AN ANALYSIS OF THE APPLICATION OF RECENT ESTATE AND INHERITANCE TAX LEGISLATION TO AGRICULTURE

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ABSTRACT

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Estate and inheritance taxation is playing an increasingly important role in agriculture. This paper analyzes recent federal estate and state inheritance tax legislation that is directed primarily at agriculture.

The objectives of this paper are to determine how much the provisions under discussion are used in Michigan, examine alternative methods of provision implementation, and discuss controversial issues surrounding the provisions. To accomplish this an extensive literature review was conducted, professional farm estate planners throughout Michigan were interviewed and case examples were developed.

The provisions examined have not been used extensively in the agricultural sector. This is attributable to several reasons. The provisions are still relatively new but more important, professional ignorance and ambiguity in parts of the code have limited the provisions' use. Increased use by, and benefit to, the agricultural sector depends upon educating estate planners and clarification of the code by the legislature or the courts.

To the two people I admire most in
the world, my mother and father.

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> Those who truly help us are they who provide an attitude wherein we may become aware of and accept all that we are so that we learn to realize the strength and power of that self.
>
> --Theta Burke--

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DISCLAIMER

This paper has been written with the understanding and intent that the author is not attempting to provide specific legal or tax services. If legal or tax advice is desired, the services of a competent tax attorney or certified public accountant should be obtained. Interpretation of the tax code and regulations is based on their status as of the beginning of 1981.

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> Law is a special kind of ordering process, a special type of process of restoring, maintaining or creating social order--a type of ordering which is primarily neither the way of friendship nor the way of force but something in between.
>
> --Harold Berman--

INTRODUCTION

What Is Estate Taxation?

Almost everyone has an estate. Ownership of assets at death means an individual has an estate. Upon the death of an individual, federal and state government agencies levy a tax on the assets of the decedent. Federal estate taxation is a progressive tax rate levied on the value of the estate. Progressive taxation is a tax system where the tax rate increases as the value of the taxable item increases.

For federal tax purposes the term "estate" may be defined in several ways. The gross estate consists of the fair market value of all assets the decedent owned or had an economic interest in at the time of his or her death. The adjusted gross estate is the gross estate less the debts and administration expenses of the estate. Finally, the taxable estate is the adjusted gross estate less deductions such as charitable bequests, marital deduction, orphan's exclusion, etc. that the decedent's estate may or may not qualify for.[1]

The estate tax is imposed upon estates of citizens or residents of the United States which includes the 50 states and the District of Columbia, but excludes U.S. possessions or territories. For non-residents or non-citizens the tax is applied only to property situated within the United States. If the decedent is a non-resident and a non-citizen who has lost his or her citizenship after March 9, 1965, and within ten years of death, the tax is imposed on the value of property situated within the United States.[2]

The term "estate taxation" is often used in the same context as death or inheritance taxation. They are, however, very different. An estate tax is a tax on the estate of a deceased person and is assessed on the entire estate before distribution of property to the heirs. The estate is liable for payment of the estate taxes due. Inheritance taxes are imposed upon the heirs according to 1) the value of the assets they receive and 2) their relationship with the decedent. Together, these two tax systems are commonly known as death taxes. The federal government levies an estate tax on the transfer of a decedent's assets while most states including Michigan impose only an inheritance tax. A few states, however, levy both.

Estate and inheritance taxation in the U.S. began as a revenue raising device for the government in 1916. It was levied primarily to raise revenue during wartime or periods of economic depression. Though never a large revenue source, money received from estate taxation and gift taxation, which is designed to prevent asset transfer during a lifetime in order to avoid estate taxation, has dropped as a percentage of the federal government's total annual revenue to less than 2 percent.[3]

The emphasis and importance of the tax shifted in the 1920's and 30's due to rising social concern about wealth accumulation. The primary purpose of estate taxation over the last 50 years has been to moderate these accumulations and monitor property transfers from generation to generation.

The right to own property is a fundamental right guaranteed by the United States Consistution. However, there is not, within the legal system, a common law method of transferring property at death. Protection of property ownership and transfer rights requires a means of supervision. Those who enjoy the benefits of these rights of ownership and transfer must bear the costs incurred in the protection of these rights. Accumulated wealth is considered to be an indication of an ability to bear social costs and may represent assets that have escaped earlier taxation.

Agricultural Trends

There is no doubt that the size and value of farms is increasing while the number of farms decreases. The average value of U.S. farmland has risen from \$196/acre in 1970 to \$641/acre in 1980.[4] In Michigan the average value of an acre of farmland is \$1039.[5] Consequently the average value of a farm unit has increased from \$144,400 in 1975 to \$290,000 in 1980.[6]

These figures reflect all farms but it is more important to look at the effect estate taxes have on farms of above average size because these farms account for a very large part of agricultural production. The United States Department of Agriculture divides these larger farms into three classes, IA for farms with annual gross sales over \$100,000, IB for farms with annual gross sales from $40,000 to $99,999 and II for farms with annual gross sales of $20,000 to $39,999. These farms account for 89 percent of the total cash receipts from farming but make up only a third of the total number of farms.[7] Average farm equities for these classes were $894,422 for class IA, $387,375 for class IB and $240,098 for class II. The average equity for all farms is $222,191.[8] These values reflect farm equities, not necessarily estate equities, and the equities may be held as multi-family farm operations. The estate taxes due on the first two classes of farms are much greater than the taxes due on the average equity for all farms.

Farm Liquidity

Farm liquidity is an issue that greatly concerns estate planners and their clients. During the Ways and Means Committee hearings on the Tax Reform Act of 1976 a great deal was said about the economic hardship imposed on farm families by estate taxation. One of the rallying points of the Tax Reform Act was that illiquidity would destroy the family farm when death occurred. Inflation has pushed many farm estates beyond the exemption limits and the income derived from the farms had not changed much. Many legislators and agricultural interests stated most "family farms" did not have sufficient cash or liquid assets to pay estate taxes levied upon death. This illiquidity results in the dissolution of many family farms. The question is whether farms are illiquid enough to warrant special tax provisions because no other group in society receives this type of special legislation with respect to estate taxation. Capital requirements are often higher in farming than other businesses; therefore, it is logical to assume liquidity is more of a problem in agriculture than other industries. Whether or not farmers are less liquid than other sectors of the economy is yet to be proven, however.

Liquidity can be a two-phased problem. If it is a problem it can occur when the first spouse dies, especially if that spouse has a majority of the assets in his or her name. In most farm estates this is the husband. If no estate tax is due, there is no estate tax liquidity problem. The only costs are administration and funeral expenses. If we assume a tax is due than a liquidity problem, that of raising sufficient cash to pay the tax, may arise. However it is generally easier to reduce the tax on the first spouse's death than on the second. Therefore the first type of liquidity problem occurs where the first spouse dies and taxes are due.

A second, and perhaps more difficult, type of liquidity problem may arise when death results in an intergenerational transfer. If there are multiple heirs, and some wish to remain on the farm while others do not, severe money problems can occur. If there has not been good estate planning or large consumption of the estate between the time of the first death and second death, the taxes can be much larger upon the death of the second spouse than the first because there is no marital deduction available. Not only does the estate have to pay estate taxes but the on-farm heir or heirs often are required to compensate non-farm heirs in order to inherit the farm. An example of this is where two sons and a daughter survive their parents. The farm will only support one family. If the eldest son keeps the farm he will probably have to compensate his brother and sister for their shares of the inheritance. There may be insufficient cash available to pay the taxes and the off-farm heirs.

Consequently part of the farm may need to be sold or a loan taken which could affect the farm operation. Whether liquidity is in fact a real problem remains to be seen but it is an important reason for the existence of these provisions.

Recent Legislation

Estate taxation affected very few people for many years. From 1923-1945 the number of estate tax returns filed did not exceed 18,000. In 1975 216,000 returns, or 11.2 percent of all estates, were filed of which 150,000 paid taxes.[9] The increase in the number of returns filed is primarily due to an increase in nominal values of wealth in personal estates. As the value of goods increased due to inflation and people began to accumulate more, estate sizes grew. Therefore more estates began to reach the taxable level and resulted in an increase in the number of returns filed.

Tax Reform Act of 1976

The basic structure of the current federal estate tax system was adopted in 1932 and until 1976 only one significant change had been made since 1948.[10] The Tax Reform Act of 1976 altered the structure of the estate and gift tax systems dramatically. The act changed and unified the rate structure for estate and gift taxes. Prior to this change the gift tax rates had been less than the estate tax rates and the Tax Reform Act eliminated some of the tax advantages previously enjoyed by those who could afford to make lifetime gifts. Use of generation skipping trusts was restricted by the act. A generation skipping trust has two or more generations younger than the creator of the trust as beneficiaries. Through designation by the trust creator a number of generations could receive the benefits from the trust but it would not be included in their estates. Now a tax is imposed upon the death of a child or grandchild beneficiary which approximates the tax that would have been paid had no trust been used.

The system for calculating the basis, the value on which capital gains or losses are calculated for income tax purposes, also changed. Prior to the Tax Reform Act of 1976 the decedent's basis of an asset would be increased to the fair market value of the asset at the time of death and then passed on to the heirs. This is the stepped-up basis system. This was changed so the decedent's basis would be carried over and inherited by the heirs as their basis. In situations of highly appreciable property, significant capital gains taxes were often saved by the stepped-up basis. Carryover basis was repealed in 1980 however, and the use of stepped-up basis has returned.

The Tax Reform Act made other significant changes which relate specifically to agriculture and closely-held businesses. The act allowed farmland that met specific requirements to be valued at its current or actual use value rather than highest and best use value for estate tax purposes. A 15-year installment payment election for deferral of estate taxes was enacted as an alternative to the existing 10-year option. Joint tenancy, the co-ownership of property, was also affected by the act. Under prior law the entire value of jointly owned property was included in the estate of the first joint tenant to die unless the survivor could show a money interest contribution. The fractional interest rule, a provision of the Tax Reform Act, allows spouses to form a qualified joint interest. Thus, only one-half of the value of the joint interest is included in the estate of the first to die, thereby reducing taxes for that estate.

Revenue Act of 1978

The Revenue Act of 1978 altered and expanded some of the provisions of the Tax Reform Act. The fractional interest rule was expanded with respect to farms and closely-held businesses. An amount equal to 2 percent times the number of years the surviving spouse was active in the business, "material participation," is calculated and multipled by the value of real or personal property devoted to the farm. This amount is not included in the decedent's estate. The Revenue Act also expanded the tax deferral provisions, the 10- and 15-year options, by allowing the interests owned by family members, "attribution," to be included in the estate of the decedent with respect to interests in partnerships and closely-held corporations.

Michigan Inheritance Act

The Michigan Inheritance Act of 1979, enrolled Senate Bill No. 1477, made changes in Michigan's inheritance tax system. In addition to other provisions, the act allows an heir or qualified real property to defer payment of the taxes attributable to one-half of the farm real property for ten years with no penalty or interest. The remaining one-half of the farm real property is tax exempt and after ten years the exemption is permanent. An heir qualifies for this if the property is enrolled in or if the heir enrolls the property in the farmland development rights program, established under Public Act No. 116 of 1974.

The special use valuation, estate tax deferral options, fractional and joint interest exclusions and the state tax deferral option and their applications to agricultural estates will be discussed in this paper.

Objectives and Methodology

A great deal of estate planning is done on an individual basis. Each farm situation presents a new and different set of problems, therefore no one plan or tax provision is the answer to all estate tax problems.

In this paper the author will examine the three federal and one state statutes concerning farm estate and inheritance tax provisions. The primary objective is to analyze the estate and inheritance provisions and how they relate to agriculture. Specifically, this paper will try to determine a number of things.

1. It will examine how much the tax provisions under discussion are used in Michigan.

2. The provisions may have more than one method of accomplishing the objective. The author will show which alternative procedure, if available, is used by estate planners and administrators. Then the documentation processes used by planners once the provisions are elected will be discussed.

3. There are issues concerning the code and its interpretation surrounding the provisions and the author will discuss these.

4. The author will show in which farm situations use of the provisions is appropriate and where it is not through case examples.

Twenty-four attorneys in Michigan who work with farmers a great deal in estate planning and settlement were interviewed. The paper will determine to what extent the provisions are used among the attorneys interviewed. These attorneys were selected by asking agricultural professionals around the state which attorneys did estate planning work with farmers. These inquiries were made of all extension district farm management agents, some county extension agents, the state bar and accounting associations, the Institute on Continuing Legal Education and the attorneys themselves. There are a relatively small number of professional estate planners who work with farmers in Michigan. The professionals previously mentioned provided names of attorneys that they thought worked with farmers. Their suggestions provided a list of 46 attorneys. These people were contacted by phone to arrange an interview to discuss the paper's topic. Of the 46 names, interview appointments were set up for 24. The author did not interview the others for a variety of reasons. Some attorneys had no experience or knowledge of the tax sections of interest. Several people did not work with farmers at all. Interviews could not be arranged for some attorneys and others refused an appointment.

Some of the provisions allow more than one method of implementing the provision. The author will determine which procedure is used more often by estate planners and administrators and will also show the documentation processes used by the attorneys to substantiate their elections.

An extensive literature review was done to accomplish two purposes. The first was to review the estate tax system and its operational structure. This was necessary because dramatic changes had occurred in the system in 1976 and 1978. The second was to determine what the issues of concern were with respect to the provisions of interest. Legal and professional journals raised a number of questions concerning ambiguities in the code and ramifications of the provisions to society. A number of these issues are brought forth in this paper. Ambiguities which exist in the code sections will be analyzed and discussed and then the author will discuss interpretations of the ambiguities and their ramifications.

Case studies will be developed to demonstrate use of the provisions. Some of the provisions may be better suited to certain types of farms or particular forms of ownership. The author will discuss and show in which farm situations these provisions are appropriate and in which they are not. In doing this the advantages and disadvantages of each provision will be explained. Among issues of concern are tax savings, provision restrictions, procedures to be observed when electing any of the provisions and obligations of the decedent, heirs and personal representative. The cases will demonstrate the effects on all parties involved if the provisions are and are not elected. Because each case is different and decisions must be made on the basis of the particular facts, no overall recommendation can be made about use of the provisions. It is possible though to explain how the provisions work through these examples and provide a basis of decision making.

Code Section 2032A: Special Use Valuation

Prior to the Tax Reform Act of 1976, land, "real property," was included in an estate at fair market value which is the price where property would exchange hands between a willing buyer and a willing seller. Usually fair market value is the highest value which the seller could receive. No consideration was given to the actual use of the land at the time of transfer.

The Tax Reform Act provided that an executor* of an estate may elect to value the real property of the estate at its actual use value when certain conditions were met. Such an election cannot reduce the gross estate by more than $500,000 however.

Code section 2032A was passed because Congress felt it was not appropriate to tax farmland at its highest and best use value when that value was based on nonfarming purposes. Estate taxes on real estate worth $800 per acre as farmland and $5,000 per acre as a development site are substantially different. The burden placed upon farmers using the land as if it were worth $800 but paying estate taxes based on $5,000 often resulted in an undue hardship. It was Congress's view that such taxation endangered the family farm and that measures should be taken to alleviate some of the tax burden. Therefore, section 2032A was enacted. The purpose of section 2032A, special use valuation, is to allow farmland that is going to continue to be used as farmland by a member of the decedent's family after death to be taxed at its value as farmland, not at its alternate value. On the other hand, Congress also recognized that there was a potential windfall available to heirs who elected special use valuation but sold the property shortly thereafter. Therefore, use requirements were included and are supported by a penalty, or recapture, tax. These use requirements are intended to prevent

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*In Michigan, the person called an executor is now known as a personal representative. For purposes of this paper executor and personal representative shall have the same meaning.

heirs from receiving an undeserved advantage and also to prevent abuse by speculators and land investors looking to avoid estate and income taxes.

Code Sections 6166 and 6166A: Estate Tax Deferral

Estate tax returns must be filed nine months after a death occurs and the taxes must be paid at the time the return is filed unless extensions are granted. Tax law prior to the Tax Reform Act of 1976 allowed two types of extensions, discretionary under section 6161(a)(2) and automatic for closely-held businesses under section 6166A. Of interest here is the extension for closely-held businesses.

Under section 6166A a person may pay estate taxes in equal installment payments for a minimum of two years to a maximum of ten years. In order to qualify, a minimum percentage of the estate must be judged to be part of a closely-held business. For purposes of 6166A more than 35 percent of the gross estate or more than 50 percent of the taxable estate of the decedent must be made up of assets in the closely-held business.

The Tax Reform Act made several changes in section 6166A. Although the provision allowing a 10-year extension was kept, another section, 6166, was added allowing a 15-year extension if the decedent's interest, that part of the business owned or controlled by the decedent in the closely-held business, is greater than 65 percent of the adjusted gross estate. This 15-year alternative defers principal payments for the first five years with only interest due at the rate of 4 percent on the first $345,800 of tax, the tax on first million dollars, and an adjustable rate, currently 12 percent, on the remainder of the tax. Finally, the act provided for a special lien procedure which, if used, would relieve the executor of personal liability for the estate tax.

Section 6166 was enacted for several reasons. An estate consisting largely of assets not readily convertible into cash, "illiquid," often did not have adequate funds available to pay interest charges and estate taxes, especially if the decedent was a major owner or participant in the business. The death of a key person could set the business back substantially for a few years, making even installment payments difficult. Therefore for those estates where a large portion of the assets come from one business, the principal payments would be deferred for five years at a low rate of interest to allow the business to recover from its loss. The intent was that payments could then be made annually out of cash flow and not through liquidation of capital. The lien was included because many executors could not satisfy the bond requirements and therefore refused to use section 6166 because of the personal risk.

Code Sections 2040(b) and 2040(c): Joint Tenancy

Joint tenancy is a form of property ownership where an interest among the joint tenants is not divisible. Property owned in this manner involves a right of survivorship. That is, upon the death of a joint tenant the remaining tenants automatically receive the decedent's share. Joint property is not probated or subject to the inheritance tax in Michigan but is included in federal estate tax returns. A special form of joint tenancy is tenancy by-the-entirety which exists only between a married couple.

Under law prior to the Tax Reform Act and Revenue Act treatment of a joint tenancy had different consequences with respect to estate taxation. Upon the death of a joint tenant, the entire value of the joint property was included in the estate of the deceased unless the surviving joint tenant could prove money's worth contribution. Money's worth contribution is financial contribution in one form or another for the acquisition of an asset.

The Tax Reform Act of 1976 provided an alternative to this often difficult burden of proof. Code section 2040(b) specifies that only one-half the value of a qualified joint interest is to be included in the estate of the decedent. To be a qualified joint interest four requirements which will be discussed later must be met and the provision applies only to joint tenancies created after 1976. The Revenue Act of 1978 amended the Tax Reform Act by including the 2 percent rule, section 2040(c). If a surviving spouse materially participated in a farm or other business the decedent's estate may deduct from the estate part of the value of the jointly held property. The amount excluded from the estate is determined by how much the surviving spouse participated in the farm operation.

The changes in the joint tenancy provisions resulted from the congressional belief that the application of pre-Tax Reform Act provisions were very complex and often resulted in double taxation. When no proof of a spousal contribution is available, and in many farm cases it is not, the entire value of joint property is included in the estate and taxed. With the right of survivorship, the entire amount of joint property is again taxed upon the death of the surviving spouse. In addition, it was often difficult to trace the contribution of each spouse and Congress felt that form should not rule over substance. By this they meant that the absence of formal documents indicating a spouse's role in the operation of the farm or business should not result in the payment of more taxes than if such documentation existed.

Michigan Inheritance Tax Deferral and Exemption

All real and personal property owned by a Michigan resident is subject to a state inheritance tax when the owner dies. Real property within the state that was owned by a non-resident is also subject to the tax. The Michigan Inheritance Tax Act of 1979 allows qualified heirs of real property to be exempted from and to defer part of the tax on the property. One-half of the value of qualified real property may be exempted from inheritance taxes. The inheritance tax attributable to the remaining half of the real property may be deferred for ten years with no interest due. At the end of the ten-year deferral period the exemption becomes permanent and that part of the tax is forgiven. The deferred taxes become a lien against the property due at the end of the ten-year period. Failure to keep the land in a qualified use for the full ten years triggers a penalty or recapture tax. The severity of the penalty depends on the action which caused disqualification of the land from eligibility. To qualify for the deferment or exemption options a qualifying heir and the land must meet criteria similar to that stipulated in the Internal Revenue Code Section 2032A. However the heir must also meet another requirement. The land must have been or must become enrolled in the Farmland and Open Space Preservation Program established by Public Act 116 of 1974. Public Act 116 is designed to provide tax incentives to landowners so they will continue to keep their land in agricultural or open space use. By making this requirement the state places the decedent's heirs in a precarious position. Disposition of the land triggers a recapture tax similar to the federal recapture tax and also results in a rollback tax imposed to collect any benefits enjoyed from P.A. 116. An heir who sells the land in a manner which triggers the recapture tax must also pay back any property tax savings he enjoyed because he was enrolled in Public Act 116. The rationale for enactment of the deferral-exemption option in the state inheritance tax code was quite similar to that for section 2032A. The legislature thought land should be taxed at the value at which it was being used for agricultural purposes as long as it would continue to be used in that manner. Enrollment in Public Act 116 was an additional means of insuring the land would remain in farming. By requiring enrollment the legislature could get more farmers involved in the farmland preservation program and offer the inheritance and property tax benefits.

Chapter I--Footnotes

[1]Commerce Clearing House, Federal Estate and Gift Taxes Explained, 1979 Edition, (Chicago, Illinois, Commerce Clearing House, Inc., 1979), p. 21.

[2]Committee on Ways and Means, House of Representatives, Background Materials on Federal Estate and Gift Taxation, 94th Cong., 2d sess., p. 3, (1976).

[3]Hearings before the House Ways and Means Committee on the Tax Reform Act of 1976, 94th Cong., 2d sess., p. 1183, March 22, 1976.

[4]United States Department of Agriculture, Economics, Statistics, and Cooperatives Service, Farm Real Estate Market Development (Washington, D.C., August, 1978), Table 5, p. 17.

[5]Lindon J. Robison, "Income From Land and Land Values: Is There a Connection?" Michigan Farm Economics No. 439, (June, 1980), p. 1.

[6]Farm, Table 10, p. 22.

[7]"The Family Farm and Use Valuation--Section 2032A of the Internal Revenue Code," Brigham Young University Law Review, (1977), p. 360.

[8]United States Department of Agriculture, Economics, Statistics, and Cooperatives Service, Balance Sheet of the Farming Sector, 1979 Supplement, (Washington, D.C., February, 1980), p. 6.

[9]Hearings before the House Ways and Means Committee on the Tax Reform Act of 1976, 94th Cong., 2d sess., p. 1176, March 22, 1976.

[10]Hearings before the House Ways and Means Committee on the Tax Reform Act of 1976, 94th Cong., 2d sess., p. 1183, March 22, 1976.

CHAPTER II

CODE SECTION 2032A: SPECIAL USE VALUATION

This chapter will look at Internal Revenue Code Section 2032A in detail. The technical aspects of 2032A are complex. Therefore, the paper will discuss the qualification criteria, implementation methods and obligations of the parties in the first part of this chapter. The code is also ambiguous in some sections. These ambiguities raise some important issues regarding the use of 2032A and its effect on agriculture and society. Important issues raised in the professional literature will be discussed in the second part of the chapter. Finally, the author will relate the results of the interviews conducted with attorneys. Their comments and suggestions provide some useful insights and promote some interesting observations.

Under section 2032A of the Internal Revenue Code the executor of an estate may elect an alternate valuation figure for land based on current use rather than on the fair market value. Fair market value is the price where property would exchange hands between a willing buyer and a willing seller, and for estate tax purposes this is considered to be the highest and best use available. However the executor must specifically elect the special use provision and the reduction of the estate value resulting from the election of the provision is limited to a maximum of $500,000.

Qualification

For an estate to qualify for the special use value provision, the land must be "qualified real property," that is real property in the United States acquired by a qualified heir of the decedent and used for a qualified use.[1] Qualified use entails either use as a farm or for farming purposes or use in a trade or business other than farming.[2] A farm includes stock, dairy, poultry, fruit, furbearing animals, and truck farms; ranches; plantations; ranges; greenhouses; and other structures used for the purpose of raising horticultural or agricultural products, orchards, and woodlands.[3] "Farming purposes" means 1) cultivating the soil, raising or harvesting agricultural products on a farm, 2) handling, drying, packing, grading or storing of an agricultural product or 3) raising and cutting trees or preparing trees for market.[4] A qualified heir for purposes of section 2032A is a member of the decedent's family and could refer to an ancestor, lineal descendent, the lineal descendent of a grandparent or spouse of either the ancestor or lineal descendent. A legally adopted child is also a qualified heir.[5] These people could be qualified heirs. However, a qualified heir is one who actually acquires the property.

Qualified land must have been owned by the decedent and used for a qualified use by the decedent or a qualified heir for periods aggregating to five years or more of the eight years preceding the decedent's death. There must also have been material participation by the decedent or a qualified heir (to be determined similar to the manner used for self-employment earnings tax, paragraph (1) of section 1402(a)). Section 1402(a)(1) imposes self-employment tax on rental income received by

an owner-lessor of farmland that participates in the farm management.[6] Unless the decedent or a qualified heir can show material participation to the extent that self-employment tax was or should have been paid there can be no qualification.

The executor of an estate can choose the special use provision if; 1) the adjusted value of real or personal property being used for a qualified use and acquired by a qualified heir constitutes 50 percent or more of the adjusted value of the gross estate and 2) if 25 percent or more of the adjusted value of the gross estate is qualified real property.[7]

Implementation

If the executor elects to have the estate valued under the special use provision, then one of two valuation methods may be used--the cash rental capitalization method or the multiple factors method. The cash rental capitalization method values land by the following equation.

$$\frac{\text{5-year average gross cash rent} - \text{5-year average state and local property taxes}}{\text{5-year average annual effective interest rate for new Federal Land Bank loans}}$$

The rental and property values used in the equation must be those of land comparable to the estate which is being valued, that is land used for farming purposes and located in the vicinity of the estate's land. The method cannot be used if; 1) there is no comparable land from which to obtain rental and property values or 2) the multiple factors method is used. The multiple factors method uses various criteria to establish the land value including income capitalization of the property under prudent management, assessed land values in a state which provides use

assessment for farmland, rent capitalization, sales of comparable farmland in the same area (provided nonagricultural uses of the land are not a factor in the price), and any other factors which fairly value the farm.[8]

Obligations

Property valued according to the special use provision (section 2032A) must be used for a qualified use for 15 years by a qualified heir. Failure to do so results in the imposition of a recapture tax. The recapture tax is a tax levied when the property no longer qualifies for special use. The benefits, taxes saved,enjoyed by the heir are paid back, "recapture," to the government. A recapture tax may also be levied on the property which ceases to qualify for the special use provision because there has been no material participation for periods aggregating to three years or more during any eight year period after the decedent's death and prior to the qualified heir's death. The maximum recapture tax is equal to the lesser of either the estate tax originally saved or the difference between the proceeds of an arm's length transaction involving the land and the special use value of the interest.[9] That is, the tax paid is the lesser of the amount of tax saved when election occurred or the difference between the special use value and the amount the land sold for.

For example, if the special use value of the land is $100,000, the land is sold for $105,000 and the estate tax saved through the section 2032A election is $10,000, the recapture tax due is $5,000. This is the lesser of the difference in an arm's length transaction and the estate tax saved. If the land had been sold for $150,000, the recapture tax would have been $10,000.

If an estate is valued under the 2032A provision, a lien in favor of the United State's government is established and is enforceable until there has been a certain lapse of time or until the Secretary of the Treasury is satisfied that no further liability to the government exists.[10]

If part of the estate is sold or if it is no longer used for a qualified purpose, the estate is subject to a recapture tax. The tax is calculated on a pro rata share of the value of the interest. These procedures apply where failure to comply with the provision occurs within ten years after election.[11]

Disposition of property or cessation of the qualified use after the tenth year but before the end of the fifteenth year following the decedent's death would also subject the estate to a recapture tax. In this case though, the tax is reduced by an amount calculated as follows

$$\text{full recapture tax} \quad \text{X} \quad \frac{\text{Number of months since the decedent's death in excess of 120}}{60}$$

Using the above recapture tax situation this can be demonstrated. If the property is sold on July 1, 12 years after the special use valuation election, the full recapture tax of $5,000 would be reduced by $1,500 ($5,000 X 18/60). Thus the recapture tax is now $3,500. This additional tax is due six months after disposition of the property or cessation of the qualified use.[12] An involuntary conversion of an interest in qualified property results in no tax if qualified replacement property is purchased for an amount equal to or exceeding the conversion value.

That is, if the actual market amount received by the heir from involuntary conversion of some property is reinvested in qualified replacement property, no recapture tax will be triggered. Qualified replacement property is either real property into which qualified real property is converted or real property bought by an heir for purposes of replacing qualified real property. Replacement property is treated the same as the converted qualified real property except that the 15-year use period, and the phaseout period are extended.[13] These two periods are extended however only by the amount of time in excess of two years it takes to find replacement property. Therefore, if it takes 2.5 years to find replacement property, the 15-year use period and the phaseout period are only extended 6 months beyond their initial completion date. If the replacement property is purchased a year after the involuntary conversion, the dates for the 15-year use period and the phaseout period remain the same as at the time of the initial election. If complete reinvestment does not occur, a tax is imposed in a similar manner to that levied on a voluntary conversion.

For property to qualify for the benefits of section 2032A all persons having an interest in any property under the section must sign an agreement consenting to application of the additional or recapture tax if a failure on the part of the heirs to comply with the regulations occurs. A qualified heir is personally liable for these taxes unless the heir has furnished bond.[14] The heir may write to the Secretary of the Treasury and request notification of the maximum amount of tax for which the heir is liable and may then furnish a bond for the amount and time period necessary to discharge personal liability.[15]

Issues

In this section some topics of concern regarding section 2032A will be discussed. There are a number of issues surrounding section 2032A. Though there are others, the topics the author will discuss include several questions about the material participation requirements of the heir, whether liens affect the operation of the farm, how will basis be calculated in cases of recapture and some of the problems working with the two valuation methods. Many of these issues will only be resolved with time and as the courts rule on how certain ambiguous code sections are to be interpreted.

Material Participation

Material participation is one issue concerning section 2032A. The uncertainty surrounding material participation can be divided into two areas. The first is the question of what constitutes material participation for purposes of section 2032A and the second is whether there is a tradeoff between qualification for section 2032A and social security benefits for the retired or retiring farmer.

The Internal Revenue Code states that in order for an estate to qualify for benefits under section 2032A the decedent or a member of the decedent's family must have materially participated in the estate for at least five of the eight years prior to the decedent's death. Section 2032A(e)(6) states that material participation shall be determined in a manner similar to the manner used for purposes of paragraph (1) of section 1402(a).[16] Section 1402(a) deals with net income from self-employment. Section 1402(a)(1) and its parallel provision in the Social Security Act, section 211(a)(1), exclude rental income from self-employment tax.[17] However, self-employment tax is levied in cases where an owner-lessor of farmland materially participates in the farm production or management of the production without use of an agent. Therefore, the same criteria used to determine whether an owner-lessor of farmland has participated in the farm operation for purposes of paying self-employment tax will be used to determine whether a person has materially participated for purposes of section 2032A.

If the decedent was actively engaged in the operation of the farm at the time of his or her death, the estate usually has little trouble meeting the material participation requirements. It becomes more difficult for the estate to meet the requirement if the owner is not on or has rented the farm. In these cases the question of what constitutes material participation may be critical. There is extensive case law establishing precedents as to what does and does not constitute material participation.[18] Various district courts have defined "material" as meaning "substantial," "important" and "of consequence" and stated that the provisions in the Social Security Act concerning material participation should be given liberal interpretation.[19] Material participation cannot take place, however, through the actions of agents or employees of those attempting to qualify. While section 2032A(b)(1)(C)(ii) allows a member of the decedent's family to operate the farm prior to the decedent's death the Internal Revenue Service may declare that the family member is an agent of the decedent and therefore, the member's participation does not qualify as material participation for purposes of section 2032A. For example, a son may operate a farm his mother owns for the required time prior to her death and the participation by a potential qualified heir may not be allowed on the grounds the son is an agent of his mother.

One of the attorneys interviewed stated that the IRS office he usually works with took a position that participation of an heir prior to a decedent's death for the purpose of ensuring that the estate qualifies under the material participation requirements is unacceptable. This is not, as of yet, an official IRS position, but such a decision, if substantiated by the courts, could provide serious problems for estate planners and their clients. Such a position, however, also appears contrary to the language of the code and the intent of Congress.

The second issue concerning material participation is the possibility of a farmer having to choose between social security benefits and estate tax benefits. This situation may face a large number of retiring or retired farmers. A retired farmer who wishes to collect social security faces the same social security requirements as when he was attempting to qualify income but from the opposite viewpoint. If a retiree is over 65 years old and has been retired for more than one year, he or she could not have realized over $5,500 from self-employment if he or she wishes to collect social security benefits in 1981.[20] Farmers may wish to limit their participation in the management of the farm so they may qualify for social security but this apparently precludes them from qualifying for special use valuation. Qualification for one benefit appears to be mutually exclusive of the other and this was a source of substantial concern to all the attorneys interviewed who had dealt with section 2032A. They stated that there is substantial resistance on the part of their clients to forego receiving social security payments in favor of qualifying for special use valuation and there is some question as to whether their clients can qualify for both social security and special use valuation. The working of the code is ambiguous about how "similar" section 2032A material participation (special use) is to that of section 1402(a)(1) (social security) and to date there have been no test cases to address the question. Meanwhile, the Internal Revenue Service has taken the position that the special use and the social security provisions are mutually exclusive.

Valuation Methods

Section 2032A provides two valuation methods, the cash rental capitalization method and the comparable factors method. The technical details of their operation have been previously discussed. There are some considerations to be made when looking at the use of both methods. Often, the two methods are compared but there are limited circumstances where the comparable factors method is appropriate. If the Federal Land Bank rate is low the resulting capitalization value may be higher than the comparable factors value. Low property tax value may also affect whether the cash rental capitalization method is used.

The cash rental capitalization formula is used almost exclusively by attorneys filing section 2032A elections. Of those attorneys who had filed a section 2032A election or were planning to do so, not one had utilized the comparable factors method. On the average, cash rental formula values were approximately 40 percent of fair market value while comparable factors method values were substantially higher. Therefore, using the cash rental formula is more benefitical for estate tax purposes because it lowers the estate value.

Several points are evident from the interviews. First, a major problem when using the formula is obtaining cash rental values of comparable land. Farmers are usually very reluctant to divulge the amount they pay to rent land for fear that their neighbors will find out. This makes valuing the land more difficult and more expensive. Several attorneys interviewed have started data banks of rental values either in their office or through the appraisers they employ. These data banks store information about the type of land and rent paid. This information is gathered through appraisals and other work done for farmers.

Second, the IRS insists on cash rents as prescribed by section 2032A(e)(7)(A)(i). This requirement can be very difficult to meet in areas where crop share leases are prevalent such as in the Saginaw Valley. Crop share leases involve the lessee and lessor each paying a specified percentage of the expenses and splitting the receipts from the sale of the crop. There is no cash rent charged, just a part of the crop. Failure by the executor to obtain cash rents for either of these reasons may greatly increase the tax bill if the estate cannot qualify for section 2032A.

Liens

Recapture of the tax saved by special use valuation is triggered via the mechanisms previously discussed. The tax is imposed if one of the following occurs; 1) the property ceases to be used for a qualified use or 2) the qualified heir does not transfer the property to a "family member" as defined by section 2032A(e)(2).[21] A member of the family is an ancestor or lineal descendent or their spouse.

The recapture tax is secured by a lien in accordance with section 6324B. The lien provisions were the subject of some confusion and doubt among the attorneys and their clients. The question that arose was how does the lien affect loan availability and farm financing? Would it affect the operation of the farm? After clarification of the law in the Revenue Act of 1978 this confusion is diminishing. The Revenue Act of 1978 amended the Internal Revenue Code to provide that liens filed under the provision of section 6324B were subordinated to any lien that was in the interest of the management of the farm if the Secretary of Treasury determined that the federal government was adequately protected from loss.

Many of the attorneys commented on the liens whether they had filed a section 2032A election or not. Their impressions of and exposure to their clients led them to project one of two conclusions. While most farmers do not like liens of any kind placed upon their property, government liens bring a much stronger reaction than any other. Farmers do not want the federal government telling them what they can and cannot do with their land. The other view is that the government liens are more readily accepted today than a few years ago. About half of the attorneys stated that the liens would not cause their clients serious problems about whether to elect special use valuation or not. The existence of Public Act 116 was thought to be a major contributor to this attitude. Many farmers consider the lien that arises from an election like section 2032A the same as going down to the bank and borrowing money.

There were also a number of instances cited of problems with bank acceptance of the liens as well as client acceptance. Despite the subordination of the estate tax lien to other farm liens granted under the

Revenue Act some banks are not pleased with the existence of the lien. This displeasure has made financing for the farm a problem in a few cases.

A final point made during the interviews was that the liens may initially pose a problem for their clients but the "bottom line," the final tax bill, can change a client's mind. An initial rejection of section 2032A by a client because of a lien may be changed to acceptance if the tax savings are substantial and there is going to be someone on the farm for the necessary amount of time so that the recapture tax is not triggered. The question of whether a lien resulting from a section 2032A election affects the financial status of a farm is no longer very significant in the minds of many attorneys. Though some banks do not like the lien, especially the Federal Land Bank, most have accepted it.

Basis

A much more important topic with respect to section 2032A is the issue of basis. Basis for accounting and tax purposes is the amount of money assigned to an asset. The Tax Reform Act of 1976 changed the way basis was calculated upon death. Prior to 1977, the income tax basis of a decedent's property for his or her heirs would be the fair market value of the asset at the time of death. Upon the decedent's death the basis would increase from the value it had under the decedent's ownership to its fair market value at the time of death. The Tax Reform Act eliminated this "stepped-up basis" and instituted carryover basis. "Carryover basis" transfers the decedent's basis to the heir and does not allow the tax avoidance that stepped-up basis does. Consequently, if the asset is sold, more of the cash received is taxable. In addition, if the asset is depreciable, carryover basis allows less depreciation expense to be written off by the heir because the basis is smaller.

Enactment of carryover basis provision was delayed a number of times and finally in 1980, the Windfall Profit Tax Act, Public Act 96-223 repealed it completely, reverting back to stepped-up basis.[22] With the removal of carryover basis, some appreciation of property that passes to an heir avoids capital gains taxation if the property is disposed of later. Only the appreciation from the decedent's death to the date of sale is taxed. A tax is levied only on the amount by which the land appreciates.

If section 2032A is chosen the special use value is the new basis for the heirs. However, the treatment of basis upon recapture of the tax is an unclear issue. There is no procedure set down about whether the basis is affected by a recapture. Does the basis remain the same and therefore is income tax calculated from the special use value or does the basis increase by the amount of tax paid? Does the basis revert to the fair market value of the asset at the time the heirs acquire the property? If the basis increases to the fair market value at the time of the decedent's death a section 2032A election is more attractive than if the other two alternatives occur. If the basis increases by the amount of tax paid the value of the asset will increase to some level below the level to which it would have risen had special use not been elected. How much the basis increases depends upon the tax rate being administered.

The highest estate tax rate is 70 percent and therefore the tax paid could have been a maximum of 70 percent of fair market value. A lower tax rate means a smaller increase in the basis from what it would have been. If the basis remains the same even though a recapture tax is paid, the heir is in a very difficult situation. Not only does the heir pay the recapture tax but he or she faces increased income taxes upon the heir's disposition of the property. If disposition of the property is the cause of recapture the total tax bill could be quite large. Such a threat could be a deterrent to section 2032A election if basis and income taxes are important considerations to the heirs.

If the basis increases to the fair market value at the date of the decedent's death the use of section 2032A becomes much more attractive. This situation would allow an executor to elect special use valuation even if he or she felt that the qualified heirs would not keep the land in a qualified use or stay on the farm. There is no interest charged on the recapture tax due and if the basis reverts back to fair market value at the time of death there is not the deterrent to election of section 2032A as in other situations described above.

At this point it is unknown how the basis of an asset will be figured upon the recapture of estate tax saved. The Internal Revenue Service has not issued a statement or any regulations concerning the subject. An Internal Revenue Service supervisor hypothesized that the Service's position may be that upon recapture the basis is equal to the fair market value at the death of the decedent. This is not, however, an official IRS position and there is no case law to support it.

Basis plays an important role in the decision making process of attorneys with respect to section 2032A. A number of them stated it was one reason they were hesitant to use or had rejected special use valuation. From the interviews it appears that the attorneys think the basis either remains at special use value upon recapture or is equal to special use value plus the recapture tax paid. If however, the basis reverts to the value it would have been if section 2032A had not been elected, that is, fair market value of the asset at the time of the decedent's death, a question arises whether basis should be a serious consideration. Even if the attorney does not expect the farm to qualify for special use for the full 15 years, the estate may still benefit by its election. If the time value of money is considered, election of section 2032A may prove very beneficial even if disposition of the asset or cessation of a qualified use occurs within the 15 year recapture period. A tradeoff also exists between the value of deferring the amount of tax saved by special use valuation and any additional administrative or personal costs. The executor must always consider the effects of keeping a case open for an extended period of time.

At this point, a discussion of basis is very hypothetical but the alternatives should be looked at very carefully. If the IRS adopts the position proposed, a major deterrent, according to the interviews, has been substantially removed.

Special Use Valuation Comments

The final section of this chapter involves a summarization of the important points of the attorney interviews conducted. The interviews lead to some general conclusions about attorneys' views of section 2032A and some personal observations on the author's part regarding the attorney's use of section 2032A. In addition there are several important points made by those attorneys with more experience in working with special use valuation.

The most noticeable point of the interviews was the small number of estates where section 2032A had been elected. Of 24 attorneys only seven had elected to use section 2032A in an estate and of those, only four had filed more than one special use valuation return with the maximum being five estates by one attorney.

The small number of section 2032A elections could be attributed to the short period of time the special use provision has been in effect. There probably were not a large number of qualifying deaths in the first four years of the provision's existence. There is more to be considered than that however. There was a consensus among the interviewees in some of their attitudes toward the provision. They agreed that section 2032A is a very uncertain provision for several reasons. Special use valuation can be a beneficial provision but cannot be used effectively in planning. There are too many uncertainties surrounding its operation and family participation to build an estate plan around section 2032A. A number of interviewees expressed concern about whether special use valuation will be in effect for any extended period of time. The attorneys are concerned that they will build an estate plan around a provision which may be repealed some time in the future. This could destroy their work and prove very costly to their clients and the attorneys. A common approach among the lawyers was not to plan on section 2032A but if the conditions are right when settling the estate its use is then considered. While one attorney was planning on electing 2032A upon the death of a client, even he agreed that it was not generally wise to plan on it and his case was an exception to that rule.

Most of the attorneys had not used section 2032A because no opportunity had arisen or because they rejected using the provision for variour reasons. Of those who had rejected section 2032A two reasons were most often cited. First, special use valuation was not elected because the attorneys thought there was not an alternative use for the land. Because there was not much opportunity for development of farmland for other uses in the area the attorney thought there was no alternate value to consider. There is a flaw in this line of reasoning however. Even if no significant development opportunities of an industrial or other nature exist the calculations for special use value should still be made and the section 2032A election considered.

The average value of an acre of land in Michigan is $1039.[23] At the current effective Federal Land Bank rate of 10.3 percent[24] the net rental value gross rent less property taxes, must be $107/acre for the cash rental capitalization formula value to equal the fair market value of land. The average rental value for Michigan is, however, approximately $46.40[25] and the property tax on land valued $1039 is $19.76.[26] The capitalized value of land using the section 2032A cash rental formula and the above figures is $259/acre. The required five-year averages for rent, property tax and interest rate would result in an even lower per acre value (See Table II-1). That is a difference of $780/acre and on an average size farm in Michigan (167 acres)[27] that is a difference of $130,260 in the gross estate size. The lowest effective estate tax rate in the tax table is 32 percent.[28] At that rate the tax on $130,260 is $41,683 (See Table II-2). Although rental and land values vary in different regions of the state, the point is that even though there is no immediate alternate use for the land one should not dismiss a section 2032A election because there may still be substantial tax savings.

Another reason frequently mentioned for not using section 2032A is that the attorney did not expect the farm to remain in a qualified use or remain in the control of a qualified heir for the required 15 years.

Table II-1. Special Use Value Calculations

$\frac{\text{(net rent)}}{.103}$	= $1039		net rent	= $107
$\frac{\$46.40 - \$19.76}{.103}$	= special use value		special use value	= $259

Table II-2. Estate Tax Difference Using Special Use Value

$780	x	167 acres	=	$130,260
.32	x	$130,260	=	$41,683

This reasoning should be scrutinized more closely. Failure of the heirs to keep the land in the family or in a qualified use for the full 15 year period triggers a recapture tax but the maximum the recapture tax can be is the amount of estate tax originally saved. Since there is no penalty or interest charged on the tax saved, if the time value of money is considered, there may be some advantage to electing a section 2032A return even when the executor knows the land will not remain qualified for the full 15 years. For example, let us assume the estate tax saved by a section 2032A election from the above example. Even if the land is sold or fails to qualify for another reason after only five years the estate can save money. The present value of $41,683 at an 8 percent discount factor is $32,658.

There are counterarguments to this line of reasoning. A section 2032A tax return is likely to be more expensive than a return without such an election. Attorney fees, additional court costs, possible audit fees and the extra appraisal costs may be more than enough to offset any benefit realized by such action. This is unlikely however. Such an estate in many cases might also be able to elect a section 6166 or section 6166A deferral. Election of section 2032A might be considered by the executor however if the estate could not qualify for section 6166. In addition, there is always uncertainty about how long the land will remain qualified. Under these circumstances it may be difficult to compare the discounted value of the estate tax saved against the extra costs one may incur in choosing such a procedure.

Two other reasons were given for not electing section 2032A when possible. In the case of one attorney the tax deferral option, section 6166, was a preferred choice and a special use valuation would have precluded the use of section 6166. When section 2032A is elected the special use value of the land is then used for all other calculations regarding the estate. In this case the reduced value of the land prevented the estate from meeting the percentage requirements of section 6166.

Other attorneys felt that the costs of a special use election were not worth the small tax savings. By utilizing the optimal marital deduction and eliminating between 25 to 50 percent of the joint property from the estate by showing spousal contribution the taxable estate could be reduced enough for the unified credit of $47,000 to cover or almost cover the taxes due. Neither the lawyers nor their clients wished to get involved in a very complex and perhaps costly special use valuation election which would not save much in taxes.

Two attorneys have had recent and relatively extensive experience with filing section 2032A elections. Their comments were particularly insightful concerning an apparently changing attitude of the Internal Revenue Service toward section 2032A. According to the two interviewees, the IRS is becoming more resistant to section 2032A elections. It is becoming increasingly difficult to get a special use valuation election approved by the Internal Revenue Service. The Service is auditing any estate electing section 2032A which can become a costly and harrowing experience for the heirs.

The Internal Revenue Service's interpretation of the code is becoming increasingly difficult for executors also. In one area of Michigan in order to show that the cash rents used in the cash rental formula are valid the Service is demanding that the farm or farms from which comparable land rental values are taken also be completely appraised. This request greatly increases the cost of the election, especially if the comparable land comes from more than one farm, as is sometimes the case. The Service questions any claims and requires extensive documentation to prove that a qualified heir did materially participate on the farm for the required five years of the eight years prior to the decedent's death if the decedent had not. These procedures used by the IRS are not technically outside the letter of the law but the interviewees felt they were outside the spirit of the law.

A complaint among most of the attorneys was about the tremendous power of the Internal Revenue Service. They feel the IRS has ignored the intent of Congress in some of its interpretations of not only section 2032A, but the tax code in general. The consensus among the interviewees was that the IRS has too much leeway in its power to interpret and administer the code, and this needs to be curtailed.

Suggested Changes in Section 2032A

The author asked all the attorneys if they would like to see changes made in section 2032A and if so, what they would be. Some attorneys felt they were not qualified to speak on changes because they had no experience with the provision, and one stated he would like to see section 2032A remain as it is.

The majority, however, those who had used it or considered it, had some suggestions. Most thought the qualification requirements were too restrictive and therefore should be changed to make qualification easier. One interviewee disagreed with this however. He felt the requirements should be quite tough. He pointed out that no other group in society received such preferential treatment with respect to estate taxation and the qualification requirements should be tough to ensure only legitimate qualifiers use it.

Another suggested change was that there be some congressional action to clear up the ambiguities in the estate tax code. This especially applies to the question of what constitutes material participation. Since there have been no court decisions about material participation, the attorneys think congressional action is necessary to clarify the tax code. This would accomplish two things, first it would make the estate planner's job easier, and second it may reduce the power the Internal Revenue Service exercises in its interpretation of the code.

Two other changes in the estate tax code were suggested. The first relates again to material participation. None of the interviewees thought a retired landowner could qualify for section 2032A and social security benefits unless a qualified heir materially participated on the farm before the owner's death for the required amount of time. Most attorneys expressed a desire to see the code changed so that retired farmers could receive social security payments and still qualify for special use valuation. The attorneys think it is inequitable that retired farmers be prohibited from collecting social security benefits after paying in to a tax program for an extended period of time because they wish to elect section 2032A. While no alternative was suggested, the attorneys that mentioned this felt it would not be difficult to restructure the code slightly to allow a retired farmer to collect social security payments and qualify for section 2032A even if no qualified heir was on the farm prior to the owner's death, assuming the estate otherwise qualifies for section 2032A. These people felt a redefinition of material participation was necessary to accomplish this and that these two changes were compatible.

The second change frequently mentioned by the attorneys was that crop share leases should be acceptable for purposes of the cash rental formula. The interviewees felt it is unfair to farmers in those areas where crop share leases are predominant that farmers should be denied an opportunity to qualify for special use valuation because of the economic characteristics and tradition of the area. In their opinion obtaining five year averages of crop share leases, yields and prices would be no more difficult than obtaining limited cash rents available in some areas.

Finally, the interviewees made some overall comments about special use valuation. Client understanding of the technical details of section 2032A and estate taxation as a whole was thought to be low but most attorneys felt that professional knowledge of the subject of special use valuation was also quite limited. In fact a few of the attorneys interviewed were not that familiar with the provision. Their clients do however understand the "bottom line," the tax bill due. Farmers want to know how much section 2032A will save them and how much it will cost them.

Another point they made was that, though the initial publicity surrounding section 2032A sounded very good, the provision does not offer too much to most of their clients. It is too restrictive and too uncertain to be a useful planning tool and most of their larger clients' estates have considerable planning done prior to death. In addition, some attorneys feel the publicity may have lulled some farmers into a false sense of security. They feel many farmers think that these new provisions have solved all their estate problems and no other work need be done and usually this is not the case. As one attorney said, farmers need estate planning more than just about anyone else, but usually do the least of it.

Chapter II--Footnotes

[1]I.R.C. sec. 2032A(b)(1).

[2]I.R.C. sec. 2032A(b)(2)(A)-(B).

[3]I.R.C. sec. 2032A(e)(4).

[4]I.R.C. sec. 2032A(e)(5)(B)-(C)(ii).

[5]I.R.C. sec. 2032A(e)(1)-(2).

[6]I.R.C. sec. 2032A(b)(1)(C)(i)-(ii).

[7]I.R.C. sec. 2032A(b)(1)(A)-(B).

[8]I.R.C. sec. 2032A(e)(7)-(8).

[9]Commerce Clearing House, Federal Estate and Gift Taxes Explained, 1979 Edition, (Chicago, Illinois, Commerce Clearing House, Inc., 1979), p. 57.

[10]I.R.C. sec. 6324B(b).

[11]I.R.C. sec. 2032A(c)(2)(D).

[12]I.R.C. sec. 2032A(c)(3).

[13]I.R.C. sec. 2032A(h)(2).

[14]I.R.C. sec. 2032A(d)(2).

[15]I.R.C. sec. 2032A(e)(11).

[16]I.R.C. sec. 2032A(e)(6).

[17]Lorence L. Bravenec and Alfred J. Olsen, "How to Reap Estate Tax Benefits Through Use of the Alternative Use Valuation of Farmland," Journal of Taxation, (March, 1978), p. 143.

[18]Tom Normand, "Special Use Valuation of Farmland for Estate Tax Purposes: Arrangements for Material Participation," Baylor Law Review, (Spring, 1978), p. 254-259.

[19]Bravenec and Olsen, Journal of Taxation, p. 143.

[20]Gerald Harrison, "Material Participation: Social Security, Retirement, and Estate Tax Planning," Mimeograph, Purdue University, (December, 1980), p. 6.

[21]I.R.C. sec. 2032A(e)(2).

[22]2 Top. Law Rep. (CCH), par. 9558.035 (1980).

[23]Lindon J. Robison, "Income from Land and Land Values: Is There a Connection?" Michigan Farm Economics No. 439, (June, 1980), p. 1.

[24]Emanuel Melichar and Paul T. Balides, Agricultural Financial Databook, (Washington, D.C., Division of Research and Statistics, September, 1980), p. 34, Appendix Table 1.

[25]Robison, p. 1.

[26](.019 x \$1039) = \$19.76.

[27]Michigan Department of Agriculture, Michigan Agricultural Reporting Service, Michigan Agricultural Statistics, 1980, p. 5.

[28]Commerce Clearing House, Federal Estate and Gift Tax--Code and Regulations, (Chicago, Illinois, Commerce Clearing House, Inc., 1979), p. 7-8.

CHAPTER III

ESTATE TAX DEFERRAL: SECTIONS 6166 AND 6166A

In this chapter the author will discuss sections 6166 and 6166A of the Internal Revenue Code. The qualification requirement of both provisions will be examined. The provisions use different equations to determine how much of the estate tax may be deferred. There are also obligations placed upon the heirs that accompany the benefits granted by the provisions. All of the technical aspects of the tax deferral options will be discussed and explained in the first part of the chapter.

There are also some subjects which are surrounded by questions and controversy. One of these issues concerns the treatment of the estate and its election of sections 6166 or 6166A when part or all of the closely-held business is disposed of. Other issues are the relationship of the deferral options with section 303 stock redemptions for close corporations and what constitutes a "trade or business." These subjects will be discussed further later on in this chapter.

The final section presents the results of the attorney interviews conducted with respect to the tax deferrals. Their comments and observations are discussed and summarized in the last part of the chapter.

Estate Tax Deferrals

An estate tax return is due nine months after the decedent's death, however, there are two exceptions to this rule. The date for filing a return may be extended under section 6161 or the tax may be deferred according to sections 6166 and 6166A.

Sections 6166 and 6166A are the topics of this part of the discussion. Both provisions allow deferral of estate taxes for more than 12 months. Section 6166A, which was section 6166 prior to the Tax Reform Act when it was renumbered, allows the estate tax attributable to a decedent's interest or share owned in a closely-held business to be paid in equal installments for up to ten years. Section 6166 was enacted by the Tax Reform Act and also allows payment of the tax in ten equal installments but the first payment is not due until five years after the decedent's death.

Though section 6161 is not the subject of this paper it should be mentioned because it is an alternative. The section permits the Secretary of the Treasury to grant a 12-month extension to pay the tax if reasonable cause for the extension can be shown.[1] Prior to the Tax Reform Act's passage, the executor in order to qualify for a 6161 extension had to show that payment of the estate tax when due would result in undue hardship on the estate.[2]

Qualification

While the principles behind the qualification requirements for sections 6166 and 6166A are similar, many of the technical requirements are not the same. The paper will discuss the requirements for both sections and show the differences.

For an estate to qualify for section 6166, the decedent must have had an interest in a closely-held business such as a sole proprietorship, a partnership in which the decedent had owned 20 percent or more of the capital interest, or a partnership having 15 or fewer partners. An interest in a closely-held business for purposes of section 6166 also exists where stock in a corporation of 15 or fewer shareholders is included in the gross estate or 20 percent or more of the stock is included in the gross estate. Whether or not the estate qualifies under section 6166 depends on whether the decedent had an interest in a closely-held business immediately preceding death.[3] For the estate to qualify for section 6166A the same criteria apply except the number of partners or shareholders in the business is limited to ten.[4]

For section 6166 qualification the decedent must be a citizen or resident of the United States and the interest in the closely-held business must exceed 65 percent of the adjusted gross estate.[5] The term "adjusted gross estate" means the value of the gross estate less the sum of the allowable deductions under sections 2053 and 2054 of the Internal Revenue Code.[6] Section 2053 concerns expenses, taxes, and indebtedness of the estate and section 2054 concerns losses incurred by the estate. It is important to note that the adjusted gross estate for section 6166 deals with deductions <u>allowable</u>, not necessarily those <u>taken</u> for estate tax purposes. Some deductions may be used for the income tax return of the estate and not for estate tax purposes but are still deducted from the gross estate to calculate the adjusted gross estate. In a farm situation the residential and related improvements to the residence which are occupied by an owner or lessee of the farm or people employed by the owner or lessee are included as part of the closely-held business.[7]

Percentage requirements for section 6166A are less stringent in some respects. The value of a closely-held business must exceed either 35 percent of the gross estate or 50 percent of the taxable estate.[8]

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The estate does not have to meet both requirements. Taxable estate and gross estate are the same as previously defined. However, the deductions must be taken by the estate to calculate a section 6166A election value unlike section 6166 where the deductions just being allowable is acceptable. If the deductions are used on the estate's income tax return they cannot be used to qualify for section 6166A.

If the decedent had an interest in two or more closely-held businesses a section 6166 election is still possible. All business property included in the estate in which the decedent had an interest greater than 20 percent of the total value of the business may be treated as an interest in a single closely-held business.[9] That is, if the decedent's interest in each business was greater than 20 percent of the values of all interests which the decedent owned or which can be attributed to his or her estate they can be combined into one interest to meet the 65 percent of the adjusted gross estate requirements. For example, if the decedent owned 25 percent of the stock of three companies and each company's stock value equalled 30 percent of the adjusted gross estate, the decedent's estate would qualify for section 6166. Section 6166A differs from section 6166 in this respect. Section 6166A requires that the decedent must have an interest greater than 50 percent rather than 20 percent required by section 6166 of the total value of each business in order to combine the values.[10]

There are attribution rules in sections 6166 or 6166A regarding ownership of stock or partnership interests. According to the tax code, the decedent may have "attributed" to his or her estate for purposes of sections 6166 and 6166A the stock or partnership interest owned by members of his or her family. These interests are not included in the gross estate when calculating taxes but can be used when determining whether the decedent owned a required percentage of a business. For example, section 6166 requires that the decedent must have owned more than 20 percent of the stock of a corporation and there be 15 or fewer shareholders in the company. If the decedent owned 18 percent and his or her spouse owns or owned 7 percent of the stock, the decedent's estate will meet the greater than 20 percent requirement. Twenty-five percent of the firm will be attributed to the decedent.

Most of the attribution rules apply to section 6166 but there is one rule for section 6166A. Under section 6166A, more than 50 percent of the value of each business must be included in the estate to be treated as a closely-held business. Section 6166A(d) permits spousal co-ownership to apply in limited form to aggregating interests in two or more businesses. Section 6166A(d) allows an interest which represents the survivor's interest in what was community property between the decedent and his or her spouse to be treated as if it had been included in the decedent's gross estate for purposes of qualifying for a tax deferral.[11] This inclusion only applies in determining whether the business interests of the decedent can be aggregated to meet the 50 percent of each business rule. However, the community property interest of the survivor will not be included as part of the estate for the purpose of meeting the 35 percent of the gross estate or 50 percent of the taxable estate requirement.[12]

The attribution rules for section 6166 are much more complex. Section 6166(b)(2)(B) treats community property or any other interest held by husband and wife as being owned by one individual. It cumulates all married people's interests in the partnership or corporation.

Therefore, if more than the maximum number of people have interests in a firm, qualification can still occur if there are married couples involved, for each married couple is treated as one individual. For example, if 17 people own stock in a corporation and among those 17 are three married couples, by counting the married couples as individuals, section 6166(b)(2)(B) would leave 14 shareholders. Hence, a firm which previously could not qualify as a closely-held business because it had too many shareholders, now can. Section 6166(b)(2)(B) also permits the stock owned by a husband and wife to be combined to determine whether the decedent controlled more than 20 percent of the firm.[13]

There is also an indirect ownership provision in section 6166. Section 6166(b)(2)(C) states that property owned by a firm or estate is considered to be owned proportionately by those with an interest in the firm or estate.[14] Section 6166(c) allows the same aggregation of stock for spousal co-ownership as does section 6166A(d) but is broader because it allows inclusion of property held as joint tenants, tenants by-the-entirety and tenants in common as well as community property.[15] Section 6166(b)(2)(D) extends the reasoning of section 6166(b)(2)(B) because it allows an interest owned by a member of the decedent's family to be considered as owned by the decedent for purposes of the numerical tests qualification.[16]

The last attribution rule was enacted by the Revenue Act of 1978 and allows the executor to include a capital interest in a partnership or a non-readily-tradeable stock attributed to the decedent in the decedent's gross estate for the 20 percent percentage tests and the 20 percent aggregation rule if more than one business is involved.[17] This section, 6166(b)(7), has two restrictions however which make it

unattractive. It denies use of the five-year estate tax deferral available in section 6166 and the 4 percent interest rate charged on the first $345,800 of tax due.[18]

Implementation

The amount of tax that can be deferred and paid in installments is limited to the amount calculated in the following manner.

$$\text{total tax due} \times \frac{\text{interest in closely-held business}}{\text{value of the adjusted gross estate}}$$[19]

Though commonly known as the 15-year tax deferral option section 6166 actually extends the deferral for only 14 years. The first five years of a section 6166 election the tax may be deferred. At the end of five years the first installment payment is due. The remaining nine payments are then due annually.[20] Section 6166A does not allow the five-year deferral of tax. The first installment payment is due nine months after the decedent's death and the remainder of the payments are made annually.[21]

The amount of tax which can be paid in installments in a section 6166A election differs from section 6166 and is calculated in the following manner.

$$\text{total tax due} \times \frac{\text{interest in closely-held business}}{\text{value of the gross estate}}$$[22]

There is another important difference between sections 6166 and 6166A in addition to the five-year deferral. The interest rate charged on the unpaid balance of tax for section 6166 differs from the rate in section 6166A. For section 6166 interest is charged at 4 percent on the first $345,800 of the tax[23] and at rates established by section 6621 on any additional tax for the deferral period.[24] Section 6621 allows the

Secretary of the Treasury to adjust the interest rate. After payments are begun, interest is paid with the installment payments on the unpaid balance. If there is any tax which is subject to more than 4 percent, the interest is calculated on a pro rata basis.[25] Interest rates on section 6166A elections are determined entirely by the methods stipulated in section 6621.[26]

Obligations

Once a section 6166 or section 6166A election is made and accepted by the Internal Revenue Service the estate and the heirs have certain obligations. A failure by the estate to make an installment payment on time may result in the entire amount of the unpaid tax becoming due upon notice and demand from the Secretary of the Treasury.

Another restriction on the estate is that no more than one-third of the estate's interest in the closely-held business can be sold, exchanged, or otherwise disposed of. Nor can the aggregate money withdrawals or withdrawals of other property from the closely-held business exceed one-third of the estate's interest in the business. If any of these events occur, the unpaid balance of the deferred tax is due upon notice and demand from the Secretary of the Treasury.[27]

A section 303 stock redemption may exceed the above restrictions if (on or before the due date for the first installment payment) an amount of estate tax not less than the amount of money or other property distributed is paid. A section 303 stock redemption allows a gradual sale of stock by the estate back to a company in which a decedent had an interest to pay estate taxes with beneficial income tax considerations to the estate. The payment acceleration obligations are also not applicable were

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where the exchange of stock is for the purpose of the firm's reorganization according to section 368(a)(1).[28] Section 6166A contains accelerated payment provisions similar to those of section 6166 but the specifications are a little more lax. The reduction of the interest in the closely-held business may not exceed one-half for purposes of section 6166A. All other requirements and actions are the same as those of section 6166.

Issues

The tax deferral options are ambiguous in areas. The code is not clear and consequently uncertainty exists concerning the interpretation of some of the code and the intent of the legislature. The Internal Revenue Service has issued regulations and revenue rulings about section 6166A but none to date concerning section 6166. In this section the author will examine some of the ambiguous provision topics of uncertainty and their various interpretations.

Delinquencies, Dispositions and Withdrawals

An important issue concerning the estate tax deferral-installment payment elections is the treatment of accelerated payments. Failure by the estate to make a payment when it is due results in the unpaid balance of the estate tax becoming due upon notice and demand from the Secretary of the Treasury. The regulations in section 6166A state, however, that the unpaid balance becomes due and shall be paid upon notice and demand from the Internal Revenue Service's District Director.[29] One case has challenged this position, Lake Shore National Bank v. Coyle.[30] In this case the Seventh Circuit Court held that default did not automatically terminate the deferral. In the opinion of the court, an omission in the language of the code indicated a congressional intent to give the District Director flexibility in dealing with delinquent tax payments. The court ruled such flexibility by the District Director was necessary because the payment delinquency was evidence of the need for deferral in the case.[31]

However, this is only one case and does not establish a strong precedent. It is limited to the Seventh Circuit and applies only to section 6166A. The IRS does not agree with the ruling and still considers the deferral terminated upon delinquency and the tax due.[32] The IRS will also demand accelerated payment if the estate disposes of its business interests or substantial money or property withdrawals from the business occur. The withdrawals may not exceed one-third of the value of the closely-held business. What constitutes a "withdrawal" is difficult to determine. The regulations state that the withdrawals must be money or "included property." Included property is defined in regulation 20.2032-1(d) as property interests owned by the decedent forming part of the decedent's gross estate, as determined by sections 2033 through 2044, and valued according to section 2032.[33] This definition could have ramifications with respect to an exchange of assets by the business. Exchanging assets is a common occurrence in agriculture. For example, the sale and trading in of machinery or land exchange deals are common occurrences. A change in the business organization of the farm such as conversion from a partnership to a corporation may also affect the status of the deferral. Another problem may arise if the nature of the business changes. Firms change the products they sell or the services they render. A drastic change may constitute a withdrawal and trigger

accelerated payment. If exchanges or changes in the firm's structure are made and the replacement asset does not constitute "included property" a withdrawal may have occurred. If the withdrawal is large enough to trigger payment acceleration, the balance of the estate tax is then due.

The estate's disposition of the qualifying interest in a closely-held business can also cause acceleration of payment. Dispositions are measured in terms of the business interest included in the decedent's gross estate and not the entire value of the business as is the case in withdrawals. That is, when measuring the value of the disposition, the one-third limitation is calculated with the estate's interest in the closely-held business as the numerator. Many of the same problems facing withdrawal situations exist with respect to dispositions but they may be accentuated because dispositions have a smaller base, the value of the decedent's interest in the business.

Qualification

Another ambiguity is how the term "trade or business" is defined. A qualification requirement of sections 6166 and 6166A is that the firm must have "carried on a trade or business" just preceding death. There is no clear definition of what constitutes a trade or business in either section. The Internal Revenue Service has interpreted the term to mean an "active trade or business."[34] Three revenue rulings by the IRS have held that passive business activities do not qualify under sections 6166 or 6166A and two of the three rulings involved agricultural situations. Passive rental of land to a tenant for agricultural production does not constitute an active trade or business according to the IRS but

if the landlord plays a significant part in management of the farm, the business will qualify.[35] For agricultural estate planners some of the same problems involved in qualification for special use valuation may exist. An estate planner and his or her client must be careful if they wish the estate to qualify for the deferral options. The revenue rulings do not specify that the management activities of the landlord-lessor be similar to those for which social security is determined but they do emphasize two factors 1) participation of the decedent in the management decisions of the farm and 2) the decedent's dependency on the income from the farm's crop share lease.[36]

Section 303 and Tax Deferrals

An alternate method of funding payment of the estate taxes is through the use of section 303 stock redemptions. This section allows the estate to sell the decedent's stock over time with beneficial tax consequences. This option is available only to farm corporations, however, and consequently has limited use in agriculture because just under 1 percent of all Michigan farms are incorporated. There are five requirements to be met to qualify for a section 303 redemption; 1) the value of all of the decedent's stock in the closely-held business in the gross estate must be greater than 50 percent of the adjusted gross estate, 2) the stock must be included in the gross estate, 3) the amount to be redeemed under section 303 cannot exceed the total taxes due and expenses allowed as deductions for federal estate tax purposes, 4) funds raised by section 303 can be used only to the extent that the shareholder's interest is reduced by payment of taxes or expenses and 5) the

amount of money to be distributed through a section 303 stock redemption must be done in accordance with the time limits of section 303.[37]

Section 303 and the tax deferral options are closely related. Even if one of the tax deferrals is elected, the estate must still raise the money and make the payments. Section 303 provides a means for doing that. The Tax Reform Act changed section 303 to allow exchange treatment on stock redeemed more than four years after death providing the amount redeemed does not exceed the lesser of two values, 1) the unpaid estate taxes due and the administration and funeral expenses or 2) the taxes and expenses paid within a year after distribution. Exchange treatment treats the sale of the redeemed stock as a capital gain and not as ordinary income for the estate's income taxes. Therefore the taxable income is reduced by 60 percent and then taxed as ordinary income rather than treating all money received by the estate as ordinary income. The provision allows use of section 303 throughout the entire deferral period of sections 6166 and 6166A. Stock redemptions made within four years of the decedent's death, however, are not limited to the above restrictions.[38]

The executor must also take care not to violate the reduced interest rules of sections 6166 or 6166A so a disposition or withdrawal is not triggered. A section 303 redemption does not constitute a withdrawal if the money is used to pay estate taxes before the next payment is due. It is crucial, therefore, that the tax payment and stock redemption be coordinated to avoid triggering a withdrawal that would result in the unpaid balance of the tax coming due.

Estate Tax Deferral Comments

In this section the author will comment on the attorneys' views of sections 6166 and 6166A in general and on several aspects of the tax deferrals in particular.

The attorney interviews revealed several interesting, and in some cases, conflicting opitions about the use of the tax deferral options. Of the 25 people interviewed only three had elected a section 6166 deferral and five had chosen a section 6166A deferral. This limited amount of use was similar to that of the special use valuation and for some of the same reasons. There were, however, some significant differences between the attorneys' views of section 2032A and sections 6166 and 6166A.

Some of the attorneys did not comment on the subject of the estate tax deferrals because they felt they did not have the expertise to speak on it. Though not a unanimous opinion, a majority of those who felt qualified to speak on the subject thought the tax deferrals were, in general, more useful than special use valuation from an estate planning standpoint. A minority of the attorneys thought an estate planner could not use tax deferrals in his or her planning because of the uncertainties involved with qualification. The majority however, thought that often, use of tax deferral options was necessary for effective, intelligent estate planning. One attorney thought that most sophisticated farmers with an estate tax problem would use the 15-year deferral because of the low 4 percent interest rate. Another said that he thought of sections 6166 and 6166A whenever he was dealing with a farmer or owner of a small business. The overall impression was that the deferral options were something the attorneys felt more comfortable with and had a great deal more confidence in than the special use valuation.

One problem tax deferrals have in common with the special use valuation provision is the question of qualification. Though many of the definitional problems that exist with special use valuation are not present with the tax deferrals most of the interviewees felt that the qualification criteria were too difficult to obtain and that could prevent some deserving estates from qualifying for sections 6166 and 6166A. Therefore, most of the attorneys thought the qualification requirements should be relaxed somewhat to allow more estates to qualify. This is however, a biased viewpoint. Most of the attorneys admitted they were speaking from a tax avoidance, or pro-taxpayer, point of view. The same attorney that did not think section 2032A qualification requirements were too tough also did not think section 6166 or 6166A requirements were unreasonable. He stated that the requirements should be difficult to meet to ensure the privilege is not abused. Estate tax deferrals are used more in estate planning than section 2032A because the deferrals form a very important part of the planning, the availability of money to pay the taxes.

One complaint similar to the one concerning section 2032A pertains to the existence of the liens upon the property until the tax is paid. Section 6324A places a lien on property of an estate electing tax deferrals similar to section 6324B liens used for a section 2032A election and the complaints by the attorneys are generally the same. Some attorneys thought that the liens significantly affect a client's desire to elect sections 6166 or 6166A while others felt most of their clients were unaffected by these types of liens.

Generally, the attorneys prefer to defer rather than pay the estate taxes. Therefore, deferral under sections 6166 or 6166A is preferred to special use valuation because section 2032A requires immediate albeit reduced payment. Many attorneys felt that deferred taxes were equivalent to unpaid taxes. However, this attitude needs to be put into context. While most of the attorneys prefer to defer the tax if possible, a number of them also indicated a desire to pay off estate tax liabilities immediately. Several attorneys wanted to do both. Although this may appear contradictory, one must remember that the desires of the decedent and the heirs are of paramount importance in deciding whether to defer the taxes or pay them off. Many attorneys thought that most of their clients did not want anybody, particularly the federal government, monitoring their business for 10 to 15 years and many clients prefer not to drag out the payments for personal reasons. The heirs often choose to pay the taxes and close the estate even if it means paying a higher tax bill. The attorneys also prefer to pay the tax when regularly due if possible because they have to "stay on top of" their clients the entire period of the deferral to ensure all of the necessary steps are being completed on time. This can be a costly and time-consuming process for the attorneys and their clients.

When dealing with more sophisticated clients or those with substantial tax problems, the attorney may elect a tax deferral. According to the interviewees, tax avoidance is not the prime objective of estate planning; minimization of the taxes while meeting the needs and desires of the heirs is the goal. Those clients who feel comfortable with the restrictions of the deferrals or who have large estate tax bills are usually more willing to work within the provisions of sections 6166 and

6166A. In many of these cases, the deferral is preferred to special use valuation for reasons which may or may not be sound.

As previously discussed, the estate tax deferral has a longer history and its operation is clearer. One attorney prefers to work with the tax deferrals rather than special use valuation because there are fewer "future" problems involved with them. He thinks the restrictions imposed by sections 6166 or 6166A on the future use of the property are less severe and more beneficial to the estate than the provisions in section 2032A.

Another reason cited by attorneys and previously mentioned in the discussion of section 2032A is basis. A number of attorneys did not like section 2032A because of its effect on basis of property. If, however, an asset's basis is to be treated in cases of recapture in the manner described by the IRS supervisor in the discussion of special use valuation the reason for electing tax deferrals over special use valuation appears questionable. Electing the tax deferral options allows the stepped-up basis to be applied to the estate's property. If an asset's basis rises to fair market value at the time of the decedent's death in the event of a section 2032A recapture, the advantage that tax deferrals had over special use valuation no longer exists. The preferrence for tax deferrals appears to be partly attributable to the attitude that tax deferred is tax unpaid and partly to a generally negative reaction to section 2032A.

One attorney had elected special use valuation but not sections 6166 or 6166A because he thought they were mutually exclusive and he found special use valuation more attractive. That is, election of one provision precluded election of the other. There is no stipulation in the code that prevents election of both however. The value used for section 2032A is used in meeting the percentage requirements of sections 6166 or 6166A if special use valuation is elected but there is no reason not to elect both if all qualification requirements are met and the situation warrants it. No attorney interviewed had chosen to elect both simultaneously so far but several stated they could envision situations where it would be possible.

A final subject the attorneys commented on was the relationship between a section 303 stock redemption and estate tax deferrals. There were three people that had done more than minimal work with section 303, though most of these situations had not involved farms. In their opinion whenever a farm corporation is involved in estate planning or settlement, section 303 becomes very important. Those interviewees that had worked with stock redemptions agreed that it was complex but they preferred to work with section 303 rather than tax deferrals if possible because of section 303's case history. There are more cases establishing precedents with respect to section 303 than tax deferral cases and the attorneys liked this. Two attorneys had used deferrals, section 6166A specifically, in combination with a stock redemption. Section 6166 had not been used to date because the estates where a stock redemption had been chosen did not qualify for section 6166 but did qualify for section 6166A. A plan used by these attorneys was to qualify for the tax deferral at the time of death, then use a stock redemption within two or three years of death to pay off the estate tax liability. This was done to allow the corporation to recover from the decedent's death and redeem the stock to pay off the tax obligations. A complaint registered by one attorney was that the two provisions appeared to work against each other. This can be true if the executor is not careful to redeem the stock according to the withdrawal provisions of sections 6166 or 6166A. For those attorneys with several farm corporations, and their number is limited, the use of estate tax deferral options and section 303 stock redemption are key elements in planning how to pay the estate tax obligations.

The attorneys' comments on the estate tax deferrals lead to several observations. Quite often neither the executors nor their clients want to defer payment of estate taxes. Neither party wishes to drag the payments out if a reasonable and financially sound alternative can be found. The attorneys felt that often their clients will sacrifice some financial benefit for the knowledge that the estate is closed and the heirs can do what they desire with the property. This is an important consideration. Good estate planning accomplishes the objectives of the heirs and those objectives may not necessarily result in absolute tax minimization. At the same time, the attorneys often do not like to use deferrals because it increases their responsiblity and the amount of time they spend on the case. The attorneys prefer to elect tax deferrals in cases where they are dealing with their more sophisticated clients or there is an extremely large tax bill. What constitues a large estate tax bill is difficult to determine. Tax liabilities of a million dollars or more are certainly large, but a $10,000 bill may also be large. What constitutes a large tax bill must be determined by the estate planner on the basis of the facts of the case. The sophisticated clients recognize the advantages of tax deferral and in situations of large estate tax bills, deferral may be the only way to avoid massive liquidation.

A second point evident from the attorney interviews is the preference for tax deferral over special use valuation for various reasons. Sections 6166 and 6166A have case histories, although they are somewhat short and this is very important to the lawyers. The attorneys stated they need a base on which to make sound decisions and section 2032A does not offer as sound a base as deferral options. Deferral options are also considered to be easier to incorporate into an estate plan. The uncertainty about material participation in a section 2032A election does not exist in sections 6166 and 6166A elections. In the attorneys' opinion it is much too difficult to plan on meeting the 15-year qualified use-qualified heir requirement of section 2032A and the "future" problems are not as serious with deferrals. This does not mean all the interviewees said they plan on using deferrals when devising estate plans but many more plan on using tax deferrals than special use valuation.

A final observation is that the number of attorneys using these provisions and the number of estates they have been used in are still relatively small. In addition to the previously mentioned reasons for why attorneys do not use the provisions, the short period of time section 6166 has been available and the stringent qualification requirements are still important reasons for the small number of times section 6166 has been used.

Chapter III--Footnotes

[1]I.R.C. sec. 6161.

[2]Jerry W. Wark, "Section 303 Stock Redemptions: A Post-1976 Tax Reform Act Appraisal," Notre Dame Lawyer, Vol. 53, No. 5, (June, 1978), p. 928.

[3]I.R.C. sec. 6166(b)(1)-(b)(2)(A).

[4]I.R.C. sec. 6166A(c).

[5]I.R.C. sec. 6166(a)(1).

[6]I.R.C. sec. 6166(b)(6).

[7]E. Hood, L. Chalstram and P. Brown, "Special Elections: The Use of Sections 6166, 6166A, and 303 of the Internal Revenue Code," University of Missouri-Kansas City Law Review, Vol. 47, No. 4, (Summer, 1979), p. 514.

[8]I.R.C. sec. 6166A(a)(1)-(2).

[9]I.R.C. sec. 6166(c).

[10]I.R.C. sec. 6166A(d).

[11]I.R.C. sec. 6166A(d).

[12]Hood, Chalstram and Brown, University of Missouri-Kansas City Law Review, p. 499.

[13]I.R.C. sec. 6166(b)(2)(B).

[14]I.R.C. sec. 6166(b)(2)(C).

[15]I.R.C. sec. 6166(c).

[16]Hood, Chalstram and Brown, University of Missouri-Kansas City Law Review, p. 502.

[17]I.R.C. sec. 6166(b)(7).

[18] Hood, Chalstram and Brown, University of Missouri-Kansas City Law Review, p. 504.

[19] I.R.C. sec. 6166(a)(2).

[20] I.R.C. sec. 6166(a)(3).

[21] I.R.C. sec. 6166A(a).

[22] I.R.C. sec. 6166A(b).

[23] I.R.C. sec. 6601(j)(2).

[24] I.R.C. sec. 6166(f).

[25] I.R.C. sec. 6601(j)(3).

[26] I.R.C. sec. 6621.

[27] I.R.C. sec. 6166(g)(3).

[28] I.R.C. sec. 6166(g)(B)-(C).

[29] Hood, Chalstram and Brown, University of Missouri-Kansas City Law Review, p. 525.

[30] Ibid.

[31] Ibid.

[32] Ibid.

[33] Ibid., p. 528.

[34] Ibid., p. 505.

[35] Ibid., p. 507.

[36] Ibid.

[37] I.R.C. sec. 303.

[38] Hood, Chalstram and Brown, University of Missouri-Kansas City Law Review, p. 552.

CHAPTER IV

FRACTIONAL INTEREST RULE AND 2 PERCENT SPOUSAL PARTICIPATION RULE: SECTION 2040(b) AND SECTION 2040(c)

This chapter discusses two provisions of the Internal Revenue Code that deal with joint tenancy. Joint tenancy is a form of multi-person real property ownership. The two provisions, sections 2040(b) and 2040(c), allow farmers to reduce the value of their estates if the provisions' requirements are met. This chapter is divided into three parts. In the first section the author will discuss the technical aspects of the two provisions under analysis including the qualification requirements and implementation procedures. In the second section the major question concerning the provisions, i.e., the contribution of the spouse to the farm or closely-held business, will be examined. The author will also discuss what determines the basis of contribution, how the contribution of a spouse is valued, and what constitutes the fine line between domestic services which do not qualify as contribution and other services which do qualify as contribution. Finally the author will discuss the comments made by the attorneys about the two provisions, sections 2040(b) and 2040(c), and joint tenancy. There were some vast differences of opinion on how joint tenancy should be handled in estate planning and settlement.

Qualification and Implementation

Joint tenancy is the most common form of multi-person ownership in agriculture and differs from tenancy in common which allows persons to have distinct but undivided interests in the real estate. Tenants in common can bequeath their interests at death so their heirs receive the interest in the tenancy in common.

Joint tenancy is the undivided ownership of property by two or more persons with the right of survivorship. This right of survivorship means that upon the death of one owner, the remaining owner, or owners, assumes full ownership of the property. Ownership of jointly held property is not subject to division by one owner and cannot be severed by a will.[1]

A special form of joint tenancy is tenancy by-the-entirety. This special type of joint tenancy exists only between a husband and wife and cannot be severed unless both parties agree to dispose of what they own.[2] Upon the death of one tenant the value of all joint property in which the decedent had an interest is included in the estate of the decedent, however the property itself is not included in the estate because it is owned by the surviving joint tenants. Section 2040(b), the fractional interest rule, enacted by the Tax Reform Act, and section 2040(c), the 2 percent spousal participation rule which is part of the Revenue Act, allow exclusion of joint property from the gross estate based on the participation and contribution of the survivor.

In order to examine the provisions in question a brief discussion of joint tenancy is necessary. Section 2040(a) states that the gross estate of a decedent shall include the value of all property held in joint tenancy by the decedent and any other party except that part of the joint property which can be shown to have been acquired by the other person in an arm's length transaction. An arm's length transaction is an exchange of assets for full value and consideration by both parties. The other person must have given full consideration for the property and such consideration cannot have come from the decedent. However, any property inherited or received as a gift by a tenancy by-the-entirety from an outside source shall be included in the estate at half of the property's value.[3] In other words, all joint property owned by the decedent and his or her spouse is included in the estate unless the survivor can prove ownership of the property prior to the formation of the joint tenancy or acquisition of the property through a gift or inheritance. Gifts from the decedent are not excluded however.

The first provision under analysis is section 2040(b), the fractional interest rule. This section allows exclusion of one-half the value of a qualified joint interest from the gross estate.[4] A "qualified joint interest" is an interest in property that is held jointly by spouses or as tenants by-the-entirety and a qualified joint interest must have been created by the decedent, his or her spouse, or both after December 31, 1976. If the qualified joint interest involves personal property, the creation of the interest must include completion of a gift for gift tax purposes and for real property the creation of the qualified joint interest is a taxable event at that time.[5] Any additions to the qualified joint interest require filing of additional gift tax returns.[6] Existing joint tenancies may be severed and a new joint tenancy created. Upon such a creation, a gift tax return is filed by the donor spouse and the amount of the gift equals one-half of the appreciation of the property multiplied by the ratio of the donor's excess contribution to the total contributions for the property.

Section 2040(c), the 2 percent spousal participation rule, allows exclusion of the value of property from the decedent's estate if the decedent's spouse had materially participated in the farm or other business.[7] This exclusion is available to eligible joint interests. "Eligible joint interests" means a joint interest between spouses only which was created by the decedent, the decedent's spouse, or both.[8] An eligible joint interest is not necessarily a qualified joint interest. Property qualifying for section 2040(c) is real or tangible property devoted to farming purposes or used as a farm according to the definition in section 2032A, or property used in any other trade or business.[9] The decedent's spouse must have materially participated in the farm or other business within the context of material participation for self-employment earnings.[10] If such participation occurs, an amount equal to the following equation is excluded from the gross estate.

$$\left(\begin{array}{c}\text{value of}\\ \text{eligible}\\ \text{joint}\\ \text{interest}\end{array} - \begin{array}{c}\text{adjusted}\\ \text{consideration}\\ \text{furnished by}\\ \text{the decedent}\\ \text{or spouse}\end{array}\right) \times \left(.02 \times \begin{array}{c}\text{number of}\\ \text{taxable years}\\ \text{the spouse}\\ \text{materially}\\ \text{participated}\end{array}\right)^{11}$$

Adjusted consideration is the consideration furnished by the decedent plus any interest such consideration would have earned over the time period it was invested in the farm at a rate of 6 percent simple interest.[12] Section 2040(c) is limited to a maximum reduction of $500,000 or 50 percent of the value of the eligible joint interest from the gross estate.[13]

Issues

In this section the author will examine the issue of spousal contribution and joint tenancy. Proving a surviving spouse's contribution can save the first decedent's estate a great deal of money and should be given due consideration.

Spousal Contribution

The key issue concerning joint tenancy and sections 2040(b) and 2040(c), is the contribution of the surviving spouse. There are a number of important questions relating to the contribution of the surviving spouse such as what constitutes contribution and how is contribution valued? What determines the line between domestic services provided and business contribution? How are mortgage payments and property appreciation treated with respect to contribution? One case history examined the questions but offered no clear answers.

Treatment of appreciation and income used as contribution provides an example of some apparent inconsistencies about the contribution of a survivor. According to the Internal Revenue Code regulations, income received by the survivor as the result of a gift from the decedent may constitute a legitimate contribution to joint property by the survivor. However, the property that produces the income is not a legitimate contribution by the survivor at any time. Appreciation of property which the surviving spouse received as a gift from the decedent and then sold also does not constitute a legitimate contribution to joint property. Therefore, if the consideration furnished by the survivor in acquisition of a joint interest is the income from a gift of the decedent, a legitimate contribution is made. Any consideration furnished by the sale of a decedent's gift to his or her spouse for either the value of the gift or appreciation of the gift is not a valid contribution by the survivor.[14]

Case history does not support the IRS treatment of appreciation. Two cases, Swartz v. United States[15] and First National Bank v. United States,[16] have allowed the amount of money representing appreciation from a sale of property received as a gift and reinvested in a joint tenancy to be a valid contribution by the surviving spouse. These rulings could have tremendous implications for agricultural firms and estates. With land values rising rapidly a gift from husband to wife or father to son could help freeze the value of the farmer's estate. This is applicable, however, only if there were succeeding purchases of jointly held property.

Another topic of concern is whether the survivor can receive credit for contribution made through mortgage payments even though the decedent provided the entire down payment. Income from the tenancy by-the-entirety is split equally in most cases and this helps support the claim that the survivor should be given credit for one-half of the mortgage payments if the payments came from income derived from the jointly held property. One case, Bremer v. Luff[17] substantiates this conclusion albeit to a certain degree. The court ruled that the survivor contributed equally to a property purchase even though the decedent had paid off the mortgage because the survivor was "jointly and severally liable" for the mortgage with the decedent. Such situations could also have a substantial impact on agricultural business firms and estates. A father-son partnership or husband-wife partnership could reduce the amount of joint property in the decedent's estate under this procedure.

A crucial issue with respect to joint ownership is the proof of a partnership between husband and wife and its relationship to contribution.

Formal title of ownership does not always determine how estate taxation is to occur. The existence of a partnership between spouses, whether formal or informal, is the key to exclusion of part of the asset value from the estate. If a partnership is shown to exist between spouses, inclusion of joint property in the estate is done proportionately, but in cases where no partnership exists the entire value of joint property is included in the decedent's estate. If no partnership can be shown, the survivor must be able to trace any consideration furnished in accordance with section 2040(a) in order to exclude the value of joint property from the gross estate.

Five court cases in the past 40 years have established to a degree what a partnership involves.[18] Though each case rests on the merit of its own facts there were some common characteristics among them. All of the cases involved situations in which both spouses participated substantially in the business operation and management. The cases also involved some form of agreement between the parties to share the profits and losses. In United States v. Neel[19] the court presented a definition of partnership in what may be considered the "classic family business" case. The court held that "a partnership is created by persons joining together their money, goods, labor or skill for the purpose of carrying on a trade, business, or profession, when there is community interest in the profits and losses." Though this decision was delivered 15 years ago it is still applicable. A more recent case, Craig v. United States,[20] involved a farm in South Dakota. The court found that a partnership existed between the husband and wife who had begun farming with a few assets 40 years before and who had developed a sizeable farm operation. The court found equal participation between the spouses and therefore only one-half of the farm value was included in the husband's estate. The manner in which income tax returns were filed was not considered in this case.

These cases may be very important to farm families. In these cases the manner in which income tax returns were filed, that is, whether partnership or individual returns were filed was not considered but an agreement by the spouses to share the results of the business venture and the contribution of both parties were the key factors in determining whether a partnership existed. If a partnership did exist, then an amount, usually one-half of the joint property, was excluded from the gross estate. In many farm situations the wife does a great deal of the work on the farm and such a partnership may be able to be shown. It is, however, very difficult to make blanket statements about proving the existence of a partnership. Each case will be determined on the basis of its own facts.

Another point to note with respect to these cases is that all of the cases involved tenancy by-the-entirety, that is, they were joint tenancies between husband and wife. Consequently, the income tax aspects ignored in these cases may assume a different role if the parties attempting to prove a partnership are not married. For example, proving a father-son partnership may be much more difficult.

Provision of domestic services is another difficult point in the law. Several cases regarding domestic services have been decided and still the question of whether domestic services should be treated as consideration furnished in a joint tenancy remains.[21] Section 2040(a) states consideration is money or money's worth contribution and may be excluded from the gross estate of the decedent. Therefore, do domestic services have a money's worth? From an economic perspective there is little doubt that these services are an imputed income to the family. From a legal perspective established through case law however, domestic services do not have any economic value. In the Estate of Otte[22] the married couple operated a farm. The court found that the wife's contribution had a money's worth and one-half of the gross estate was excluded from taxation. The court held that the wife's "effort, industry, and skill" were more extensive than if she had not resided on the farm. However, the status of domestic services is still ambiguous. If domestic services do not constitute money's worth consideration, where is the dividing line between domestic services and services with a money's worth? How much of the estate's value can be excluded from the estate in cases where the wife helps operate the farm but provides many of the domestic services too?

Fractional Interest and 2 Percent Spousal Participation Comments

When questioned about sections 2040(b) and 2040(c) the attorneys offered various responses. Only once did any of the attorneys ever use either of the provisions. That attorney favors use of corporations in agriculture much more than any other attorney interviewed and he thinks section 2040(b) and section 2040(c) fit into estate planning and settlement quite well for some of those cases.

All of the attorneys had some comments to make on joint tenancy in estate planning and settlement. The two provisions of interest, the fractional interest rule and the 2 percent material participation rule evoked some very interesting comments concerning their use, the intent of

Congress when the provisions were passed, and the statutes' effect on the estates of the attorneys' clients.

It is fair to say that the great majority of the attorneys did not think very highly of the two provisions. Of the two sections, their comments about section 2040(c) were less harsh but still unfavorable. The attorneys thought that most well-planned estates have little, if any, jointly held property and section 2040(c) is unnecessary for those estates. The general consensus was that section 2040(c) may be useful on rare occasions but is not a good tool for planning purposes because good tax planning would not leave an extensive amount of joint property.

Some of the attorneys were more critical than others in statements about the 2 percent rule. One attorney called section 2040(c) an administrative "cop-out" on the part of the estate planner. He thought if the executor could show material participation by the survivor a greater advantage to the estate could be achieved by establishing a constructive partnership using the precedents established in the court cases mentioned earlier. This is the crux of the issue with respect to section 2040(c). Attorneys historically have been able to exclude up to 50 percent of an estate's joint property by using affidavits and other procedures to show that the survivor, usually the wife, contributed to the farming operation. One interviewee felt that election of section 2040(c) was, in effect, throwing spousal contribution away. The formula in section 2040(c) allows a maximum exclusion of 50 percent of the appreciation in the joint property, after subtracting a 6 percent appreciation value from the joint property. The amount attributable to the survivor can therefore never equal one-half of the joint property and is usually much less.

For example, assume a couple owned $100,000 worth of joint property that had been pruchased by the husband 25 years ago for $20,000. The wife had materially participated for 25 years in the business but had not contributed to the initial purchase. After deducting the $20,000 and 6 percent simple appreciation the estate can exclude 50 percent of the remainder of the property value. The estate must deduct $50,000 from the $100,000 value and then can exclude half of the remaining $50,000. The attorneys thought that they were better able to exclude property using techniques already established through case history than use the new provision which might not yield as large an exclusion and required approximately the same amount of proof. This is a valid point. In order to exclude a percentage of joint property from the estate, the interviewees used affidavits establishing the survivor's material participation. To qualify for section 2040(c) material participation must also be shown and the rewards of section 2040(c) are often not as great as can be gained through other means.

While the 2 percent rule was not highly regarded as an estate tax tool, it did not receive the scathing criticism that section 2040(b), the fractional interest rule, did. This provision is contrary to almost all precepts of good estate planning. Consequently, the terminology used by the attorneys to describe it ranged from "ridiculous" to "a tax sham." Use of section 2040(b) is considered to be poor tax planning because it does not accomplish anything in the way of tax minimization. The fractional interest rule requires creation of a qualified joint interest or requires severance of an existing joint tenancy and creation of a qualified joint interest so that at the decedent's death one-half of the value of the joint property may be excluded from the estate of the deceased. Creation of a qualified joint interest or severance and creation may constitute a gift from one spouse to another that is taxable. Since a qualified joint interest must be between a husband and wife, if the gift tax is sufficient it may be reduced by using the $100,000 marital gift exclusion but use of that in turn may affect the marital deduction available at the time of death. The key point is that there is no benefit to be gained by severing an existing joint interest and recreating another, a qualified joint interest. If severance is going to occur and a gift tax is triggered it is more prudent to place the property in the form of tenants in common or split the property entirely and create two separate estates. This action will not change the tax at the time of the first spouses death from what it would be using section 2040(b) but could substantially alter the estate tax upon the second spouse's death which is when most estate tax problems occur. For this reason section 2040(b) is considered to be a short-sighted tax provision. Minimization of the total tax on both estates is usually one of the objectives of an estate planner. Property held jointly under section 2040(b) provisions may be taxed no more than property held separately or as tenants in common at the time of the first tenant's death but joint property passes to the survivor immediately upon death and is not subject to the directions of a will. This increases the survivor's estate size and leaves the survivor without the benefit of the marital deduction unless the survivor remarries. Consequently, the estate tax burden upon the death of the survivor has the potential to be much greater. If the property is held as tenants in common the right of survivorship does not exist and the decedent may direct that the property go to other heirs. The property does not have to go to the surviving spouse but may go instead to the next generation. This action reduces the survivor's estate and, consequently, any tax due when the survivor dies. It does, however, give control of the property to others. There is one major consideration to this. The first concern in estate planning is usually the financial security of the surviving spouse. If the property in the decedent's estate is necessary for the survivor to live on, then that is an important concern and tax minimization may be secondary. There are still other means of accomplishing the goal of section 2040(b). In cases in which the property is not needed or the survivor has sufficient income to live comfortably, use of section 2040(b) does not appear to be wise tax planning.

Many of the attorneys said they would like to be able to sever more estates and create two separate estates or have the land held as tenants in common but they found a great deal of resistance by farmers to their efforts for a couple of reasons. First, payment of any gift tax upon severance of a joint tenancy usually dissuades clients from electing such a move and use of the $100,000 marital gift tax exclusion is not considered favorably by a number of attorneys because of its effect on the estate marital deduction. Second, jointly held property in Michigan avoids probate and many of the attorneys' clients want to avoid probate at any cost.

A number of attorneys expressed concern that these provisions will lead to complacency in the minds of many people that these provisions have solved their tax problems. They are concerned that these provisions, section 2032A and holding joint property, may lead many people to acquire a false sense of security about their estates when in fact the use of these tools does not aid many people very much.

Chapter IV--Footnotes

[1]Harold W. Hannah, ed., Beuscher's Law and the Farmer, 4th ed., (New York, Springer Publishing Company, 1975), p. 71-72.

[2]*Ibid*., p. 4.

[3]I.R.C. sec. 1040(a).

[4]I.R.C. sec. 2040(b)(1).

[5]I.R.C. sec. 2040(b)(2).

[6]I.R.C. sec. 2515(c)(2).

[7]I.R.C. sec. 2040(c)(1).

[8]I.R.C. sec. 2040(c)(3)(A)-(B).

[9]I.R.C. sec. 2040(c)(4).

[10]I.R.C. sec. 2040(c)(7).

[11]I.R.C. sec. 2040(c)(5).

[12]I.R.C. sec. 2040(c)(6).

[13]I.R.C. sec. 2040(c)(2).

[14]Hugh D. Brown, "Joint Interest Taxation," Vanderbilt Law Review, Vol. 32, (1979), p. 1440.

[15]182 F. Supp. 540 (D. Mass. 1960).

[16]223 F. Supp. 963 (W.D. Mo. 1963).

[17]7 F. Supp. 148 (N.D. N.Y. 1933).

[18]Eric D. Whitesell, "Estate Taxation of Joint Tenancy Property Acquired by Spouses with Funds Generated from the Family Business--the 'Family Partnership' Exception to Section 2040," William and Mary Law Review, Vol. 21, (Fall, 1979), p. 194.

[19] 235 F. 2d. 395 (10th Cir. 1956).

[20] 451 F. Supp. 378 (D.S.D. 1978).

[21] Ann E. Kruse, "Estate Tax Section 2040: Homemaker's Contribution to Jointly Owned Property," Tax Lawyer, Vol. 29, No. 3, (1979), p. 627.

[22] 41 T.C.M. (P-H) par. 72,076 (1972).

CHAPTER V

MICHIGAN INHERITANCE TAX EXEMPTION-DEFERRAL

This chapter will examine a provision enacted in a recent amendment to the Michigan Inheritance Tax Code. The amendment included the farmland exemption-deferral option, the subject of this chapter. The exemption-deferral option is a cross between the federal special use valuation provision and the federal estate tax deferral. It allows one-half the farmland value to be exempted for inheritance tax purposes and also allows deferral of the part of the inheritance tax attributable to the remaining half for up to ten years.

In this chapter the author will discuss the qualification requirements that the estate and heirs must meet in order to elect this option. That will be followed by a discussion of how the provision is implemented and how the tax is calculated when the provision has been elected. As is the case with the federal estate tax options, this state inheritance tax provision also places obligations upon the heirs which are supported by a recapture tax. These obligations and the penalties for failure to meet the obligations are also discussed. Throughout this chapter the author will show where the state law differs from the federal code.

Since the provision is very new there have not been very many cases where it has been elected. Consequently how the provision will be interpreted by the state in some questionable areas is unclear. These questions will be addressed and alternative interpretations examined.

Michigan Inheritance Tax

The Michigan inheritance tax is the second oldest tax in the state with only the property tax being older. The inheritance tax is however, a relatively small percentage of total state revenue at approximately one-half of 1 percent.[1]

The tax is computed by the county probate judge and a bill presented to the executor of the estate. Though inheritance tax is a state levied tax it is paid to the treasurer of the county in which the decedent resided. From there the money is sent to the state's general fund.

Qualification

This section describes the qualification requirements that must be met in order to elect the exemption-deferral provision. The property qualifying must be "qualified real property."[2] Qualified real property is real property located within Michigan which was used primarily for agricultural use according to the definition of agricultural use given in Public Act 116, the Farmland and Open Space Preservation Act. "Agricultural use," according to P.A. 116, means substantially undeveloped land devoted to the production of plants and animals useful to man.[3]

The qualified real property must pass to a "qualified heir." A qualified heir is a grandparent, parent, spouse, issue, the spouse of issue, brother, sister, or any person with whom the decedent stood in a mutually acknowledged relation of a parent, a lineal descendent of the decedent or a farm business partner.[4] This provision differs from federal estate tax section 2032A in this respect. The federal tax code does not allow a farm business partner to be considered a qualified farm heir.

Many of the other requirements for the state exemption-deferral provision are similar to the federal special use provision. The adjusted value of the qualified real property must constitute at least 25 percent of the adjusted value of the estate and the adjusted value of real and personal property devoted primarily to agricultural use must equal at least 50 percent of the adjusted value of the estate.[5] The adjusted value of the estate is the clear market value of the estate reduced by deductions for an unpaid mortgage, debts or liens, adjusted value, in the case of real or personal property, is the clear market value less unpaid mortgage, debts or liens on the relevant property.[6]

Implementation

The state exemption-deferral option is a crossbreed of the federal special use valuation and the estate tax deferrals. The provision allows a qualified heir to exempt one-half of the clear market value of qualified farm property from taxation and defer the taxes due that are attributable to the remaining one-half of the land. Taxes attributable to the remainder of the assets in the estate are due within nine months of the decedent's death.[7]

To accomplish this, the executor of the estate and the qualified heir must make the election for the exemption-deferral by filing an affidavit with the county probate judge. The judge in turn determines whether the heir is, in fact, a qualified heir and whether the land is qualified real property.[8] In order to determine whether the land is farmland the judge may consult with the soil conservation district agency or the state land use agency.[9] The state land use agency is the land use agency of the Department of Natural Resources.[10] If the land or heir fail to qualify the taxes become due immediately. If the probate judge approves the application to elect the provision he or she then issues an order which suspends payment of all inheritance taxes for six months, authorizes the transfer of the qualified farm real property to a qualified heir, and requires the heir to apply for a farmland development rights agreement, Public Act 116, within 30 days of the order if the land is not already enrolled. Failure to apply for P.A. 116 within the required time results in the inheritance tax becoming due immediately.[11]

If the property remains in a qualified use for ten years after the date the land enters into the farmland development rights agreement, the 50 percent exemption becomes permanent and the tax deferred becomes due at that time. The farmland development rights agreement is a covenant between the owner of the land and the state. This agreement states that the state and landowner jointly hold the right to develop the land for an agreed upon period of time.

The amount of tax deferred is that amount of tax which is attributable to the remaining one-half of the clear market value of the land. This is determined by using the following equation.

$$\text{tax due} \times \frac{\text{value of real property inherited by the individual}}{\text{taxable inheritance of individual}}$$

The remainder of the tax is due when it would normally be due had the exemption-deferral not been elected.[12]

For example, a son may inherit a farm worth $150,000 and the land is worth $100,000. If he elects the exemption-deferral option, $50,000 of the land value is exempted from tax. The tax due is then $2,800. But $1,400 of that value may be deferred because the land value is half the inheritance value.

Obligations

When the qualified heir and the executor elect the exemption-deferral option a lien is placed upon the transferred property for the inheritance tax and any interest which may be charged on this tax. The provision has a penalty mechanism similar to the federal recapture tax for heirs who sell the land or cease to use the land for a qualified use within ten years of the effective date of the farmland development rights agreement.

If the farmland is sold by the heir within five years of the effective date of the agreement one of four penalties is charged depending upon who the land is sold to. If the land is sold to another qualified heir who complies with the agreement the exemption-deferral remains intact. If the buyer is not a qualified heir but complies with the agreement the exempted and deferred taxes are due immediately without penalty or interest. The total amount of exempted and deferred taxes are due at a penalty of 3/4 of 1 percent per month compounded from the time the exemption was granted until the taxes are paid if the owner's request for relinquishment of the agreement is approved according to Public Act 116, section 12(2)(b). Section 12(2)(b) provides a procedure for the owner of land enrolled in a farmland development rights agreement to request his or her land be removed from the program. Finally, the exempted and deferred taxes are due without penalty or interest if the state agrees to relinquish the farmland development rights agreement.[13]

Sale of the land by the owner after the fifth year but not after the tenth year of the effective date of the agreement results in the same treatment as before except that the amount of tax due is prorated over the time remaining in the deferral period. The exact procedure that will be used in such cases has yet to be determined by the state and alternatives will be discussed in more detail later.[14]

In cases where the qualified heir does not sell the land but ceases to keep the land in an agricultural use the recapture procedure is slightly different. Failure to keep the land in an agricultural use at any time results in the entire amount of exempted and deferred tax becoming due with a penalty of 3/4 of 1 percent interest compounded monthly added to the tax bill from the time the exemption was received until the taxes are paid.[15]

Failure to meet the obligations required by the farmland development rights agreement triggers not only a recapture of deferred and exempted inheritance taxes but also other taxes. The farmland development rights agreement also gives a property tax break to the heirs of the land and by violating the agreement any penalties levied by Public Act 116 also become due. Thus, a failure by the heir to honor the farmland development rights agreement places him in a precarious position. He or she faces payment of inheritance taxes and property taxes at the same time.

Exemption-Deferral Issues and Comments

The exemption-deferral provision was enacted January 6, 1979, and the number of times it has been elected is still very small. To date there have been no more than half a dozen elections of the provision.

Not a single attorney interviewed had even considered using the provision. While it can be severe in some cases, the Michigan inheritance tax is not as big of a concern to estate planners as the federal estate tax is. The maximum tax rate is 17 percent for a class II heir with an inheritance in excess of $500,000 and 10 percent for a class I heir with an inheritance in excess of $750,000.[16] A class I heir is the same as a qualified heir and a class II heir is all others. The federal estate tax on the other hand carries a maximum rate of 70 percent on asset transfers in excess of $5,000,000 and consequently the inheritance tax does not receive as much attention from attorneys. Unless an unusual case arises the attorneys and their clients usually prefer to pay off the state inheritance tax rather than stretch it out. Quite often in farm cases there is not a large inheritance due. If the decedent and his or her spouse owned the property as joint tenants the inheritance tax is reduced dramatically because jointly held property is not taxed in Michigan. Real property usually makes up a large percentage of a farm estate therefore at the death of the first spouse, the inheritance tax bill is usually manageable. As is the case with estate taxes, inheritance taxes usually become more of a factor at the death of the second spouse.

Since the provision is relatively new there are still some ambiguities in its interpretation. Section 202 d.(4) states that if the land enrolled in a farmland development rights agreement is sold by the heir not less than five but not more than ten years after the effective date of the agreement, the exempted and deferred taxes shall become due but the amount due is prorated. At this point it is unclear how the prorating is to be calculated. There is no specific equation given in the amendment as is the case in the federal statutes for section 2032A. The inheritance tax provision states there will be a proration of the remaining months. There have been no cases up to now where a sale has occurred after five years because the provision has only been in effect since 1979. The question is whether the denominator in a fraction with the number of remaining months in the ten year deferral period as the numerator is 60 or 120. This fraction is then multiplied by the tax due. For example, if an heir sells the land he or she inherited after seven years in a qualified use would the initial tax due be multiplied by a value of 36/60, which is the number of months remaining in the ten-year deferral period over the number of months remaining after the first five years of the deferral occur and proration begins, to get a prorated value of the tax due? Or would the exempted-deferred taxes be multiplied by a fraction with a value of 36/120? The numerator, 36, is the number of months remaining in the ten-year deferral period and the denominator is the total number of months in the deferral period. If the denominator is 60 the pro-rata inheritance tax will be twice as much than if the denominator is 120. For example, using 120 as a denominator in the equation results in \$3,000 being due and using 60 would give a value of \$6,000 due.

A representative of the State Treasury Department stated that he did not know which method would be used. There have been no test cases and when the first situation appears the Treasury Department will then ask for a legal interpretation of the statute. The federal statute, section 2032A, utilizes the first method to calculate its proration on the final five years of the special use valuation. This is however, designated within the code and no uncertainty exists about how it is to be handled.

Another question mark with respect to the exemption-deferral option is how it will treat farm partnerships and corporations. Will decedents who owned shares of stock in a farm corporation or an interest in a farm partnership qualify for the provision? If, for example, the decedent placed all property, real and personal, in the corporation there may be difficulty in qualifying. State law does not provide for indirect ownership of the necessary real and personal property. The state inheritance tax provision has the same percentage qualification requirements as the federal estate tax special use valuation, 50 percent of the adjusted gross estate must be the adjusted value of real or personal property devoted to an agricultural use and 25 percent of the adjusted gross estate must be the adjusted value of the real property. The federal law in section 2032A(g) allows indirect ownership of property through a farm corporation or partnership via regulation 2032A-3(b). This regulation also requires the estate to meet the requirements of section 6166(b)(1) in order to qualify for section 2032A. Section 6166(b)(1), as previously discussed, places a limit of 15 shareholders on a qualifying corporation and requires at least 20 percent of the corporation to be included in the estate.

The Michigan exemption-deferral option makes no allowance for corporations or partnerships and according to the representative of the Treasury Department, failure by the decedent to own the land outright will result in disqualification of the estate for the provision. The state's position at this time is that indirect ownership does not qualify for the exemption-deferral.

Though very few farm estates have utilized the exemption-deferral option in the future we may see a much greater use of the provision. As estate planners become more successful in encouraging their clients to hold property separately or as tenants in common and not as joint tenants more estates in Michigan will reach taxable levels. The exclusion of joint property from inheritance taxes has kept many estates out of inheritance tax trouble but joint property causes big problems in federal estate tax planning. Therefore, estate planners encourage their clients to avoid holding too much property jointly. There is a tradeoff being made but in most cases the federal estate tax is more severe than the state inheritance tax and therefore receives more attention. Consequently an increase in the number of estates using the exemption-deferral option should increase as the amount of joint property ownership decreases.

Chapter V--Footnotes

[1]Michigan Department of Management and Budget, State of Michigan Financial Report, 1979, (Lansing; annually), p. 97-98.

[2]Mich. Stat. Ann. sec. 7.562(4), Mich. Comp. Laws sec. 205.202d.

[3]Farmland and Open Space Preservation Act, Mich. Stat. Ann. 26.1287(2), Mich. Comp. Laws sec. 554.702(1).

[4]Mich. Stat. Ann. sec. 7.582, Mich. Comp. Laws sec. 205.221.

[5]*Ibid.*, sec. 205.221(d)(i)-(iv).

[6]*Ibid.*, sec. 205.221.(e)(i)-(ii).

[7]*Ibid.*, sec. 205.202d.(2).

[8]*Ibid.*, sec. 205.202d.(1)(a)-(c).

[9]*Ibid.*, sec. 205.202d.(2).

[10]*Ibid.*, sec. 205.221.(i).

[11]*Ibid.*, sec. 205.202d.(2).

[12]*Ibid.*

[13]*Ibid.*, sec. 205.202d.(3)(a)-(d).

[14]*Ibid.*, sec. 205.202d.(4)(a)-(d).

[15]*Ibid.*, sec. 205.202d.(5).

[16]Ralph E. Hepp and Myron Kelsey, Michigan Inheritance Tax Michigan State University, Cooperative Extension Service, 1979), p. 2, Table 1.

CHAPTER VI

CASE EXAMPLES

In this chapter case examples will be developed to demonstrate the operation and application of the federal estate tax and state inheritance tax provisions discussed in this paper. The cases will examine the special use valuation, section 2032A, the estate tax deferral options, sections 6166 and 6166A, the fractional interest rule and the 2 percent spousal participation rule, sections 2040(b) and 2040(c), the Michigan inheritance tax exemption and deferral, and the use of trusts and other estate planning devices in a typical farm situation. The last case will look at the possible tradeoffs between a section 2032A election and a section 6166 election.

Most of the case examples present more than one farm estate size to demonstrate the different decisions that the executor and heirs of different size estates must face. Smaller estates probably do not need the same type of tax planning that very large estates do.

Case I--Special Use Valuation: Section 2032A

Situation I

Situation I demonstrates the use of special use valuation in a relatively large estate. A widow, age 74, dies and leaves her entire estate to her two sons, ages 50 and 48. The younger son is married with two children and the older son was divorced many years ago.

The decedent owned 1,000 acres of farmland with a fair market value of $2,250 per acre. She had inherited the land from her husband upon his death ten years before. The two sons are partners in a cash grain operation and rented all the land from their mother. They have rented the land from her since their father's death and they own all of the machinery and equipment in the farm operation.

The mother's gross estate is $2,675,000 of which $2,250,000 is tied up in land. The mother took an active part in the decision making and management of the farm operation until her death. Her balance sheet is listed in Table VI-1.

Table VI-1. Balance Sheet--Situation I

Assets		Liabilities	
Farm real property	$2,250,000	Mortgage	$ 240,000
Other real property	175,000	Total Liabilities	240,000
Personal property	50,000		
Life insurance	50,000		
Savings	150,000	Net Worth	2,435,000
Total Assets	$2,675,000	Total Liabilities and Net Worth	$2,675,000

The decedent's net worth, gross estate less debts, is $2,435,000 and the probate and administration costs of the estate are estimated on this figure. For this estate, probate and administration costs are $144,360. Therefore the adjusted gross, and in this case the taxable estate is $2,290,640.

In order to qualify for a special use election the estate must meet minimum percentage requirements. The adjusted value of the real and personal property in the farm business must be at least 50 percent of the adjusted value of the decedent's gross estate and real property must comprise at least 25 percent of the adjusted value of the gross estate. The adjusted value of the gross estate in this case is \$2,290,640. The qualified real property constitutes 87.7 percent of the adjusted value of the gross estate therefore meeting both requirements.

The tentative federal estate tax due if special use is not elected, that is, federal tax before the deduction of the unified credit and state death tax credit, is \$923,213. The federal government allows a reduction in federal estate tax for the payment of any state inheritance on estate taxes levied. The amount deductible is the lesser of two amounts, the state death taxes paid or the amount of the state death credit allowable in the Internal Revenue Code. State inheritance taxes levied in this case amount to \$171,664 while the federal credit is \$122,051. Therefore the federal tax payable could be reduced by \$122,051. Another credit granted by the federal government is the unified credit of \$47,000. This is a federal tax credit which is deducted directly from the federal tax due. It provides a tax exemption for the equivalent of \$175,625 worth of assets. The final federal estate tax due on the decedent's estate is \$754,162 (see Table VI-2).

If this estate had elected to use section 2032A however, the estate taxes could have been reduced. Under section 2032A the decedent's land would not be included in the estate at fair market value. Instead it would have been valued according to the following equation.

Table VI-2. Estate Tax Calculations--Situation I

	Without section 2032A election	With section 2032A election
Taxable estate	$2,290,640	$1,790,640
Tentative federal tax	923,213	686,588
(State tax credit)	(122,051)	(84,526)
(Unified credit)	(47,000)	(47,000)
Federal tax due	754,162	555,062
State inheritance tax	171,664	171,664
Total taxes	$ 925,826	$ 726,726

Tax difference = $199,100

$$\frac{\text{(5-year average cash rent) \$75 - (5-year average property tax) \$27.5}}{\text{(5-year average Federal Land Bank loan rate) 10.3\%}}$$

This equation places a value of $461.16 per acre on the land. The land would be worth $461,160 if included in the estate at this value. The maximum deduction allowable however under section 2032A is $500,000. Taking the maximum reduction, the land is included in the decedent's estate at $1,750,000 instead of $2,250,000. This reduces the taxable estate to $1,790,640. The state death credit is changed because it is a function of the value of the taxable estate. It is now $84,526. The state inheritance taxes remain the same however, because the land is still included at fair market value for state inheritance tax purposes. The tentative federal tax due is $686,588. Reducing this figure by the allowable state death tax credit of $84,526 and the federal unified credit of $47,000, the federal estate tax due is $555,062. Election of special use valuation saved the estate $199,100 in federal taxes (see Table VI-2).

Situation IA

Farm situation IA involves a widow that dies at age 62. She has two children, a son and a daughter who are both married. The son has a wife and three children and operates the farm, while the daughter and her family live off the farm. The mother and son operate a dairy farm as a partnership. The mother had received the land from her husband a few years before at her husband's death. The decedent owned all of the land, 325 acres valued at $1,500 per acre. The son, meanwhile, owned most of the machinery and livestock. The decedent's balance sheet is shown in Table VI-3.

Table VI-3. Balance Sheet--Situation IA

Assets		Liabilities	
Real farm property	$487,500	Real estate debt	$110,000
Machinery	20,400	Other liabilities	50,000
Livestock	15,000		$160,000
Life insurance	10,000		
Cash and bonds	5,000	Net Worth	377,900
Total Assets	$537,900	Total Liabilities and Net Worth	$537,900

The probate and administration costs for the estate are $27,497. This estate also meets the minimum percentage requirements to qualify for section 2032A therefore the decision must be made whether to elect special use valuation or not. This case differs from the previous case in two respects. First, the estate is much smaller. In this situation the taxable estate is $350,403 compared to the previous estate which had a taxable estate of $2,290,640. Since the estate tax rates are progressive, the larger estate will incur a much larger tax liability. Second, the first case had both children staying on the farm and operating it as a partnership. In this case, the daughter lives in the city and is not involved in the farm operation at all. However she has inherited one-half of the estate and if section 2032A is elected she must sign an agreement that makes her liable for failure by her brother to keep the land in a qualified use by a qualified heir. She may have reservations about agreeing to such an action which would prevent a special use election.

If special use valuation is not elected, the tentative federal estate tax is $104,937. The state inheritance tax for the estate is $11,616, while the state death tax credit is only $5,212.80. Therefore, the state death tax credit is deducted from the tentative federal estate tax due. Use of the $47,000 federal unified credit further reduces the federal tax due to $52,725 (see Table VI-4).

Table VI-4. Estate Tax Calculations--Situation IA

	Without section 2032A election	With section 2032A election
Gross Estate	$537,900	$199,250
Debts, Mortgages	(160,000)	(160,000)
Prob. & Adm. Costs	(27,497)	(27,497)
Taxable Estate	$350,403	$ 11,753
Tentative Federal Tax	104,937	2,150.60
State Tax Credit	(5,212)	(5,212)
Unified Credit	(47,000)	(47,000)
Federal Tax Due	52,725	0
State Inheritance Tax	11,616	11,616
Total Taxes Paid	$ 64,341	$ 11,616

Election of section 2032A involves recalculating the value of the real property. In this case the five-year averages for cash rent and property taxes are $70 per acre and $22.80 per acre. The value of the land according to the equation $\frac{\$70 - \$22.80}{.103}$ is $485 per acre. Total land valued at $458 per acre is $148,850, a reduction in the gross estate of $338,650. At this value the gross estate is worth $199,250 and the taxable estate is $11,750. The tentative federal estate tax due is $2,150.60 and this is negated by the $47,000 unified credit. The state inheritance tax of $11,616 is still due, but election of section 2032A saved the estate $52,725 in federal taxes (see Table VI-4).

In both of these cases there are decisions to be made about whether to elect special use valuation or not and how election will affect the heirs. In the first case the tax bill is substantial and may therefore dictate that a course of action be taken. Also, in the first case there are no off-farm heirs who may object to the implementation of section 2032A. The lien is in effect and its existence may create some disagreement about what to do but with a federal estate tax bill of over $750,000, as in Situation I, these arguments would probably become less frequent. The second case may be more difficult to analyze. To determine whether the election was beneficial or not one must look at more than the taxes saved. Election of section 2032A imposes restrictions upon the heirs and their use of the property. If the property is going to be used in a farm operation there are no significant costs to the heirs and election may be very beneficial. The extra costs that may be incurred in administering an estate that elects section 2032A will not be nearly as much as the taxes saved. The tradeoff to the heirs in a case such as this is one of deciding whether the restrictions placed upon the land use by a section 2032A election are worth the amount of taxes saved. As the estate tax liability increases the heirs may be more willing to elect special use valuation than cases in which the estate tax is not as large. Where that level is, however, is difficult to say because each farm situation is different.

A final point with regard to the special use valuation cases is that it is unclear at this point how the Internal Revenue Service will treat the asset's basis in situations in which a recapture tax is triggered. No penalty or interest is charged on the taxes due if the land fails to remain in a qualified use or is not used by a qualified heir. At this time it is not clear how basis will be affected by recapture. These factors are very important to the decision making process of the executor and heirs.

Case II--Estate Tax Deferral Options

Situation II

This case example examines the operation of the estate tax deferrals, sections 6166 and 6166A. Altering the facts of Situation I slightly will provide appropriate examples to accomplish this. In Sitution II a widow passes away at age 74 with a gross estate of $2,675,000 of which $2,250,000 consists of 1,000 acres of farmland. Her balance sheet is listed in Table VI-5.

In the previous case there were two sons who were going to inherit the farm and continue the farm operation. In this case the sons are both off the farm and will not return. There is no qualified heir willing to keep the land in a qualified use for the required period of time

Table VI-5. Balance Sheet-Situation II

Assets		Liabilities	
Farm Real Property	$2,250,000	Mortgage	$240,000
Other Real Property	175,000	Total Liabilities	$240,000
Personal Property	50,000		
Life Insurance	50,000		
Savings	150,000	Net Worth	$2,435,000
Total Assets	$2,675,000	Total Liabilities and Net Worth	$2,675,000

so the estate will not qualify for special use valuation. Since the decedent took an active role in the management of the land prior to death her real property can qualify as a closely-held business. She meets the percentage requirements specified by both section 6166 and section 6166A. Section 6166 is more attractive to the estate because of the availability of a deferral at 4 percent interest. The adjusted gross estate is $2,290,000 and the value of the closely-held business is $2,250,000. The estate may defer the amount of tax attributable to the closely-held business as determined by the following ratio.

$$\frac{\text{value of the closely-held business}}{\text{adjusted gross estate}}$$

This ratio is equal to .982, so 98.2 percent of the federal estate tax due may be deferred using section 6166. The estate may defer $740,587 of a total tax bill of $754,162 over a 15-year period. During the first five years of the deferral period only the interest is due. The interest is charged at the rate of 4 percent on the tax attributable to the first $1,000,000 of taxable assets and at 12 percent on any tax thereafter. Estate taxes on the first million dollars of assets are $345,800.

This is deferred at 4 percent and the remaining $408,362 due in this case is deferred at 12 percent. That tax which is not deferred, $13,575, is paid when the return is filed, nine months after the decedent's death. Interest payments of 4 percent on $345,800 and 12 percent on $408,362 are due on an annual basis for the next four years. Five years after the return is filed a similar interest payment is made along with the first installment of the principal payments, $74,058.70. Principal payments are due on an annual basis thereafter. Interest charges are due on the unpaid principal on a pro-rata basis. The principal reduction is deducted from part of the principal upon which 4 percent interest and 12 percent interest is calculated. In this case, 4 percent is calculated on $345,800 and 12 percent is calculated on $408,362. The principal payment of $74,058.70 reduces the 4 percent principal by $34,580 and the 12 percent principal by $39,478.70. Therefore the next period's interest charge is 4 percent of $311,220 and 12 percent of $367.526 and so on.

In this case the total payout over the 14 years of the deferral is $1,351,110.70 on an original tax liability of $754,162 (see Table VI-6). This can be misleading however. To judge whether election of the deferral was beneficial the present value of the flow of funds paid out must be calculated. In other words, if a business can earn some percentage return over a period of time, then a dollar today is worth more than a dollar one year from now. Therefore the money paid out in the future by the estate must be discounted to determine whether it is cheaper to pay off the tax liability immediately or pay it off over time. It is difficult to determine what rate of return the farm could earn. Therefore the payments were discounted at rates of 8, 10 and 12 percent.

Table VI-6. Estate Tax Deferral Values--Situation II

Time period	Payment	8%	10%	12%
0	13,575	13,575.00	13,575.00	13,575.00
1	62,835	57,762.27	56,714.20	55,703.57
2	62,835	53,482.66	51,554.96	49,733.32
3	62.835	49,521.21	46,869.85	44,405.64
4	62,835	45,852.98	42,608.96	39,645,67
5	136,893	93,169.85	84,997.30	77,673.49
6	130,610	82,310.42	73,729.35	66,167.03
7	124,327	72,554.80	63,804.62	56,223.10
8	118,044	63,779.17	55,067.53	47,677.97
9	111,761	55,902.85	47,397.84	40,301.02
10	105,478	48,857.41	40,661.77	33,963.92
11	99,195	42,544.74	34,767.85	28,518.56
12	92,912	36,895.36	29,601.76	23,850.51
13	86,629	31,853.48	25,096.42	19,855.37
14	80,346	27,357.81	21,155.10	16,438.79
Total	$1,351,110	$745,420.01	$687,602.51	$613,742.64

The present values of the deferral at those discount rates are $745,420.01 at 8 percent, $687,602.51 at 10 percent and $613,742.64 at 12 percent.

In this case, it is beneficial to the estate to elect the deferral even if the discount factor is 8 percent. There is a difference of $8,741.99 between the present value figures of no election and electing section 6166. The personal representative and heirs must weigh this benefit against any costs they feel are imposed by the restrictions of section 6166. These costs cannot always be given a monetary value. Another consideration here is the size of the estate tax. The estate may have difficulty raising $745,162 nine months after death and meeting the resulting interest and principal payments. Use of section 6166 is probably the only way the heirs can save their farm. Bearing some of the intangible costs imposed by the code is preferrable to the alternative of losing their farm.

Situation IIA

The second case involving estate tax deferrals demonstrates the difference between section 6166 and section 6166A. The facts of the case are similar to that of Situation IA (see Table VI-7). A widow passes away but in this case the son is not interested in running the farm, therefore the estate will not qualify for section 2032A.

Table VI-7. Balance Sheet--Situation IIA

Assets		Liabilities	
Farm Real Property	$487,000	Real Estate Debt	$110,000
Machinery & Equipment	20,400	Other Liabilities	50,000
Livestock	15,000	Total Liabilities	160,000
Life Insurance	10,000		
Cash	5,000	Net Worth	377,900
Total Assets	$537,900	Total Liabilities and Net Worth	$537,900

The estate tax due is $52,725. Section 6166 allows deferral of the estate taxes in the same ratio as the amount invested in the closely-held business to the adjusted gross estate. In this case the value of the closely-held business, the farmland rented and managed, is $487,500 and the adjusted gross estate is $350,403. Therefore the entire amount of the tax can be deferred. Four percent interest is charged on the entire $52,725 deferred and the total payout over 14 years is $72,756. The present values of the payout total at 8, 10 and 12 percent are $39,648.92, $34,364.84, and $30,195.33 (See Table VI-8). If the discount factor is larger than 12 percent, the present value of the payout total will be even smaller. Only if the opportunity cost of the estate's money is less than 4 percent will it be cheaper to pay off the tax liability.

Section 6166 is more advantageous to an estate than section 6166A for two reasons. Section 6166 charges 4 percent interest on the first $345,800 of tax due while section 6166A charges 12 percent. A second advantage section 6166 offers is that more tax can be deferred than under section 6166A. Section 6166 allows deferral of tax equal to the ratio of the closely-held business to the adjusted gross estate multiplied by the total tax. Section 6166A defers an amount of tax equal to the ratio of the closely-held business to the gross estate multiplied by the total tax. Unless there are no debts or probate and administration costs in the estate, the gross estate will be larger than the adjusted gross estate. A larger denominator in section 6166A means a lesser amount to be deferred.

To demonstrate this, the figures in Situation IIA will be changed slightly. Let us assume the widow sold all but 135 acres to someone before her death and had the receipts from the sale invested in certificates of deposit. Her net estate has not changed. She paid off her mortgage and put the remainder of the receipts of the sale in the certificates of deposit. The estate tax is again $52,725 but now the estate's interest in the closely-held business is only $202,500. The estate can no longer qualify for section 6166 because $202,500 is only 58.8 percent of the adjusted gross estate. The estate does, however,

Table VI-8. Estate Tax Deferral Present Values--Situation IIA

Situation IIA: Present Value Analysis of Section 6166 Election

Time period	Payment	8%	10%	12%
0	0	0	0	0
1	$2109.00	$1952.72	$1917.29	$1883.13
2	2109.00	1808.05	1742.87	1681.29
3	2109.00	1674.12	1584.49	1501.19
4	2109.00	1550.12	1440.45	1340.27
5	7381.50	5023.85	4583.17	4188.26
6	7170.50	4531.76	4047.75	3632.57
7	6959.50	4333.69	3571.62	3147.78
8	6748.50	3646.21	3148.18	2725.72
9	6537.50	3270.06	2772.55	2357.42
10	6326.50	2930.43	2438.87	2037.13
11	6115.50	2622.94	2143.48	1758.21
12	5904.50	2344.68	1881.17	1515.69
13	5693.50	2093.50	1649.41	1304.95
14	5482.50	1866.79	1443.54	1121.72
	$72,756.00	$39,648.92	$34,364.84	$30,195.33

Situation IIA: Present Value Analysis of Section 6166A Election

Time Period	Payment	8%	10%	12%
0	$32,900.40	$32,900.40	$32,900.40	$32,900.40
1	4361.41	4038.23	3964.95	3894.39
2	4123.51	3535.09	3407.67	3287.26
3	3885.61	3084.40	2919.38	2765.78
4	3647.71	2681.06	2491.38	2318.12
5	3409.81	2320.72	2117.15	1934.73
6	3171.91	1998.94	1790.54	1606.89
7	2394.01	1711.99	1505.73	1327.05
8	2696.11	1456.71	1257.74	1088.96
9	2458.21	1229.59	1042.53	886.43
10	2220.31	1028.45	855.93	714.94
	$65,808.99	$55,985.58	$54,253.28	$52,725.00

qualify for section 6166A. The interest in the closely-held business must be at least 50 percent of the taxable estate or 35 percent of the gross estate and the estate meets both requirements. Section 6166A allows a tax deferral of an amount equal to the interest in the closely-held business divided by the gross estate and multiplied by the total tax. In this case, ($202,500/$537,900) x $52,725. According to this equation $19,824.60, 37.6 percent of the tax, may be deferred. The total payout over ten years of $65,808.99 has a present value of $55,985 at 8 percent, $54,253.28 at 10 percent, and $52,725 at 12 percent. This is because section 6166A charges 12 percent interest (currently) on deferred taxes (see Table VI-8). Only if the estate could earn more than 12 percent on the money paid would it pay to defer the taxes. In this case it may be wiser to borrow the money from the Federal Land Bank at a lower rate of interest if possible and pay off the tax bill.

Case III--Sections 2040(b) and 2040(c)

Situation III

This situation is designed to demonstrate the operation and use of section 2040(b), the fractional interest rule, and section 2040(c), the 2 percent spousal participation rule. A married couple, both age 65, have a gross estate of $1,424,839 in their cash grain farm. Of the gross estate, $936,250 is in jointly held real estate. The farmer is trying to decide whether to elect section 2040(b) or not. If he does, he must create a qualified joint interest and make a gift of one-half the joint property to his wife. Their balance sheet is listed in Table VI-9.

If the farmer makes a gift of $468,125, one-half the joint property, to

Table VI-9. Balance Sheet--Situation III

Assets		Liabilities	
Farm Real Property	$936,250	Real Estate Debt	$374,500
Feed, Crops & Supplies	268,145	Other Debt	57,510
Machinery & Equipment	172,870	Total Liabilities	$432,010
Non-Farm Assets	24,936		
Cash	22,638	Net Worth	$992,829
Total Assets	$1,424,839	Total Liabilities and Net Worth	$1,424,839

his wife he will pay a gift tax of $18,700 (see Table VI-10). The tentative tax on the taxable gift is $65,700 but is reduced by the $47,000 unified credit. If the husband lives another ten years, according to life expectancy charts, and a simple 8 percent growth rate is assumed, his gross estate will be $2,564,710 and his net worth will be $1,787,092.

Table VI-10. Gift Tax Calculation--Situation III

Gift from husband to wife	$468,125.00
Less marital deduction	(234,062.50)
Less $3,000 annual gift exclusion	(3,000.00)
Taxable gift	$231,062.50
Tentative gift tax	65,700.00
Less unified credit	(47,000.00)
Gift tax due	$ 18,700.00

For purposes of this example the author will assume the unified credit allowable in federal taxes is indexed. From 1976 to 1981 the credit increased at a rate of 11.86 percent annually. At that rate of increase the credit would be $113,890 at the time of the farmer's death. The credit is increased because the author thinks it is reasonable to assume the government will increase the credit over time, even though there are no current plans to do so. The author will assume, for simplicity, that the estate tax rate will not change in the ten-year period.

The decedent leaves his entire estate to his wife. The marital deduction excludes one-half of the adjusted gross estate. A qualified joint interest was created ten years prior and therefore 50 percent of the jointly held property, $842,625, is excluded from the estate leaving a gross estate of $1,722,085. Half of the adjusted gross estate of $883,532.40, $441,766.20, is subtracted via the marital deduction to leave a taxable estate of $441,766.20. The tentative estate tax on this taxable estate is $136,000.50. To calculate the final estate tax, the state inheritance tax or the federal death tax credit, and the federal unified credit must be deducted from the tentative tax. The state inheritance tax, $536.84 in this case, and the federal unified credit of $66,890, $113.890 less the unified credit used ten years earlier to reduce the gift tax, reduce the final estate tax liability to $68,573.66 (see Table VI-11). The total federal estate and gift tax paid to transfer the farmer's assets to his wife is $87,273.66 ($68,573.66 + $18,700).

There are alternatives to this method of estate transfer which should be considered. If a qualified joint interest is not created a number of situations could arise upon the death of the husband. The personal representative may not be able to prove any type of spousal contribution by the survivor in which case the entire value of the

Table VI-11. Estate Tax Calculations--Situation III

Gross estate	$1,722,085.00
Less debts	(777,618.00)
Probate and administration costs	(60,934.60)
Adjusted gross estate	883,532.40
Less marital deduction	(441,766.20)
Taxable estate	441,766.20
Tentative federal tax due	136,000.50
Less state tax credit	(536.84)
Less remaining unified credit	(66,890.00)
Federal estate tax due	$ 68,573.66

estate, $2,564,710, is included in the decedent's estate. If all other factors are the same as before the federal estate tax due is $168,781.09, a substantial increase from the $87,273.66 paid to transfer assets using the qualified joint interest (see Table VI-12).

Table VI-12. Alternative Estate Tax Calculations--
Situation III

	No action	50% excluded	2040(c)
Gross estate	2,564,710.00	1,722.085.00	2,064,710.00
Less debts	(777,618.00)	(777,618.00)	(777,618.00)
Net estate	1,787,092.00	944,467.00	1,287,092.00
Less probate costs	(108,077.00)	(60,934.60)	(80,077.15)
Adjusted gross estate	1,679,015.00	883,532.40	1,207,014.85
Less marital deduction	(839,507.50)	(441,766.20)	(603,507.42)
Taxable estate	839,507.50	441,766.20	603,507.42
Tentative tax due	283,207.93	136,000.50	194,097.75
Less state death tax credit	(536.84)	(536.84)	(536.84)
Less unified credit	(113,890.00)	(113,890.00)	(113,890.00)
Federal estate tax due	$168,781.09	$ 21,573.66	$ 79,670.91

Another possibility is that up to one-half of the jointly held property can be excluded at the time of death from the estate by proving the survivor contributed to the farm through affidavits and other forms of documentation. If 50 percent of the joint property is attributed to the spouse the gross estate is the same as the case in which a qualified joint interest is created but the effect on the estate taxes is substantially different. The unified credit is not reduced by $47,000 because no gift was made. The estate tax in this case is $21,573.66 (see Table VI-12).

The final alternative for the estate is to elect section 2040(c). This provision, the 2 percent spousal participation rule, allows an exclusion of joint property from the estate equal to 2 percent multiplied by the number of years of material participation of the spouse multiplied by the appreciation in the joint property.

The decedent bought the land 55 years before his death at $200 per acre. According to section 2040(c) the initial consideration furnished by the decedent, $107,000, must be appreciated at 6 percent simple interest for the amount of time he owned the property. This appreciation ($353,100), and the initial consideration are deducted from the value of the estate. The land's value at the time of death is $1,685.250. Deducting the initial consideration of the husband and its appreciation, $107,00 and $353,100 respectively, from the estate's property value leaves $1,225,150. If the couple was married and farmed together for the past 45 years the section 2040(c) equation would be .02 x 45 = .9. A maximum reduction of the lesser of 50 percent or $500,000 is set by the provision however. Therefore the estate could exclude $500,000, leaving the decedent's net worth at $1,287,092. In this case the taxable estate (gross estate less debts, administration costs and the marital deduction) is $603,507.42. The tentative federal estate tax is $194,097.75 and this is reduced by the state inheritance tax and the unified credit leaving a federal tax of $79,670.91 (see Table VI-12).

The final estate tax liabilities for the four options discussed are $87,273.66 if a qualified joint interest is created, $168,781.09 if nothing is done and no proof of spousal contribution can be shown, $21,573.66 if 50 percent of the joint property is excluded from the estate and $79,670.91 if section 2040(c) is elected. Since the decision to create a qualified joint interest is being made now and the subsequent gift tax is paid now and not at the time of death, an expected ten years from now, these values must be discounted to a present value in order to accurately judge the best alternative. Using 8 percent as the present value factor the cheapest alternative to the farmer is to try to exclude 50 percent of the joint property at the time of death. The present value of this alternative is $9,992.92. If the executor can only exclude something less than 50 percent of the joint property, as is often the case, the cost of this alternative would increase. Election of section 2040(c) is the second cheapest option. It has a present value cost of $36,903.56, followed by creation of a qualified joint interest with a present value of $50,463.32. The most expensive alternative for the farmer is to take no action in planning and have no exclusion for spousal participation. In this case the present value cost is $78,179.40.

This case demonstrates a couple points about sections 2040(b) and 2040(c). First, they have limited usefulness. The estate taxes due if a percentage of the joint property can be excluded are a quarter of the taxes incurred using section 2040(b). A section 2040(b) election would provide no benefit to the couple in this case. The second point to note is that often the most expensive thing you can do with respect to estate taxation is to do nothing. Taking no action at all was much worse then any of the other alternatives and should be avoided.

Case IV--Michigan Inheritance Tax Deferral-Exemption

Situation IV

This case uses the same estate as in Situation I. The circumstances are altered somewhat, however. In this case there is only one son who is working on the farm when his mother passes away and he inherits everything. The son is married with three children.

In Michigan there are two classes of heirs, Class I and Class II, for purposes of the state inheritance tax. Class I heirs include grandparents, parents, children, spouse's siblings, the wife of a son, the husband of a daughter, an adopted person or a person who stood for a parent if the relationship began before the decedent was 17. The decedent's son and his wife are the only Class I heirs in this case. Michigan taxes the two classes differently and provides to tax exemptions for Class II heirs. All Class I heirs receive a $10,000 exemption and a spouse receives an additional $65,000 exemption.

The executor wishes to elect the Michigan inheritance tax deferral-exemption option. This provision allows the estate to exempt 50 percent of the fair market value of the real property from the estate and defer the inheritance tax attributable to the remaining 50 percent of the farm real property. Qualification for the provision is similar to section

2032A of the Internal Revenue Code. An additional requirement is that the property be enrolled in Public Act No. 116, the Farmland and Open Space Preservation Act. In this case, the farm was already enrolled in the P.A. 116 program.

Without the deferral-exemption election the estate has a taxable estate of $2,290,640 upon which a state inheritance tax of $200,364 is levied (see Table VI-13). Michigan levies an additional state tax if the federal state death credit taken on the federal estate tax return is greater than the state inheritance tax calculated. In those cases the difference between the state inheritance tax calculated and the federal credit allowed is added to the state tax due. The state death tax credit allowed is $122,051 so no additional state tax is due.

Table VI-13. State Inheritance Tax Calculations--Situation IV

	Rate	Without Election		With Election
Taxable estate		$2,290,640		$1,165,640
Exemption		10,000		10,000
Tax on $ 40,000	2%	800		800
Tax on $ 200,000	4%	8,000		8,000
Tax on $ 250,000	7%	17,500		17,500
Tax on $ 250,000	8%	20,000		20,000
Tax on $1,540,640	10%	154,064	$415,640	41,564
Total state tax		$ 200,364		$ 87,864

If the state deferral-exemption option is elected, one-half of the real property value, $1,125,000, is excluded from the gross estate leaving a taxable estate of $1,165,640. The state inheritance tax due on this value is $87,864 (see Table VI-13). Of this, the amount attributable to the real property may be deferred for ten years.

To calculate the amount of the tax deferred the ratio of the farm real property included in the estate to the adjusted gross estate value is multiplied by the tax due. In this case the amount deferred is 96.5 percent of the tax bill, or $84,800. The remainder of the tax, $3,064, is due nine months after the decedent's death. The present value of the deferred tax at 8 percent is $42,343.36 and decreases as the interest rate increases.

There are some obvious financial benefits from electing the exemption-deferral option. The tax is significantly reduced initially and the deferral reduces its present value even more. Once again in cases of larger tax bills, and what is large depends upon the particular situation, the choices that the heirs and personal representative have may be limited. In smaller estates, the heirs will have to weigh the tax savings against the restrictions imposed by the provision. The provisions of the state statute are more restrictive than the federal code. The state places land use obligations on the heirs via the inheritance tax and through enrollment in P.A. 116. These restrictions may become too burdensome in cases of smaller tax liabilities. In this case however, election of the exemption-deferral would be wise especially if the estate intends to elect section 2032A of the federal tax code.

Case V--Trusts

There are other estate planning techniques available other than the provisions discussed so far. The most common device used is a trust.

This case is designed to demonstrate the tax savings that can be realized through the use of a trust. The case will show the estate tax liability if no action is taken, if a trust is used, and also if section 2032A is used instead of a trust.

Trusts are very popular estate planning tools. Their main advantages are that they will usually reduce estate and inheritance taxes and they can be very flexible. After meeting the basic legal requirements of forming a trust, a trust can be designed to do just about anything. Any instructions or conditions the grantor desires may be incorporated into a trust. This flexibility is an important reason for its popularity.

There are a number of types of trusts but they can be divided into two groups, inter vivos, or living, and testamentary. A living trust becomes active during the lifetime of the grantor while a testamentary trust does not become active until the grantor's death. These two types of trusts can also be broken down into two groups, revocable or irrevocable. Revocable trusts allow the grantor to change the trust while he or she is alive. Irrevocable trusts, on the other hand, cannot be altered by anyone once entered into. For purposes of this case a living, revocable trust is used to demonstrate how trusts can save estate taxes.

Situation V

A farmer and his wife operate a cash grain farm in the Saginaw Valley. They have one son who farms with them. The farmer's gross estate is $915,000 with debts of only $115,000 (see Table VI-14). The balance sheet follows. The real property consists of 300 acres valued at $2,000 per acre. This case will assume the husband and wife own everything as joint tenants and there has been equal contribution in the acquisition of the assets.

Table VI-14. Balance Sheet--Situation V

Assets		Liabilities	
Farm real property	$600,000	Mortgage	$100,000
Feed, crops & supplies	125,000	Other	15,000
Machinery & equipment	175,000	Total liabilities	$115,000
Non-farm assets	15,000		
Cash	5,000	Net worth	$800,000
Total Assets	$915,000	Total Net Worth and Liabilities	$915,000

There would be no estate tax levied on the farmer's estate at his death if no action was taken and an equal contribution had been made by the decedent and his wife. Equal contributions by the spouse halves the gross estate of $915,000 and by using the marital deduction and other available deductions the tax is eliminated. There is no state inheritance tax because all the property is joint. There is, however, a substantial tax due upon the death of the wife. All property transferred to her upon the husband's death results in a gross estate of $774,910. There is a reduction in the estate size of $25,090 which is due to the probate and administration costs of the husband's death leaving an estate of $774,910. For simplicity in this case no appreciation will be assumed. The federal estate tax due is $172,396.08 and the state inheritance tax bill, if all property is left to the son, is $44,187.22 (see Table VI-15). The total estate reduction attributable to the deaths, probate and administration plus taxes, is $292,992.99.

Table VI-15. Estate Tax Calculations--
Situation V: No Trust

Decedent	Husband	Wife
Gross estate	$457,500.00	$774,910.00
Less debt	(115,000.00)	(0)
Net estate	342,500.00	774,910.00
Less probate & adm. costs	(25,090.00)	(51,319.69)
Adjusted gross estate	317,410.00	723,590.31
Less marital deduction	(250.000.00)	(0)
Taxable estate	67,410.00	723,590.31
Tentative tax	14,926.60	238,528.41
Less unified credit	(47,000.00)	(47,000.00)
Less state tax credit	(0)	(19,132.33)
Federal estate tax due	0	$172,396.08

If this individual had set up a living revocable trust the estate shrinkage would have been much less. Assuming equal contribution again by the husband and wife the estate tax on the husband's death would still be zero. However, in order to effectively use the trust the property could not be held jointly. This presents no problem in this case since there is equal contribution. An agreement by both parties to sever the joint tenancy and hold the assets as tenants in common will not trigger any gift tax. Upon the husband's death, the asset's remaining in his estate are placed in a trust, the income from which goes to his wife. The beneficiary of the trust is the son. By severing the joint tenancy the husband does subject his estate to a state inheritance tax of $13,518.70. His gross estate of $457,500 is reduced by the payment of debts, $115,000, probate and administration costs, $6,250, and state inheritance taxes of $13,578.70 for a total of $322,731.30 left to be placed in the trust. Upon the wife's death a federal estate tax of $75,719.25 is due (see Table VI-16). All assets are inherited by the son and he also receives the proceeds of the trust established by his father. The wife's estate of $457,500 shrinks by a total of $129,211.13 to a value of $328,288.87. This shrinkage is due to probate costs, state inheritance taxes and federal estate taxes. The trustee also charges a fee for administering the trust. An annual fee of .7 percent is charged in this case which would equal $2,127. For simplicity, this fee is deducted from the trust's income and therefore does not affect the principal or the estate taxes. Using trusts the estate shrinkage after both deaths is $167,819.83, $125,173.16 less than if no action was taken prior to death.

Table VI-16. Estate Tax Calculations--
Situation V: With Trust

Decedent	Husband	Wife
Gross estate	$457,500.00	$457,500.00
Less debt	(115,000.00)	(0)
Net worth	342,500.00	457,500.00
Less probate & adm. costs	(6,250.00)	(32,437.50)
Adjusted gross estate	336,250.00	425,062.50
Less marital deduction	(250,000.00)	(0)
Taxable estate	86,250.00	425,062.50
Tentative tax	19,950.00	130,321.25
Less unified credit	(47,000.00)	(47,000.00)
Less state tax credit	(0)	(7,602.00)
Federal estate tax due	0	$ 75,719.25

If no trust had been set up the personal representative may decide to elect section 2032A as an alternative measure to reduce the estate taxes. Using the same values presented in Case I gives a value of $461.16 per acre and a total real estate value of $138,348. This is a reduction of $461,652 from the previous valuations and within the $500,000 maximum. This reduces the gross estate of the husband to $226,674 from $457,500. Using section 2032A does not provide any benefits in this case however. There was no estate tax in the first case with no action taken and equal contribution by the spouses. The probate costs, while calculated as a function of the net estate should not be less for a section 2032A election than for a return where such an election is not made. There is no benefit upon the death of the second spouse if we assume no special use valuation is elected at that time but only on the death of the husband. The wife's estate values all of the property she may have owned at fair market value, therefore, no benefit is derived from the election.

Assuming the estate would qualify for section 2032A at that time a much more beneficial election would be to elect section 2032A upon the death of the wife but not the husband. Since there was no tax on the husband's death election of special use valuation serves no purpose but to place unnecessary restrictions on the heirs. Election of section 2032A on the death of the wife results in a large reduction in the taxes paid. The total estate shrinkage after both parties have passed away using a section 2032A election is $145,768.82 compared to $167,819.83 using trusts (see Table VI-17). This may appear beneficial but with a section 2032A election go restrictions that the executor and the heirs should weigh (the trust restrictions and special use restrictions) carefully before making a decision.

Table VI-17. Estate Tax Calculations--Situation V: Wife Elects Section 2032A After Use of Trust

	With Section 2032A	Without Section 2032A
Gross estate	$313,258.00	$457,500.00
Less debt	(0)	(0)
Net estate	313,258.00	457,500.00
Less probate & adm. costs	(51,319.69)	(32,437.50)
Adjusted gross estate	261,938.31	425,062.50
Less marital deduction	(0)	(0)
Taxable estate	261,938.31	425,062.50
Tentative tax	74,859.03	130,321.25
Less unified credit	(47,000.00)	(47,000.00)
Less state tax credit	(2,686.52)	(7,602.00)
Federal estate tax due	$ 25,172.57	$ 75,719.25

The same type of analysis could be done if any level of contribution had been made by the wife. The results would be similar except that the numbers would be larger as the amount of contribution decreases. Taking no action whatever is very expensive to the estate. The shrinkage using a trust and special use valuation were not different enough to make the decision easy when the obligations section 2032A places on an heir are also considered.

This case demonstrates the use of the most popular type of trust and how it may be compared with one of the provisions in this paper. It is not the only estate planning tool that is available but should be looked at in most cases.

Case VI--Section 2032A v. Section 6166: A Tradeoff?

Situation VI

This case is designed to demonstrate the potential tradeoff that may exist for an estate between section 6166, estate tax deferral, and section 2032A, special use valuation. When an executor elects section 2032A the value placed on the real property is used for all other estate tax purposes. Therefore, after a special use valuation election the estate must try to meet section 6166, or any other provision's qualification requirements using the special use values. If the estate is able to meet the requirements before a section 2032A election but not after an election, a decision must be made by the personal representative and the heirs as to which provision would be most beneficial to the estate. If we use an adaptation of Situation IA this can be shown.

A widow who owns 350 acres of farmland dies leaving a gross estate of $1,212,500 and debts of $240,000. The estimated probate and administration costs are $62,532, leaving a taxable estate of $909,968. The 350 acres have a value of $2,250 per acre for a total of $787,500. Using the cash rent and property tax figures from Situation I places a value of $161,350 on the real property which is a reduction of $626,150. The maximum reduction is $500,00 so the land is included in the estate at $287,500.

If no special provisions are elected the tentative federal estate tax is $310,687.52 and the final federal estate tax due is $235,529.52 (see Table VI-18). If section 2032A is elected, however, the taxable estate is reduced from $909,968 to $409,968 and the federal estate tax due after deductions for the state death tax credit and the unified

Table VI-18. Estate Tax Calculations--Situation VI

	Without Section 2032A	With Section 2032A
Gross estate	$1,212,500.00	$712,500.00
Less debt	(240,000.00)	(240,000.00)
Net estate	972,500.00	472,500.00
Less probate & adm. costs	(62,532.00)	(62,532.00)
Adjusted gross estate	909,968.00	409,968.00
Taxable estate	909,968.00	409,968.00
Tentative tax	310,687.52	125,189.00
Less unified credit	(47,000.00)	(47,000.00)
Less state death tax credit	(28,158,00)	(9,039.00)
Federal estate tax due	$ 235,529.52	$ 69,150.00

Note: If section 2032A is not elected, section 6166 is. In this case the estate pays $44,986.14 nine months after death and defers $195,543.38 over the next 14 years at 4 percent interest.

credit are made is $69,150 (see Table VI-18). Under section 6166, $44,986.14 of an estate tax liability of $235,529.52 is paid nine months after the decedent's death and the remainder, $195,543.38, is deferred over the next 14 years.

The executor would prefer to reduce the tax if possible but would also like to stretch out the payments using section 6166 because it has an attractive 4 percent interest charge attached to it. Unfortunately for the estate, election of section 2032A leaves only $287,500 in assets held by a closely-held business. With a gross estate of $1,212,500 and an adjusted gross estate of $909,968, the estate needs to hold $590,931.25 in a closely-held business and it is far short of this value. Therefore the executor and heirs must decide which provision to elect.

In this example the estate must pay either $69,150 or $44,986.14 nine months after death. The $69,150 is the total tax under section 2032A and the $44,986.14 is the amount of federal estate tax not deferred in the section 6166 election. This analysis assumes that in both cases the amount paid when the return is filed is borrowed from the Federal Land Bank at 10.5 percent and paid off over ten years.

If section 6166 is elected the estate pays out a total of $314,935.85 over the 14-year deferral period. The present value of this payout at an 8 percent discount factor is $109,952.94. Contrasted to this the present value of the special use value election at 8 percent is $76,313.81. In this case, then, election of the special use valuation provision is cheaper than deferral of the taxes but it is also cheaper to pay the debt off immediately at an 8 percent discount factor.

This will not always be the case, however. Whether it is more beneficial to the estate to elect section 6166 or section 2032A in situations where both cannot be elected will depend upon a number of factors. These are the amount of tax owed, the opportunity costs facing the estate, the amount of tax which can be deferred, and the desires of the personal representative and heirs. The last of these is probably the most important. The personal representative and heirs may not like the election which is cheaper for any number of reasons. A good estate plan and settlement accomplishes the objectives of the heirs at minimal cost.

CHAPTER VII

> Much of the uncertainty of law is not an unfortunate accident: it is of immense social value.
>
> --Judge Jerome Frank--

SUMMARY AND CONCLUSIONS

Review

This paper has presented five federal estate and one state inheritance tax provisions that have been passed recently and may be used in agricultural situations. The author has discussed the qualification requirements in each provision, ambiguities in the code and the concomitant confusion in interpreting the provisions and the opinions of professional estate planners who work with farmers regarding the provisions. The purpose of this paper has been to examine the provisions in an attempt to explain how the provisions may be effectively used by farmers and estate planners in agricultural estate planning.

The first chapter briefly discussed the concepts and operation of the estate tax system, distinguishing between estate and inheritance taxes. The chapter also noted the changing structure of agriculture caused by an increase in the size of the average farm and a decrease in the number of farms in the country. Inflation, especially in land values, has made agriculture much more susceptible to estate taxation which can no longer be called a "rich man's tax." Many average size farm operations, which in the past have never been confronted with estate tax problems, are now facing estate tax liabilities. Farm liquidity was also briefly discussed and it was noted that it is difficult to determine at this point whether farms are less liquid than other sections of the economy. Previous studies have yielded conflicting results about farm liquidity.

Chapters II through V examined the various estate tax provisions in detail. Special use valuation, code section 2032A, was the subject of Chapter II. Section 2032A contains some rather stringent qualification requirements. The estate must meet requirements concerning how much of the estate consists of farmland and farm property, the decedent's, or his heirs', participation in the operation of the farm, and who may inherit the farm under section 2032A. Special use valuation election offers two methods of valuing the farmland, one of which, the cash rental capitalization method, is used exclusively by attorneys electing section 2032A. The other valuation method, comparable factors, has not been used by any of the attorneys interviewed who had made a special use election. Section 2032A means obligations as well as benefits to inheritors of farm estates. An heir must pay a recapture tax if the land is removed from a qualified use or title transfers to a non-qualified heir. Chapter II also discussed some relevant issues that involve special use valuation. Determining the definition of material participation and the effect of a section 2032A election and recapture tax on the land's basis are two significant issues that may have a powerful influence on whether special use valuation is used extensively. Few of the attorneys had used section 2032A and their responses indicated disapproval of a number of the provision's sections. They thought it was too difficult for an estate to qualify for the provision and they hesitated to elect special use valuation because of the 15-year recapture tax period.

Chapter III presented an analysis of sections 6166 and 6166A, the estate tax deferral option. The philosophy of the tax deferrals is that estates with a large percentage of their assets in one business should not be forced to liquidate the business in order to pay the estate taxes. Both the deferral options offer the estate an opportunity to pay its estate tax obligations over time. Section 6166 allows a 14-year repayment period and section 6166A, a 10-year period. There are other differences between the two. The 65 percent of the estate requirement in 6166 is more difficult to meet than the corresponding 35 or 50 percent requirements in section 6166A. However, section 6166A is stricter on the number of people that may be involved in a multi-person business and the percentage of the business controlled by the decedent when combining more than one closely-held business. The provisions also differ in their implementation. Section 6166 allows deferral of tax equal to the total tax multiplied by the ratio of the value of the closely-held business to the adjusted gross estate. Section 6166A uses the value of the gross estate as the denominator.

Although the attorneys preferred to work with the tax deferral options rather than special use valuation, they did not make much use of either provision. "Tax deferred is tax unpaid" was a common philosophy among the attorneys, yet at the same time for both their own and their clients' benefit most attorneys preferred to pay off the estate tax liability if the estate could afford it. Most farm clients do not like liens on their property and to a certain point they are willing to pay extra taxes to avoid that. When the tax burden becomes large, tax deferrals are more readily accepted by clients and their counsel.

The fourth chapter presented a discussion of section 2040(b) and 2040(c), the fractional interest rule and the 2 percent spousal participation rule. The author briefly explained the two types of multi-person property ownership, joint tenancy and tenancy in common. Upon death any jointly held property which the decedent had an interest in is included in his or her estate. Section 2040(b) allows a husband and wife to create a special form of joint tenancy, a qualified joint interest, which, upon the first spouse's death excludes one-half of the joint property in the gross estate. The provision requires that a gift tax be paid upon the creation of the qualified joint interest if a gift is made. Not a single attorney had used this provision and none could anticipate doing so. The fractional interest rule is diametrically opposed to almost all estate planning precepts. Joint tenancy is a tremendous problem for most estates. In most cases of medium or large estates tenants should buy property either as individuals or as tenants in common but not as joint tenants. If creation of a qualified joint interest requires severance of an existing joint tenancy payment with a gift tax, it is more advantageous to sever the joint tenancy and hold the property as tenants in common or separately, thus avoiding the right of survivorship problem, which joint tenancy brings at the second death. Section 2040(c), which allows exclusion of joint property based on the surivor's material participation, is not a very useful estate tax management tool either. Most executors are able to exclude as much as 50 percent of the joint property at the time of one tenant's death through affidavits attesting to the surviving spouse's contribution to the joint property. The 2 percent spousal participation rule could be useful in some rare cases of estate settlement but it is not a provision to be used for estate planning.

The dominant issue in a discussion of joint tenancy in estates larger than $425,000 is what constitutes contribution by the surviving spouse, who is usually the wife. A money or money's worth contribution by the surviving spouse is clearly to be excluded from the decedent's estate but determining whether some services rendered by the survivor have a "money's worth" is not as clear. Until recently each case involving the value of services had been decided on the merits of the particular case. It seems clear, however, that the guidelines which have been used in the past may have to be reevaluated and appropriate adjustments made.

The qualification, operation, and issues surrounding the Michigan inheritance tax exemption-deferral option were discussed in Chapter V. The option was enacted only recently and its use to date has been limited. The provision allows an exemption from inheritances taxes of one-half the fair market value of farmland in the estate. The inheritance tax attributable to the remaining half of the farmland value may be deferred for up to ten years at no penalty or interest. Election of this option requires enrollment of the land in a land preservation program as established in the Farmland and Open Space Preservation Act, if the land has not been enrolled already. Two questions concerning this option that need to be answered are: 1) whether the provision will allow indirect ownership of farmland through a partnership or farm corporation and 2) how the proration of the inheritance tax during the final five years of the deferral period would be calculated.

In the sixth chapter to demonstrate the operation of the estate tax provisions and the kinds of decisions which must be made by executors and heirs concerning election of these provisions case examples were presented. One of the criteria used in deciding whether to elect one of the provisions could be the size of the estate. In cases of small tax liabilities the heirs would often prefer to pay the tax and be allowed to do as they choose with the property rather than subject themselves to government interference. On the other hand large estates which usually incur substantial estate tax liabilities often do not have the "luxury" of simply paying the bill. In addition to examples involving each of the provisions, a case showing the use of trusts in estate planning and a case demonstrating the possible tradeoff between section 6166 and section 2032A were also developed. Trusts, which are a popular and effective means of estate planning, should always be considered in estate planning. The estate tax deferral-special use valuation case is an example of how the use of one provision can exclude the use of another and the decisions which then must be made.

General Estate Planning

A brief discussion of general estate planning approaches follows. The first step in any estate planning is determining the needs and goals of the client and his family. After this has been accomplished, a will should be drawn up so the desires of the client can be satisfied. Often, a will is insufficient to meet the client's goals. It is, however, a starting point.

Dying intestate, without a will, leaves the estate subject to the probate procedures the state has devised for distribution of the decedent's assets.

For net estates of less than $175,625, little more need be done other than draft a will. The will should stipulate to whom property is to go and may include instructions regarding special situations and how they are to be handled.

The objectives of most attorneys and their clients are twofold, to ensure the security of the surviving spouse and minimize total estate taxes. A common estate planning objective of most of the attorneys in cases where tax problems exist is to equalize the estate values of spouses. By equalizing the values the minimum total tax on both deaths will be paid because of the progressive nature of the tax structure. If one spouse, the husband in most farm situations, owns a large share of the property, a good estate planning procedure is to give gifts to the fullest extent allowed by the law. Many attorneys emphasize extensive gift giving programs but only when the client can afford it. Many farm situations exist where the client is wealthy according to his balance sheet but it is difficult to make gifts due to the nature of the assets.

If the farmer can afford it, a gift giving program is initiated but this is often not possible. Another suggestion often made is to sever a joint tenancy, at least in part, so that no more than one-half of the property is held jointly. This allows the estate planner to set up a trust, usually living revocable, which will pass some of the assets on to the next generation through the trust rather than to the spouse. To ensure the spouse's financial security, he or she will often have an income interest in the trust and limited rights to invade the corpus of the trust. The income interest gives the surviving spouse the right to any income generated by the trust. The invasion right allows the survivor to take some limited value from the trust's principal under certain circumstances. The jointly owned property passes directly to the spouse through the right of survivorship and is available to meet the survivor's living needs.

The use of life insurance cannot be overlooked in estate planning. Life insurance provides cash at death which can be used to meet expenses and help pay the estate taxes but it should not be used as a cure-all to any estate tax problem. Life insurance owned by the decedent is included in the estate and the greater the amount of insurance owned to pay the taxes, the greater the taxes that must be paid.

In the farming sector, the most common means of asset transfer involves use of some type of trust and a gift giving program if possible. Each case must have an estate plan tailored to meet its particular needs in order to be completely successful.

Some Policy Issues

The tax provisions discussed are surrounded by questions regarding their interpretation and their operation but there are other questions, broader than those previously discussed, which need to be mentioned. Though a detailed examination of these issues is beyond the scope of this paper a brief discussion will be beneficial. Will these provisions affect the structure of American agriculture, and if so, how? Historically, estate taxation was a "rich man's tax"; a tax that few people even knew of, much less worried about paying. That is no longer the case in an inflationary economy, particularly in the agricultural sector. Rapidly rising land values have lifted many farmers to taxable levels without their awareness and many of those farmers that are aware, are unable to substantially reduce the transfer taxes because of the nature of their property ownership. One question that surfaces in this discussion of agricultural structure is whether the estate and inheritance tax provisions examined will reduce the amount of farmland available to the next generation. Will farmers at, or near, retirement age continue to hold on to their property to gain the estate tax benefits these provisions may offer rather than transfer the property to the next generation?

Initial indications derived from this paper are that this will not occur. Clients of attorneys interviewed were generally unwilling to forego their retirement benefits in favor of estate tax savings. However, it is too soon to make definitive statements. Traditional intergenerational transfers usually involve gradual purchasing by the younger generation or gifts by the elder generation of the assets and it appears these exchanges have not been largely affected by the tax provisions to date. It is not clear if this is due to an unwillingness by the estate planners and their clients to use the relevant provisions or due to an ignorance of the provisions' operations by the estate planners. The ambiguity surrounding certain aspects of the provisions' operations has played a role in the small number of elections. The issue then, is, if favorable interpretations for the taxpayer evolve as cases are decided, will these tax provisions begin to play a more importand role in agriculture? Favorable decisions in the areas of basis and material participation could make special use valuation a very beneficial and very popular election. In order to utilize the provision the elder generation must continue to own a substantial part of the farm and this may have an impact on the role of the tenant farmer.

Another question which needs to be raised is whether estate taxation, and these provisions in particular, affect the economic efficiency of agriculture. The concern here is with human capital and its allocation or misallocation. Does estate taxation cause a misallocation of human capital in a case where a young farmer who had been in business with his father and upon his father's death is forced to sell the operation or incur heavy debt which is attributable to the estate tax liability? The debt, which has not increased farm producitivity, may prove to be too heavy a burden for the farm and consequently the farm is sold. An alternative to the young farmer is to sell part of the farm to pay the estate tax liability. The risk of this option is that what was an efficient, profitable farm may no longer be a viable farm operation after such a sale. If this happens the young farmer is no longer in a business he prefers to be in and may be good at. Not only is there a probable loss due to an asset transfer of this nature but also a potential waste of human capital. The good, young, productive farm manager is no longer engaged in a vocation he or she enjoys and excels at. This is waste which cannot be ignored.

The author is not proposing solutions to these questions at this time but it is important to recognize that the firm-level questions discussed in previous chapters are not the only issues with respect to these particular estate tax provisions and estate taxation in general.

Conclusions

Special Use Valuation

Section 2032A is a rarely used but potentially very valuable estate tax provision. A degree of uncertainty about special use valuation and lack of opportunity to elect it have limited the use of section 2032A in Michigan. The uncertainty stems from ambiguity in the Internal Revenue Code about some aspects of the provision's procedures and from professional ignorance about the section's operation. The code is unclear on what qualifies as material participation and how basis is calculated in the case of recapture. The ambiguity is compounded by a lack of case history to which an estate planner or executor can refer. Although the manner in which the Internal Revenue Service has interpreted some of the provisions appears to be more inflexible than the way in which Congress intended the provisions to be construed, attorneys are hesitant to confront the IRS in an audit because they have no precedents to cite. Misinterpretation and misunderstanding of the code are also to blame for the section's lack of use. Many attorneys thought if no alternative use existed there was no need or purpose in calculating a special use value. This is absolutely without foundation. Even if there is no other use for the land, the special use value should be calculated; that value will almost always be below, usually substantially below, the fair market value of the land.

Lack of opportunity to elect special use valuation must also be cited as a reason for the provision's limited use. Since the provision has only existed for five years and because of the nature of Michigan agriculture, the number of estates that have been considered for special use valuation as a serious alternative in estate planning and settlement is limited. Few farmers with estates that have estate tax problems have died in the past five years. Michigan agriculture is also of a different nature than some other states. The average farm size and land values are less than those of the corn belt for example. The type of agriculture also reduces the number of farm estates that may need special use valuation. Dairy, fruit and other types of farming do not usually have as large an investment in real estate as a cash grain operation and the benefits of section 2032A may not be as great for those farm types. Of the seven attorneys that had election section 2032A, six were located in either southeastern Michigan or the Saginaw Valley, predominantly cash crop agricultural areas. The seventh attorney was located in an area in which tourism and land development are very important.

Special use valuation in its present state of uncertainty is not a very useful estate planning tool. The questions surrounding qualification by the decedent and the heirs makes planning on the provision almost impossible for most attorneys. A common approach taken by the attorneys was to develop an estate plan using other tools and at the death of a client special use valuation is then considered. If the estate qualifies, then the election is made. If the heir has changed his or her mind about remaining in farming, the client still has a developed estate plan and election of the provision is rejected. It is not wise to develop an entire estate plan around special use valuation but the provision should be given more attention and consideration by professional estate planners than it has. The provision is potentially very beneficial but the extent of the benefits rest on some shaky assumptions and uncertain interpretations. If the special use value property's income tax basis will revert from the special use value to the fair market value when a recapture of the tax occurs electing section 2032A could become, in effect, another form of tax deferral. The provision's material participation requirement is another factor which prevents and discourages election. The Internal Revenue Service's position is that a retired farmer cannot qualify for social security benefits and special use valuation. This position has not been substantiated by the courts however. Many farmers are not willing to sacrifice their social security benefits for estate tax benefits. The code is unclear about how material participation is viewed in such cases. Qualification by a retired farmer for special use valuation and social security would probably make a significant difference in the number of section 2032A elections. These problems and others of this nature will only be solved through the courts or legislative action. Until that time estate planners will back away from cases unless they are positive no future problems will arise.

Fractional Interest Rule and 2 Percent Spousal Participation Rule

The fractional interest rule and 2 percent spousal material participation rule provide little, if any, estate tax benefit to farmers. Of the two, section 2040(c) may provide some aid to an estate on occasion. Section 2040(c) can be used by an attorney as a last ditch attempt to exclude part of the value of the decedent's jointly held assets from the gross estate. In most cases, however, an executor who is able to show material participation for purposes of section 2040(c) would be able to exclude a percentage of the joint property anyway. Only in those cases where this is not possible, and from the attorneys comments that is rare, would section 2040(c) be used. This is not to say the 2 percent rule should be ignored. In some cases the section 2040(c) value may be greater than the value which can be excluded from the gross estate using other methods and in those cases section 2040(c) should be elected. But the method section 2040(c) uses to determine how much joint property can be excluded lessens the possibility of that occurring. The courts have been willing to exclude 25 to 50 percent of the jointly held property from the decedent's gross estate when the executor uses affidavits and other proof that shows the survivor's material participation. It is doubtful whether section 2040(c) can eliminate as much in most cases.

Section 2040(b) is of no benefit to an estate tax planner or client in most estates. The fractional interest rule is contrary to all estate planning precepts. Creating a qualified joint interest will not benefit the estate at all. If there is no spousal contribution to the joint property, creation of a qualified joint interest will result in a gift tax being levied on one-half the value of the property. Payment of a gift tax in itself is enough to dissuade most people from electing the provision. If, however, a gift is going to be made, from husband to wife for example, the estate does not benefit from holding the property as joint tenants. The property will be excluded from the estate of the first spouse to die but joint tenancy's right of survivorship places the property into the survivor's estate, which will not minimize the total tax paid by both spouses. It is more beneficial, whether a gift tax is paid or not, to own the property as tenants in common or own it separately. A trust or trusts can be established which will lessen the estate tax upon the death of the surviving spouse, thus minimizing the total estate tax paid.

Estate Tax Deferrals

The estate tax deferrals are the best known and most widely used of the tax provisions examined in this paper. Section 6166 has not been used much because it is relatively new and it has rather strict qualification requirements but the philosophy behind it, and section 6166A, is understood and accepted by estate planners. "Estate tax deferred is estate tax unpaid" is a common thought. The tax deferrals are also considered to be easier to incorporate into an estate plan than the other provisions. There are other tools, such as trusts, that are used more extensively than deferrals, but a tax deferral is preferred to special use valuation at this point. Estate tax deferrals are also easier to qualify for than special use valuation. Sophisticated clients and estates with large tax liabilities may use estate tax deferrals, but they do not solve many estate tax problems. Most heirs do not like to drag out the payments and neither do their attorneys. Tax deferral elections require the attorney to keep abreast of the family situation for the entire deferral period and send out reminders periodically about payment of the tax installment. Professionals would generally prefer to close the estate if possible and not be bothered with this.

Michigan Inheritance Tax Exemption-Deferral

The Michigan inheritance tax exemption-deferral provision is in a very uncertain status. It is an attempt by the state to combine the philosophies of the federal special use valuation and tax deferrals.

The provision is so new that only a handful of estates have elected it. This does not diminish its potential as an inheritance tax saving tool. If offers an advantage over the federal provisions in that qualification for the exemption includes qulaification for the deferral which is not always the case in the federal code. It is difficult to say how significant the exemption-deferral option will become. If estate planners are successful in their attempts to reduce the amount of property held in joint tenancy the provision could play a bigger role in inheritance taxation. State inheritance taxes are relatively small, however, compared to federal estate taxes and estate planners and their clients may choose to pay the tax rather than subject the estate to the ten year lien.

Attorneys' Knowledge of the Tools

Overall the attorneys interviewed were not overly knowledgeable with respect to the provisions in question and their operation. Those attorneys that had elected one or more of the provisions were fairly knowledgeable about that particular provision but many had limited knowledge of the code sections and no experience. Some attorneys that had used a provision were unfamiliar with parts of that particular provision. One interviewee had made several special use valuation elections but never used a tax deferral in conjunction with section 2032A, not because the estate did not qualify, but because he thought the two sections were mutually exclusive. Election of section 2032A does not, however, preclude the use of a tax deferral or other tax provisions. Another attorney claimed he had created a qualified joint interest under section 2040(b) between a father and son. This is impossible because a qualified joint interest can only exist between a husband and wife. Section 2032A was not used in a number of situations by a number of attorneys for the reason that no alternate use was immediately evident. This demonstrates a lack of professional understanding about how the provision operates and the benefits that are available.

Many of the attorneys interviewed do not fully understand the operation, the potential benefits and the possible pitfalls of the provisions. This failure can be attributed to a number of things. First, the attorneys themselves are at fault for not keeping up to date on relevant estate tax issues. Professional responsibility dictates that this be an important facet of the practice of law. It is difficult however, to keep up to date when an attorney works in many different areas of the law. The Internal Revenue Service has not made the estate planner's position any easier with some debatable positions on the provisions. The Service has also been slow in developing regulations to accompany the provisions. Special use valuation went into effect in 1977 and not until July 1980 did the IRS regulations on the section appear. In the short amount of time the regulations have been in existence there have been no court cases decided that address some of the ambiguities in the code: no precedent makes an attorney hesitant to stick his client's and his own neck out over an issue. Consequently, a number of attorneys have rejected the provisions, particularly section 2032A, because there is no proven decision making base.

There is a definite need for a strong legal education program to examine the code, the regulations and procedures that have been used in the past. This information needs to be transferred to professional estate planners. Depending upon the Internal Revenue Service's interpretations of the code and the inevitable rulings of the court, these tax provisions, with the exception of section 2040(b), could be very beneficial. Judicial decisions favorable to the taxpayer will make the provisions much more attractive. Adverse decisions, from the taxpayers perspective, will not eliminate all of the benefits that can be derived from the provisions but will certainly reduce the number of elections.

Provision Use Summary

Thus far the paper has discussed the operation, potential uses, and problems of the estate and inheritance tax provisions. Table VII-1 presents a summary of possible applications of the provisions according to a client's situation. This table is designed to show which provisions an estate planner should give consideration to when formulating an estate plan or settling an estate. The estate may not qualify for a specific provision but the section should be looked at.

If one or more of the provisions is deemed to be useful for the situation, the personal representative must take steps to elect the provision. A section 2032A election requires the following:

1) The personal representative must determine whether the estate qualifies for the provision.
2) The personal representative must determine whether a qualified heir will keep the land in a qualified use for the required length of time.
3) The previous five-year average cash rents, property taxes from comparable farmland must be obtained, plus the previous five-year average of the effective Federal Land Bank loan rate.

Table VII-1. Estate Tax Provisions to Consider

	Estate Size	
	$175,000-$425,000[1]	$425,000
DECEDENT NOT MARRIED	(Consider these provision sections)	
Decedent participated in farm management, no heir had participated, no heir will manage farm.	6166, 6166A[3]	6166, 6166A[3]
Decedent participated in farm management, no heir had participated, an heir will manage farm.	6166, 6166A 2032A, Mich. Exemp.	6166, 6166A 2032A, Mich. Exemp.
Decedent participated in farm management, heir had participated in farm, no heir will manage farm.	6166, 6166A[3]	6166, 6166A[3]
Decedent participated in farm management, heir had participated, an heir will manage farm.	6166, 6166A 2032A, Mich. Exemp.	6166, 6166A 2032A, Mich. Exemp.
Decedent had not participated in farm management, no heir had participated, no heir will manage farm.	None	None
Decedent had not participated in farm management, no heir had participated, an heir will manage farm.	None	None
Decedent had not participated in farm management, heir had participated on farm, no heir will manage farm.	6166, 6166A[2]	6166, 6166A[2]
Decedent had not participated in farm management, heir had participated on farm, an heir will manage farm.	6166, 6166A[2] 2032A, Mich. Exemp.	6166, 6166A[2] 2032A, Mich. Exemp.
DECEDENT MARRIED		
Decedent participated in farm management, no heir had participated, no heir will manage farm.	None[4]	6166, 6166A[3]
Decedent participated in farm management, no heir had participated, an heir will manage farm.	None[4]	6166, 6166A 2032A, Mich. Exemp.
Decedent participated in farm management, heir had participated on farm, no heir will manage farm.	None[4]	6166, 6166A[3] 2040(c)[5]
Decedent participated in farm management, heir had participated, an heir will manage farm.	None[4]	6166, 6166A, 2040(c)[5] 2032A, Mich. Exemp.
Decedent had not participated in farm management, no heir had participated, no heir will manage farm.	None[4]	None
Decedent had not participated in farm management, no heir had participated, an heir will manage farm.	None[4]	None
Decedent had not participated in farm management, heir had participated on farm, no heir will manage farm.	None[4]	6166, 6166A[2] 2040(c)[5]
Decedent had not participated in farm management, heir had participated on farm, an heir will manage farm.	None[4]	6166, 6166A,[2] 2040(c)[5] 2032A, Mich. Exemp.

[1]The estate planning tools under discussion are not necessary for estates less than $175,000 in size.

[2]Passive role in business by owner may disqualify estate from deferral.

[3]Qualification requirements after decedent's death are not like those of section 2032A but if not met may disqualify estate if disposition or withdrawal occur.

[4]Assumes use of maximum marital deduction. If maximum marital deduction is not used, column is same as greater than $425,000 column.

[5]Wife must have materially participated in farm to qualify for section 2040(c).

These values are needed to establish the value of the special use land.

4) All qualified heirs must sign an agreement making them liable for the tax exempted if the land fails to remain in a qualified use by a qualified heir.

5) The estate tax return must be filed nine months after the decedent's death unless an extension has been granted.

The procedure for electing sections 6166 or 6166A is similar to that of section 2032A.

1) The personal representative must determine whether the estate meets the requirements of the deferral. This includes percentage of the estate requirements and whether the assets qualify as an active business. A passive role in a business by the decedent will disqualify the estate.

2) The personal representative must file the return nine months after the decedent's death unless an extension has been granted.

3) The heirs and personal representative must ensure prompt payment of the installments. Payment delinquency may result in the unpaid balance of the tax coming due immediately.

4) The parties must also be careful with respect to dispositions and withdrawals of assets. Extensive withdrawals or dispositions can also trigger payment acceleration.

Section 2040(c) allows exclusion from an estate of part of the estate's joint property. In order to accomplish this the executor must take the following steps.

1) The number of years the survivor materially participated in the farm operation must be determined. This number is multiplied by .02 to obtain the exclusion percentage. Material participation of the survivor is decided by the same criteria used for section 2032A.
2) The decedent's initial consideration must be calculated and subtracted from the value of the joint property. In addition, a 6 percent simple interest appreciation factor must also be subtracted from the joint property value.
3) The election of section 2040(c) must be made with the filing of the estate tax return, nine months after death, unless an extension has been granted.

Section 2040(b), the fractional interest rule, has not been mentioned in this discussion. The author does not think this section is of value in estate planning. Therefore, its use is not recommended and it is not included in this summary.

Some of the requirements of section 2032A also apply to the Michigan inheritance tax exemption-deferral. The Michigan provision does not require calculations of the land values based on comparable land factors. The procedure for election of this Michigan provision is as follows.

1) The personal representative must determine whether the estate and heirs meet the qualification requirements.
2) The heirs or personal representative must file an affidavit with the probate judge requesting election of the provision.
3) Upon approval of the judge, the land must be enrolled in Public Act 116, the Farmland and Open Space Preservation Act for at

least ten years. This election must occur within 30 days of the judge's notification.

4) The heirs and personal representative must be aware of the lien placed upon the property for the ten-year period.

Future Research

There are several areas of the estate and inheritance provisions which lend themselves to further action and research. The provisions are all relatively new and some of the statements made in this paper are based upon estimates of how the code may be interpreted. Further research is needed to determine what the final interpretations of some of the ambiguous parts of the code are and how they affect agriculture. Such research may help anser the following questions. How will the basis of an asset be affected if a recapture tax is triggered in a special use valuation? What will the final definition of material participation be and will a farmer be able to qualify for social security payments and special use valuation? What constitutes a legitimate contribution to a joint tenancy by a surviving spouse? Answers to these questions will only come with time as the courts rule on the issues. But interpretation of those rulings will be necessary so that estate planners and their clients may choose an appropriate course of action.

Another area that needs to be explored further is the coordination of tax provisions discussed here with other estate planning procedures. This research is dependent to some extent upon the first area of further research suggested. Without an idea of how the provisions will work development of coordinated plans is difficult. However, it should not be ignored.

A third area of future work is in the area of education. Education of estate planners and their clients is essential if these provisions are to be used effectively. These provisions could be tremendously beneficial to agricultural interests but only if the estate planners and their clients are aware of the provisions, their benefits, and their obligations.

A final area of future research would be to study what effect estate taxation, and these provisions in particular, have on the structure of American agriculture. In the past, estate taxes have had a minimal effect but that appears to be changing. Will estate taxation lead to an even greater rise in the value of land? Will estate tax liabilities become so heavy a burden upon the heirs that they are forced to leave agriculture? What effect will these tax provisions have on tenant farmers? Should the qualification requirements of these provisions be eased so fewer farms are subject to estate taxation if the provisions are elected? These are just a few of the questions which need to be examined.

APPENDIX

Federal Unified Transfer Tax Rate Schedule
(Effective January 1, 1977)
On All Transfers . . . Both Gift and Estate

APPENDIX

Federal Unified Transfer Tax Rate Schedule
(Effective January 1, 1977)
On All Transfers . . . Both Gift and Estate

Taxable Estate (1)	Federal Estate Tax (2)	Next Rate (Percent) (3)	Maximum State Tax Credit (4)	Next Rate (Percent) (5)	Net Estate Tax (6)	Next Rate (Percent) (7)
$ 0 plus	$	18%	$		$	18.0%
10,000	1,800	20			1,800	20.0
20.000	3,800	22			3,800	22.0
40,000	8,200	24			8,200	24.0
60,000	13,000	26			13,000	26.0
80,000	18,200	28			18,200	28.0
100,000	23,800	30	0	0.8%	23,800	29.2
150,000	38,800	32	400	1.6	38,400	30.4
200,000	54,800	32	1,200	2.4	53,600	29.6
250,000	70,800	34	2,400	2.4	68,400	31.6
300,000	87,800	34	3,600	3.2	84,200	30.8
500,000	155,800	37	10,000	4.0	145,800	33.0
700,000	229,800	37	18,000	4.8	211,800	32.2
750,000	248,300	39	20,400	4.8	227,900	34.2
900,000	306,800	39	27,600	5.6	279,200	33.4
1,000,000	345,800	41	33,200	5.6	312,600	35.4
1,100,000	386,800	41	38,800	6.4	348,000	34.6
1,250,000	448,300	43	48,400	6.4	399,900	36.6
1,500,000	555,800	45	64,400	6.4	491,400	38.6
1,600,000	600,800	45	70,800	7.2	530,000	37.8
2,000,000	780,800	49	99,600	7.2	681,200	41.8
2,100,000	829,800	49	106,800	8.0	723,000	41.0
2,500,000	1,025,800	53	138,800	8.0	887,000	45.0
2,600,000	1,078,800	53	146,800	8.8	932,000	44.2
3,000,000	1,290,800	57	182,000	8.8	1,108,800	48.2
3,100,000	1,347,800	57	190,800	9.6	1,157,000	47.4
3,500,000	1,545,800	61	229,200	9.6	1,346,600	51.4
3,600,000	1,636,800	61	238,800	10.4	1,398,000	50.6
4,000,000	1,880,000	65	280,400	10.4	1,600,400	54.6
4,100,000	1,945,800	65	290,800	11.2	1,655,000	53.8
4,500,000	2,205,800	69	335,600	11.2	1,870,200	57.8
5,000,000	2,550,800	70	391,600	11.2	2,159,200	58.8
5,100,000	2,620,800	70	402,800	12.0	2,218,000	58.0
6,000,000	3,250,800	70	510,800	12.0	2,740,000	
6,100,000	3,320,800	70	522,800	12.8	2,798,000	57.2
7,100,000	4,020,800	70	650,800	13.6	3,370,000	56.4
8,100,000	4,720,800	70	786,800	14.4	3,934,000	55.6
9,100,000	5,420,800	70	930,800	15.2	4,490,000	54.8
$ 10,000,000	$ 6,120,800	70%	$ 1,082,800	16.0%	$ 5,038,000	54.0%

Source: Federal Estate and Gift Tax Reporter, Commerce Clearing House, 10,121-10,124, November 8, 1976.

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