6166, and 303(b). Such a provision would be similar to I.R.C. section 2035(d) and would further Congress' intent to facilitate qualification for these sections. Such a provi-

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97. See *supra* text accompanying notes 46-49, and in particular *supra* note 44.

98. For example, if a couple owned a farm worth \$500,000 as joint tenants, and the husband also owned \$500,000 in securities, the farm could have qualified for special use valuation in the estate of the husband under previous law if the husband provided the consideration for the farm. Under ERTA only half of the farm will be included in the gross estate of the husband, and it will not qualify for special use valuation because the requirements of I.R.C. § 2032A(b)(1)(A) are not met.

99. I.R.C. § 2035(d) (1982) contains an exception which allows gifts made within three years of the decedent's death to be included in the decedent's estate to determine whether the estate qualifies for those three sections.

100. For example, in *supra* note 91 the wife could have transferred her interest in the joint tenancy to her husband in which case his estate could have qualified for special use valuation. Assuming all requirements of I.R.C. 2032A are met no estate taxes would be imposed on the farm, and other property passing to the wife and the wife's basis in the farm would be the farm's special use valuation.

sion would not affect the fractional interest rule's negative impact on the surviving spouse's tax basis.

#### CONCLUSION

This article has examined the impact of the Economic Recovery Tax Act of 1981 on agricultural estate planning. It compared the Act with the previous law and discussed the impact of the Act on agricultural estate planning strategies. This article also analyzed the policy behind the provisions of the 1981 Act.

After such an examination, it is clear that the 1981 Act will have a significant impact on agricultural estate planning. It is also clear that this significant impact is primarily due to three basic provisions: the increase in the equivalent exemption to \$600,000 in 1987, the decrease in the maximum transfer tax rate, and the unlimited marital deduction. The impact of the changes in I.R.C. sections 2032A and 6166 is perhaps not as significant. Although both sections maintain the same basic structure as when enacted in the Tax Reform Act of 1976, the 1981 Act has made both sections more accessible. I.R.C. section 2032A has become more valuable because of the increase in the aggregate reduction to \$750,000, while I.R.C. section 6166A has become less valuable because of the increased exemption.

The 1981 Act will impact agricultural estate planning, but not in the same manner as the 1976 Act which significantly restructured the federal estate tax system. Instead, the 1981 Act achieves its impact by an adjustment of the federal estate tax system established in 1976.