

# Estate Tax Savings and the Family Farm: A Critical Analysis of Section 2032A of the Internal Revenue Code

BOYD K. DYER\*

*This article examines the provision of the Tax Reform Act of 1976 that allows farmers to reduce estate tax by arranging the maintenance of a family farm. It discusses the advantages, disadvantages, and loopholes of the provision, including its relationship, in California, to the Williamson Act.*

## I. INTRODUCTION

### A. *The Problem*

Americans place a high value on doing something about a problem. The question of whether what is done solves the problem is less important. Prohibition is the great, historic example, but every year produces a new crop of symbols of congressional concern. Tax breaks are a politically attractive technique for "doing something." Their most attractive feature is that they do not appear as items in the federal budget.<sup>1</sup> A second is that there is no precise system for weighing the benefit obtained by the tax break against its cost. And, of course, if the tax break produces no benefit, the members of Congress who voted for it can defend themselves by appealing to the paramount importance of "doing something" without acknowledging that they have wasted the public's wealth.

Family farms are in trouble. The immediate problem is high costs for farm inputs and low prices for farm outputs. Ironically, low farm profits

---

\* B.A. Stanford Univ., 1962; L.L.B. Harvard Law School, 1968. The author currently is a professor at the University of Utah.

1. "Tax expenditure budgets" have been prepared by certain groups. See, e.g., ESTIMATES OF FEDERAL TAX EXPENDITURES, prepared for the Committee on Finance by the Staff of the Joint Committee on Internal Revenue Taxation (March 15, 1976); TAX EXPENDITURES, SPECIAL ANALYSIS F, SPECIAL ANALYSIS OF THE BUDGET OF THE UNITED STATES GOVERNMENT FOR THE FISCAL YEAR 1977, at 116-137 (Jan. 1976); SENATE COMM. ON THE BUDGET, TAX EXPENDITURES, A COMPENDIUM OF BACKGROUND MATERIALS ON INDIVIDUAL PROVISIONS, 94th Cong., 2d Sess. (March 17, 1976); *Tax Expenditures are Calculated by Income Class*, 6 TAX NOTES 275 (1978).

have not resulted in a proportionate decrease in the price of farm land. In spite of low farm profits, the price of farm land has been buoyed up by three related factors: (1) the expectation that farm profits will rise in the future; (2) the possibility that farm land will be converted to other, more profitable uses; and (3) prices offered for farm land by corporate farming operations and other high bracket taxpayers interested in the tax breaks available to farmers or in appreciation in land value rather than in farm profits.<sup>2</sup>

This combination of low farm profits and high land values creates a serious problem for the estate of the family farmer. The amount of the federal estate tax is based on the value of the estate, and prior to the passage of the Tax Reform Act of 1976 that value reflected the fair market value of the farm land. On the other hand, the ability of the estate to pay those taxes depends on its cash position. No matter how long the payment of the estate tax is permitted to be stretched out over time,<sup>3</sup> the present profitability of most family farms is often not adequate to pay those taxes.<sup>4</sup> Until recently the only answer for the estate was to sell all or part of the family farm.

In 1976, to do something about this problem, Congress passed section 2032A of the Internal Revenue Code. This new section permits farm property meeting certain conditions to be valued for purposes of the federal estate tax by capitalizing the value of its current use, instead of using its "fair market value."<sup>5</sup>

---

2. As part of the Tax Reform Act of 1976, Congress barred farming syndicates and corporations (other than tax-option and family corporations) from certain tax breaks otherwise available to farmers. These barred tax breaks were generally advantages of tax timing—permitting current deductions of expenditures more appropriately capitalized. I.R.C. §§ 278, 447 & 464, Tax Reform Act of 1976, Pub. L. No. 94-455, § 207, 90 Stat. 1520 (1976). Still, one major tax break, capital gains treatment of profits on the sale of farm land, encourages this form of investment as a tax shelter.

3. As part of the Tax Reform Act of 1976, Congress provided for the installment payment of estate taxes for qualifying estates over a period of fourteen years with no installments due for the first five. In addition, the Commissioner may grant further extensions for "reasonable cause." I.R.C. §§ 6166-67. In effect, this permits the estate to borrow from the government to pay the taxes.

For the prospective decedent to purchase life insurance or for the heirs to borrow against the farm income to pay estate taxes are other ways to stretch out the payments. In either of these cases, as in the case of stretching out the tax payments, the stream of farm income diverted (to the insurance company before death or to the bank or the government after death) must add up to the full amount of the taxes after taking interest into account. Thus insurance, borrowing or stretching payments are not adequate solutions to the underlying problem of a stream of farm income inadequate to pay the taxes.

4. Between 1942 and 1975, the average realized net income of farm proprietors increased approximately six times while the average value of an acre of farm real estate increased approximately thirteen times. In 1942, average farm equity was approximately six times average annual farm income. In 1976, it was approximately 23.5 times average annual farm income. Comment, *The Family Farm and Use Valuation—Section 2032A of the Internal Revenue Code* 2 B.Y.U. L. REV. 353, 354-55, & 358 (1977) [hereinafter "B.Y.U. Comment"].

5. Under the Regulations, valuation is made at "fair market value"—the price at which the property would change hands between a willing buyer and a willing seller, neither being

The basic idea seems sound, but solving a problem by relieving a group of people from taxes raises the question of fairness. What do the other taxpayers who must bear the taxes the farmers no longer pay receive in return? Not even Congress is so naive as to think tax relief is free.<sup>6</sup>

The quid-pro-quo for other taxpayers is, (1) a measure of assurance that the farm land will remain farm land, preserving it as open space, for a period of up to fifteen years and (2) the societal benefits of preserving the good people who are family farmers. It's not enough to call them good. They must be better people than common laborers, or it would not be fair to require the laborers to pay their taxes.

### B. *This Article*

The purpose of this article is to help estate planners understand the utility of special valuation under section 2032A. It is concerned primarily with the prospective decedent's planning for special valuation, even though it is the executor who must make the actual election with the agreement of those heirs who take the farm.

The basic trade-off to be evaluated by the client is this: in exchange for the special valuation, the farm must be left to close family members<sup>7</sup> who agree to pay the estate taxes saved by the election as an additional estate tax if they and their own close families do not continue to hold

---

under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Treas. Reg. § 20.2031-1(b) (1978). The Regulations do not prescribe any particular method for determining this value for real estate. Cases in which a higher valuation than current use value was reached by valuation at the most valuable potential use include: *E.F. McCabe Estate*, 475 F.2d 1142 (Ct. Cl. 1973) and *E.S. Rabe Estate*, 34 Tax Ct. Mem. Dec. (CCH) (1975). Congress expressly stated that § 2032A is intended to change this standard. H.R. REP. NO. 1380, 94th Cong., 2d Sess. 21, *reprinted in* (1976) U.S. CODE CONG. & AD. NEWS 3356, 3375 [hereinafter "House Report 1380"], S. REP. NO. 938 PART II, 94th Cong., 2d Sess. 14, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4030, 4040 [hereinafter "Senate Report 938"].

6. Governmental expenditures are a burden that must be borne by someone. If one group of taxpayers is relieved of part of that burden, that part falls on other taxpayers. Although a particular tax expenditure may be described as governmental subsidy, it is more accurately seen as a subsidy provided by all the taxpayers who are not entitled to it.

7. The family members who must receive the farm are:

- (a) The decedent's ancestors;
- (b) the decedent's lineal descendants and their spouses;
- (c) the lineal descendants of the decedent's grandparents and their spouses;  
and
- (d) the spouse of the decedent.

The statute provides that legally adopted children shall be treated as a child by blood. I.R.C. § 2032A(e)(2).

For convenience, this group will be referred to as the "close family" although, of course, they may never have seen each other or may be irreconcilable enemies.

It is not entirely clear that all the farm must be left to the close family for special valuation to be available. *See* text following note 66 *infra*.

and use the land as a family farm for fifteen years.<sup>8</sup> The liability for the additional estate tax is phased out over the period from the tenth through the fifteenth year.<sup>9</sup> A second important trade-off is not apparent from section 2032A itself. It is the loss of a substantial increase in the tax basis of the farm at the client's death.

The article will first discuss the prize to be won, the estate tax savings. Next it will discuss the burdens that must be borne in exchange for those savings and the basic form of estate plan that should be used to avoid "non-tax" problems. Finally, it will discuss the future impact of section 2032A and possible future amendments to it reflecting both economic and tax policy.

## II. TAX SAVINGS

### A. *The \$500,000/\$1,000,000 Limit*

The first aspect of section 2032A that an estate planner must master is the limitation on its use. The maximum reduction in estate tax valuation permitted to an individual's estate under the section is \$500,000. One must remember, however, that the purpose of the section is to let the farm pass intact to the next generation. Therefore, if the farm is community property the total maximum reduction available to a married couple as they leave the farm to their children is \$1,000,000.<sup>10</sup> The corresponding maximum savings of federal estate taxes is \$700,000.

If the farm is not community property, but a husband and wife own the farm in common, both holding substantial interests, a similar \$1,000,000 maximum reduction can be obtained if both leave their interest in the farm to their children. It should be noted that a "joint" tenancy will not achieve this result because the interest of the first spouse to die will pass to the other and not to the children.

Although the marital deduction is, in part, intended to provide equal treatment for common law property states and community property states under the federal estate taxes, it does not achieve equality here. If the farm is owned entirely by one spouse and that owner-spouse survives the non-owner spouse, only one \$500,000 limitation will be available. If the owner-spouse dies first, leaving half the farm to the spouse and half to the children, there will be only a \$250,000 effective maximum reduction in the owner-spouse's estate. The reason is that the mar-

---

8. The additional estate tax cannot exceed the excess, if any of the fair market value of the farm at the time of the triggering sale or change of use by the heirs over the prior special valuation of the farm. I.R.C. § 2032A(c)(2)(A). This limitation, which protects against drastic declines in farm property values, will probably have little effect.

9. I.R.C. § 2032A(c)(3).

10. To obtain the maximum federal estate tax savings with a community property farm, both spouses would have to leave their interest in the farm to their descendants and not to each other.

ital deduction is subtracted from the value of the decedent's "gross estate"<sup>11</sup> and the \$500,000 limitation is imposed in the process of calculating that amount. Thus half the reduction goes to reduce the marital deduction which isn't taxed anyway. When the non-owner spouse dies, leaving the rest of the farm to the children, the full \$500,000 reduction will be effective.

### B. *The Valuation Formula*

The second aspect of section 2032A that an estate planner must master is the formula used for special valuation. The formula answers the question of whether electing special valuation will actually result in a substantial reduction in the taxable estate and a corresponding tax saving. Only if there is a substantial tax saving is it sensible to have a client go on to compare that saving with the cost of conforming the estate to the requirements of the section.

The client must understand four aspects of the formula: (1) the arithmetic of the statutory formula; (2) the interplay of the federal formula with the lower state and local real estate tax rates available on farm land made an "agricultural preserve" under California's Williamson Act;<sup>12</sup> (3) the failure of the federal formula to provide for amortization of perennial crops and other time-limited improvements to land; and (4) the treatment of the farm buildings, including the farm house.

The basic valuation formula<sup>13</sup> determines the farm land's value "by dividing - (i) the excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm over the average annual State and Local real estate taxes for such comparable land, by (ii) the average annual effective interest rate for all new Federal Land Bank loans."<sup>14</sup> "Each average annual computation shall be made on the basis of the five most recent calendar years ending before the date of the decedent's death."<sup>15</sup> The approach is a familiar one to estate planners, capitalization of a stream of earnings. As rents rise, or state and local real estate taxes drop, the valuation in-

---

11. I.R.C. § 2056(a).

12. California Land Conservation Act of 1965, CAL. GOV'T CODE §§ 51200-51295 (West Supp. 1977) [hereinafter "the Williamson Act"].

13. I.R.C. § 2032A(c)(7)(A). The basic formula applies except where "it is established that there is no comparable land from which the average annual gross cash rental may be determined" or "where the executor elects [to use the statutory method for closely held business interests.]" I.R.C. § 2032A (e)(7). This article does not consider the alternative method because it is less precise and, probably, less advantageous. It is briefly discussed in B.Y.U. Comment, *supra* note 4, at 415-16.

14. The exact meaning of the "average" is not clear. Is the average rate computed by averaging the rate on new loans by day, each day counting equally, or by averaging the loans actually made? According to the B.Y.U. Comment, *supra* note 4, at 412-13, for 1977 the former average yields a rate of 8.086% and the latter 8.19%.

15. I.R.C. § 2032A(e)(7)(A).

creases. Conversely, as the interest rate for Land Bank loans decreases, the valuation rises.<sup>16</sup>

### C. *Coordination with the Williamson Act*

The property tax laws of California and several other states create a problem. Should "State and Local real estate taxes for . . . comparable land" in the federal formula be the rates based on "highest and best use," or the lower rates available under the Williamson Act in California (and similar legislation in some other states) if farm land use is restricted to preserve open space? Use of the lower Williamson Act rates will, of course, substantially reduce the benefits of special valuation.<sup>17</sup>

The Williamson Act permits the owners of farm land to have the land valued for purposes of state and local real estate taxes at its farm use value, excluding increments in value due to the potential for changing to more intensive uses. In exchange, the owners must agree with the appropriate county or city to restrict the use of the land to preserve its agricultural character.<sup>18</sup> By using farm use value, the Williamson Act excludes two of the three factors that tend to increase the value of farm land beyond its actual use value—the factor of conversion and the factor of tax shelters. Moreover, since Williamson Act valuation is based on the rental value for the year in question, it also excludes the remaining factor—the element of potential future increases in farm profitability.<sup>19</sup> If the future farm profits rise, future property taxes will rise. There is no need to anticipate the future as there is with an inheritance tax.<sup>20</sup>

The better position is that farmers who have made their land into an "agricultural preserve" under the Williamson Act will be required to use the lower state and local real estate tax rates for purposes of the federal formula. The first reason is that the federal formula looks to

---

16. The federal formula will reduce farm values even if none of the three factors (expected increases in farm profits, possibilities of conversion and potential for tax shelters) which were of concern to Congress is present if interest rates are high due to a general public expectation of long term inflation, as they seem to be today. If inflation is expected, past farm profits will be expressed in fewer, more valuable "early year" dollars, but the interest rates will be high to compensate lenders for the fact that they will be paid back in less valuable, "later year" dollars. The combination of low nominal historic profits and high interest rates should produce a resulting value well below fair market value.

17. In Alameda County the effect of placing land under the Williamson Act is to reduce state and local real property taxes by approximately 25 to 50%. Since these taxes are subtracted from gross cash rental under the federal formula, the effect of their reduction is to increase net cash rental and, therefore, to increase the valuation.

18. Unlike the federal special valuation which requires that the farm use continue, the Williamson Act more broadly permits uses "compatible with agricultural uses." CAL. GOV'T CODE § 51243(a) (West Cum. Supp. 1978).

19. CAL. REV. & TAX CODE § 423 (West Cum. Supp. 1978) defines the factors going into property valuation under the Williamson Act.

20. An annual property tax can be adjusted continuously to reflect the actual increase or decrease in farm profits. An inheritance tax (or other tax based on wealth) must either estimate the present value of the future farm profits or give up its claim to being a tax on wealth.

taxes on "comparable land." A like status under the Williamson Act is one of the characteristics land must have to be "comparable." Not only does this result conform to the language of the statute, but it also conforms to its policy of computing the value of the land from historic profitability. Like the availability of irrigation, status under the Williamson Act affects net farm profits, so, like irrigation, it should be a characteristic land must share to be "comparable." A third argument is that status under the Williamson Act reduces the quantum of rights held by the owner. The city or county gains an interest in land placed under the Act in the nature of a negative easement restricting its use. A like quantum of rights of the fee owner would seem to be a second criterion for deciding what land is "comparable," quite apart from whether that quantum directly affects farm profits.

Could the Service take this argument one step further, and take the position that California farmers who could place their farms under the Act, but haven't, must also use the lower tax rates, arguing that the federal statute looks to the lowest available state and local real estate taxes and that if farmers pay more taxes it is purely gratuitous on their part? While the Service might conceivably take such a position, the courts should not approve it. Placing a farm under the Williamson Act is not a unilateral act. The county or city must agree to the change applying a statutory standard. While there is a statutory duty,<sup>21</sup> backed up by a state constitutional duty,<sup>22</sup> for the county or city to treat all farmers alike, land has always been recognized as unique, so what is "alike" is always debatable. Besides, putting land into an agricultural preserve does not just reduce taxes, it reduces the quantum of rights held by the owner. Therefore, while farmers with land actually under the Williamson Act should be required to use the lower tax rates for the federal formula, farmers owning land on which the higher rates still apply should be entitled to use those higher rates even if the land could have been placed in an agricultural preserve.

If the courts agree with these conclusions, the estate planner must ask a key question: *which is worth more, the reduction in federal estate taxes without the Williamson Act or the reduction in state and local property taxes with it?*

---

21. CAL. GOV'T CODE § 51241 (West Cum. Supp. 1978) provides in part:

If [a contract to restrict use and reduce property tax valuation] is made with any landowner, the city or county shall offer such a contract under similar terms to every other owner of agricultural land within the agricultural preserve in question.

22. CAL. CONST. art. I, § 21 provides in part:

[No] citizen, or class of citizens [shall] be granted privileges or immunities which, upon the same terms, shall not be granted to all citizens.

It is not clear what this adds to the equal protection clause of the fourteenth amendment of the United States Constitution.

There are only two clear rules. It would be foolish to place land under the Williamson Act if the farmer's death is imminent. It would be foolish not to do so if a long life is confidently expected. Between these two extremes, nothing will serve but making trial computations for the particular estate in question. It will be tedious, but necessary, work.

A second question presented by this tension between the Williamson Act and section 2032A is what to do with land that is already an "agricultural preserve?" *Would a client save taxes by taking land out of the agricultural preserve just before death?* Taking the land out just before death might result in a major reduction in federal estate taxes because of the substantial increase in the rate of property taxes on "comparable land." Of course, there would be a lump sum of state property taxes to be paid,<sup>23</sup> but the impact of the lump sum payment may be softened by its being deductible for purposes of the federal income tax.<sup>24</sup>

A non-tax problem with such last-minute estate planning is that a farmer cannot cancel agricultural preserve status unilaterally. A finding by the local board or council that the cancellation is not inconsistent with the purposes of the Williamson Act and is in the public interest is necessary.<sup>25</sup> I do not believe saving estate taxes will meet that standard.

The estate planner must also be concerned lest a last minute shift be refused federal tax effect under a notion of "business purpose," although this doctrine has little application in the area of estate taxes. Estate planning tends to be accepted judicially as a pure matter of saving taxes, since to become a decedent is, so to speak, to go out of business.

The computation of the net saving or loss resulting from a deathbed cancellation of status under the Williamson Act (or from a unilateral non-renewal of that status made on ten-years' notice as permitted by the Williamson Act,<sup>26</sup> will be an interesting and, for estate planners, remu-

---

23. The owner is required to pay a cancellation fee as deferred taxes equal to 50% of the "cancellation valuation" of the property. The cancellation valuation is the full cash value of the land multiplied by the lower of the most recent official ratio of full cash value to assessed valuation or the ratio prevailing at the time the land was placed under the Act. CAL. GOV'T CODE § 51283 (West Cum. Supp. 1978). The current ratio is 25% of full cash value. CAL. REV. & TAX CODE § 401 (West Cum. Supp. 1978) so, assuming this ration applies, the current cancellation fee is 12.5% of the full cash value.

24. I.R.C. § 164. The only question is whether the cancellation fee is in the nature of a penalty and therefore not deductible either as taxes or as a business expense, I.R.C. § 162(f). California clearly regards the fee as deferred taxes and since the obligation of payment is premised on an error by the city and county, not on fraud or other wrongdoing by the landowner, it should not be classified as a penalty.

25. CAL. GOV'T CODE § 51282 (West Cum. Supp. 1978).

26. CAL. GOV'T CODE §§ 51244-51246. The problem of deferred taxes on a 10 year non-renewal is dealt with by providing that the land's valuation for real property tax purposes will be increased in steps from use value to full cash value over the last five years of the ten year period. CAL. REV. & TAX CODE § 426.

It would seem to be very difficult to predict accurately the date of death so that a 10 year non-renewal could be used. More precisely, it would either be very difficult or very suspicious.



nerative aspect of coordinating the Williamson Act with special valuation. For purposes of this article, it is enough to point out that this is the first problem a California estate planner must work out for each individual farm property. There are no shortcuts.

#### D. *Amortization of Investment and the Federal Formula*

An important aspect of the federal special valuation formula is brought into focus by comparing it with the California agricultural preserve valuation formula, section 423 of the California Government Code. The federal formula starts with the rent for comparable land, subtracts real property taxes and then divides the difference by the Federal Land Bank interest rate. The California formula also starts with rent, but does not subtract the property taxes in the same, direct fashion.

The state interest rate for its valuation formula is computed by starting with the rate available on long term United States government bonds. This rate is then increased by three components. One component is intended to adjust for property taxes. A second component accounts for the greater probability of non-repayment for farm loans than federal bonds. At this point the state formula is roughly the same as the federal formula. Both decrease valuation to account for property taxes, and the Federal Land Bank interest rate used in the federal formula can be thought of as the sum of the prevailing risk-free interest rate plus a component to compensate for the probability of non-repayment for farm loans.<sup>27</sup>

Here the difference emerges. The California formula goes on to add one more component to the capitalization interest rate. This last component is an increase to account for amortization of any investment in perennial crops over their estimated economic life when the total income from land and perennials exceeds the yield from other typical crops grown in the area. The need for this adjustment is clear. Suppose a farmer plants a vineyard and then rents it out. The cost of the planting is a long-term investment that the farmer will expect to recover over the life of the vines by increasing the rent. By providing for amortization the California formula assures that the valuation will not be made artificially high by assuming the vines, like the land, will last forever.

The federal formula does not adjust for amortization of perennial crops. It speaks, however, in terms of "rental for comparable land." Two interpretations of "comparable land" are possible: (1) special valuation is based only on the rent for the land itself, not for the perennial crop although it is admittedly real property; or (2) the special valuation is based on the rent for all the real property, land and vines, even though there is no provision for amortization of investment in the crop.

---

27. B.Y.U. Comment, *supra* note 4, at 412.

If there were a federal provision for amortization the second would be the only defensible interpretation from the viewpoint of policy. Special valuation is supposed to be based on historic farm profits. That standard looks to the whole farm, including perennial crops. To value a farm with fine buildings and an established vineyard on the basis of the rent for comparable naked ground is not to measure the farm's ability to produce cash to pay estate taxes. On the other hand, to value such a farm by its rental value without any provision for amortization of the investment is also wrong.

Since there is no federal provision for amortization, the first interpretation which speaks of "comparable land" not "comparable farms," or "comparable real property" is more in accordance with the language of the statute. For this reason, the better conclusion is that the statute looks to the rent for the land alone, not to the rent for the land and the perennial crop, if any, on the land.

It is likely that Congress will correct this ambiguity in the current formula. When the California valuation formula was first passed, it, like the present federal formula, had no provision for crop amortization.<sup>28</sup> An estate planner should be prepared for the federal formula to be amended by Congress in the direction of "rent for the whole farm" with provision for the amortization of everything on that farm with a limited life, not only perennial crops, but also irrigation ditches and similar limited-life improvements that are clearly "land" for purposes of the federal formula and whose rent is now included with no provision for amortization. The estate planner must also be prepared for the possibility that the second interpretation, even though it does not provide for amortization, will be accepted by the courts.

Still, the probability that the federal formula will be read to mean rent for the land alone is substantial and saving taxes involves taking reasonable chances. This point will now be extended from perennial crops to farm buildings.

#### *E. Can the Farm House and Other Improvements Escape the Federal Estate Tax Entirely?*

The potential for a small amount of farm "land" to permit a large amount of farm "real property" other than "land" to pass untaxed (subject only to the \$500,000 statutory or the \$1,000,000 practical limits) is too important to be ignored. The analysis of this potential starts with a careful reading of the statute. The property which is entitled to special valuation must be "real property;"<sup>29</sup> the more restrictive term "land" is

---

28. Originally passed as 1967 Cal. Stats. 4273, amended to provide for amortization by 1971 Cal. Stats. 3517.

29. I.R.C. § 2032A(b)(1).

not used. Moreover, the statute expressly provides that if the estate has enough farm "real property" passing to qualified heirs,<sup>30</sup> then "residential buildings and related improvements on such real property occupied on a regular basis by the owner . . . and roads, buildings and other structures and improvements functionally related to [farm] use shall be treated as real property devoted to the [farm] use."<sup>31</sup> Thus, the Service cannot demand that the farm house be treated for tax purposes as a "residence" on the grounds that it is like any house. Under the statute, if it is on the farm land, or, according to the legislative history, close to it or only separated from it by a road or similar obstacle,<sup>32</sup> it is part of that farm.

The second question is whether the rental value of that farm house must be added to that of the farm land. The federal formula says "rental for comparable land." In spite of the policy arguments made in discussing perennial crops, the language seems clear. Congress was well aware of the difference between "land" and "real property." They were also aware of the problem of farm buildings in general and farm residences in particular. If they had wished to include the rental value of the buildings and residence, fairness would have required a provision for amortization, and this would have introduced complexity. In addition, finding comparable land is a simpler matter than finding comparable land, buildings and so on. Thus, the statute seems to be one of many examples of Congress trading perfect equity for administrative convenience.<sup>33</sup>

Some farm improvements have a limited life but are nevertheless "land." Irrigation ditches and desalinization treatments are two examples. Under this reading of the statute, farms have won in the area of buildings and similar improvements that cannot be fairly called "land," have a good chance in the area of perennial crops but have lost in the area of limited-life improvements to the land itself. The latter will add to the rent but there will be no provision for amortization of the investment they represent. This conclusion means that special valuation per-

---

30. I.R.C. § 2032A(b)(1)(B).

31. I.R.C. § 2032A(e)(3). The special treatment of these improvements argues that Congress considered crops as part of the land and against what has been called the "better position" above.

32. "Residential buildings or related improvements shall be treated as being on the qualified real property if they are on real property which is contiguous with qualified real property or would be contiguous with such property except for the interposition of a road, street, railroad or similar property." House Report 1380, *supra* note 5, at 24 n.2, & 3378.

33. The problem of compromising equity for administrative convenience in the area of taxation is discussed generally in Sneed, *The Criteria of Federal Income Tax Policy* 17 STAN. L. REV. 567 (1965).

The B.Y.U. Comment, *supra* note 4, identifies several provisions of § 2032A that represent such compromises, but does not discuss the problem of whether the rent for farm buildings must be included in the federal formula.

mits the farm residence to escape estate taxation entirely—subject always to the \$500,000 statutory limit or, since the residence is likely to be community property, a \$1,000,000 practical limit.

### F. *Conclusion on Tax Savings*

To conclude this discussion I offer a paradigm tax plan. Just five years before decedent's death, his estate planner had him make a like-kind exchange of his old farm for a new one. The like-kind exchange was used to avoid recognizing income equal to the appreciation in value of the old farm under section 1031 of the Code. The old farm was characterized by (1) high cash profits, (2) agricultural preserve status under California law, and therefore low property taxes, (3) an absence of farm buildings, perennial crops or other limited-life improvements. The new farm is characterized by (1) no cash profits, though the value of the land is growing so rapidly due to the possibility of conversion into a subdivision that the farmer has no economic loss; (2) no agricultural preserve status; and (3) a beautiful farm house surrounded by a vineyard.

In this case the federal special valuation of the new farm is zero because the rent for comparable land, considered alone, is less than the state and local real property taxes for that land. The paradigm has one problem—how to get the decedent to live on the farm and farm the new farm for at least five years, so it will qualify for federal special valuation, but not for so much longer that the high state and local property taxes will force him to sell out. Still, it points the way to special valuation's tax savings potential and will be useful to explain the basic principles of the valuation formula to clients.

## III. THE QUID-PRO-QUO

### A. *Introduction*

This part of the article takes up the question of the quid-pro-quo for the benefits of special valuation. It will be clear that in some cases, even without considering the non-tax costs, the tax cost will be too high. This unexpected result occurs in certain situations where the combined burden on future generations of income and transfer taxes outweighs the benefits of the reduction in estate taxes. This part will examine the problem from the point of view of the prospective decedent alone because the focus of this article is on planning to take maximum advantage of section 2032A, not on salvaging an estate that did not plan ahead.

The prospective decedent must see that three sets of conditions are met to make special valuation available.<sup>34</sup> One set focuses on the farm

---

34. It would be possible for the decedent to force special valuation to apply by disinheriting his close family unless they comply with the statutory requirements. The approach taken in

itself, the second on the decedent's family's participation in working the farm, and the third on the form and content of the gift or bequest used to transfer the farm to the heirs. In addition to these conditions, the executor must elect special valuation and the close family heirs must agree to it and they and their own close families must continue to farm and own the farm for fifteen years.

### 1. The Farm Itself

To qualify for special valuation, the farm must be real property located in the United States<sup>35</sup> and used for farming purposes on the date of the decedent's death.<sup>36</sup> "Farming purposes" is broadly defined, including raising crops and animals and, surprisingly, trees for lumber.<sup>37</sup>

The second condition for special valuation is that the farm must be of a certain size relative to the remainder of the decedent's estate. Assuming, to avoid other limitations, that all the farm is left in fee to a child of decedent, fifty percent or more of the adjusted value of the gross estate must consist of the adjusted value of farm real and personal property. In addition, twenty-five percent or more of the adjusted value of farm real property must have been owned by the decedent and farmed by the decedent or his close family for five of the eight years prior to his death. This limitation will be referred to as the "50/25 percent test."<sup>38</sup> This test

---

this article assumes that the decedent does not wish to force the family to continue family farming, but only to minimize the estate taxes if they do so.

A reader may well ask whether the decedent should require special valuation, not just provide for it as an option. As a moral judgment, I feel that a decedent should not force continuation of a family farm because the decedent cannot foretell the future. Even if the decedent is sure the farm should be continued at the time the estate plan is made, future circumstances might have led to the opposite conclusion at the time the heirs are actually faced with the decision. Moreover, as a tax judgment, to elect special valuation and then to sell the farm may well incur a heavier total tax cost (considering both estate and income taxes) than no election at all.

35. I.R.C. § 2032A(b)(1).

36. I.R.C. § 2032A(b)(1). The application of the section to a trade or business other than farming will not be discussed.

37. I.R.C. § 2032A(e)(5). This last inclusion is surprising. Timberland, other than Christmas tree farms, would seem to have little place for daily chores for the children, living close to the land and so on. Moreover, the conversion of lumber producing land to residential uses is not a notorious problem. There are other, technical, objections. What is the "rent" of timberland? Under the general principles of real estate law, a short term tenant of forest-land is not entitled to cut down the trees. See 5 AMERICAN LAW OF PROPERTY §§ 20.2-20.5 (1952) on "waste." Timber is of such a nature that except for very large forests capable of being harvested on a sustained yield basis, valuing it by capitalizing an assumed perpetual stream of earnings makes little sense. For most timberland, since there is no determinable "rent for comparable land," the basic formula would give way to the alternative methods of I.R.C. § 2032A(a)(e)(8). Besides, there is a serious question of whether Congress intended to include the "rent" for the trees as opposed to the land itself. Timber is certainly a perennial crop, the income from which cannot be measured accurately without taking amortization into account.

38. I.R.C. § 2032A(b)(1).

is applied using "highest and best use" values, rather than special valuation, thus avoiding a problem of circularity.

It is very important to see that it is not the "value" of the farm and other property, but the "adjusted value" that counts. "Adjusted value" differs from "value" in that mortgages and indebtedness secured by lien on the property in question are deducted.<sup>39</sup> This leads to a potential trap and a potential bonanza.

The potential trap is the mortgaged farm. Suppose a young farmer has mortgaged her farm to the hilt, but her estate will hold substantially non-farm assets free and clear. She lives on the farm, devotes her life to it, and believes herself to be a "family farmer." Although she has no savings, she has purchased a substantial amount of term life insurance to protect her family. Representative figures are shown in a footnote.<sup>40</sup> In this situation the life insurance proceeds will be part of the adjusted estate and be large relative to the adjusted value of the farm. Therefore, the special valuation may not be available.

This is a true trap for the unwary. What the farmer must do to assure the election will not be barred is substitute her non-farm property as collateral for the farm real property.<sup>41</sup> No sale or other event that could

39. I.R.C. § 2053(a)(4).

40. Assume the farmer's federal estate consists of:

<i>Farm:</i>	Value of Farm Personal Property	\$ 50,000
	Value of Farm Real Property	300,000
	Total Value of Farm Property	\$350,000
	Mortgage on Farm Real Property	(\$250,000)
	Adjusted value of all farm property, real and personal	\$100,000
	Adjusted value of farm real property alone	\$50,000
<i>Non-Farm</i>	Total value of other property (The bulk of this is assumed to be proceeds of life insurance includable in the estate)	100,001
	Total Adjusted Value of Gross Estate	\$200,001
<i>50/25 Percent Test:</i>		
	Percentage consisting of farm real or personal property	49.99%
	Percentage consisting of farm real property	24.99%

The farm will not be eligible for special valuation because the 50/25 percent test is not met.

41. A second technique will occur to many readers—making an inter vivos gift of the term life insurance policies to, say, an irrevocable trust for the benefit of the heirs. However, there is still a caveat. All gifts made after December 31, 1976 and within three years of death (together with any gift taxes paid with respect to those gifts) are includable in the decedent's estate irrespective of the decedent's intent (except to the extent such gifts are excluded by application of the annual \$3,000 per donee exclusion). Since a term policy has little value except as insurance, the payment of the annual premium by the decedent-donor in the years following the gift may be viewed as equivalent to a new gift of the policy for that year and, by extension, of the proceeds of the policy.

In practice, the \$3,000 exclusion is enough to solve this potential problem by a gift of cash to the donees of the policy followed by the payment by them of the premium, but few young

result in recognizing gains is required. This step may be taken by the farmer or, perhaps, by the executor. Since the alternative valuation date of section 2032 may be used with section 2032A, the executor may substitute collateral and then have the adjusted values determined as of a date up to six months later than death. The possibility of this form of post-mortem estate planning should not be ignored.<sup>42</sup>

Perceptive readers will have anticipated the potential bonanza: creating a "farmer" out of a city dweller by borrowing on the strength of non-farm assets and buying a farm "free and clear." In this way, an estate can be shifted into a farm so as to meet the 50/25 percent test and take full advantage of special valuation without recognizing gains on the other property. Again, a footnote gives a representative case.<sup>43</sup> I suggest estate planners should advise even the most adamant city dwellers to consider returning to the land. Of course, some city dwellers will not want to live on the farm, but they don't have to, which leads to the next set of conditions, those that focus on the decedent rather than the farm.

## 2. The Decedent's Ownership and Farming Activities

The idea of converting a city-dweller into a farmer for reasons of estate planning alone could raise a serious objection. The person in question may be allergic to hay, farm animals, sunshine or something else found on farms—or just despise farm animals, farms or farmers. Fortunately, there is no need for the decedent to go anywhere near the farm to obtain special valuation. After the 50/25 percent test, the only test that seeks to separate the statutory family farmer from lesser breeds is that of section 2032A(b)(1)(C). It requires that for five of the last eight years of the decedent's life (1) he owned the land, (2) it was farmed and (3) there was "material participation" by the decedent or a member of his close family<sup>44</sup> in the operation of the farm.

---

farmers will think of the need for making a gift of the policy to preserve the availability of special valuation or that there is any problem with special evaluation in the first place.

42. But see B.Y.U. Comment, *supra* note 4, at 427 arguing that the alternative valuation date would not be an available option because the basic formula computes the value by reference to the five most recent calendar years ending before the date of decedent's death.

The courts should not accept this position. The terms of the basic formula going to the most recent "calendar years" show that Congress was not concerned with computing the value as of the exact date of death.

43. Assume prospective decedent owns a city town house, an office building, an apartment house, paid-up life insurance, stocks, bonds and other property free and clear to the value of \$1,000,000. Decedent borrows \$500,000 on this collateral and buys farm real property worth \$500,000 free and clear. Under special valuation, this farm will be valued at \$250,000. Decedent barely meets the 50/25 percent test since the \$500,000 farm real property is 50% of the gross estate as is the farm real property.

The federal taxable estate would drop from \$1,000,000 to \$750,000 with special valuation, with a potential estate tax saving of \$97,500!

44. Note that while prior to death the farm must be farmed by decedent or a member of decedent's close family, after death it must be farmed by the heir or a member of the heir's

This condition permits many people to take advantage of the special valuation who do not fit into the traditional idea of a "family farmer." First, the decedent as an individual need only be the *owner* of the land, perhaps a lawyer in New York who has never seen the farm in California. The statute only requires that the owner or an ancestor, descendant, uncle, aunt, first cousin (no matter how often "removed") or the spouse of the owner or any such person meet the material participation standard. Finally, "material participation" does not require calloused hands. The statutory standard is that of section 1402(a) of the Code.<sup>45</sup> This section defines who is self-employed as a farmer as opposed to a mere landlord for purposes of the self-employment tax. The Service has been under pressure to make this standard *inclusive* so that as many people as possible will be subject to the self-employment tax. Without going into details, it is enough that the decedent or close family member participate in the management to a material extent in accordance with a corresponding arrangement. The member need not participate in farm production. Thus, to meet the first part of the test either the decedent must file a return as a self-employed farmer on the income from the farm or the close family member must file it on the fee paid by the decedent to that family member to manage the farm. To meet the second part of the test, the decedent or the close family member must participate in accordance with an "arrangement" in all management decisions by inspecting the crops, advising and consulting in, if not actually making, all decisions regarding the choice of crops, purchase of seed machinery and fertilizers, planting, insecticides, harvesting, and so on.<sup>46</sup>

---

close family. An uncle, aunt or first cousin of the decedent will be close enough family before death but not after death if the heir is, say, decedent's child.

45. I.R.C. § 2032A(e)(6).

46. The test has two aspects (1) an appropriate arrangement for participation and (2) actual participation:

"[I]f in addition to the understanding that the owner . . . is to advise or consult periodically with [the tenant] as to the production of the commodities and inspect periodically the production activities on the land, it is also understood that the owner is to select the type of crops and livestock to be produced and the type of machinery and implements to be furnished and to make decisions as to the rotation of crops, the arrangement will be treated as contemplating material participation of the owner . . . in the management of production of such commodities." Treas. Reg. § 1.1402(a)-4(b)(3)(iii) (1978).

If the owner does all that is contemplated by such an arrangement, he will meet the "actual participation" side of the test. [Treas. Reg. § 1.1402(a)-4(b)(4)]. To obtain an idea of the degree of actual participation necessary, compare Treas. Reg. § 1.1402(a)-6 Example (3) with Example (4).

Although § 1402(a)(1) has been amended to exclude an agent's activities in considering whether there is material participation by the owner, the regulations still say that the test for material participation by the owner is met if he employs an agent to inspect, consult and make decisions. These regulations are a trap for the unwary.



The degree of "material participation" required by section 1402 is an absurd standard for determining who is a family farmer. A wealthy Los Angeles lawyer living in Beverly Hills who flies to his farm in the central valley on weekends can qualify. Still, as far as Congress is concerned, he (and his heirs) can't beat God—he's a country boy.

I find it ironic that the tenant who lives on the farm and whose children actually do the farm chores will gain nothing by reason of the special valuation. Shouldn't Congress help the tenant's children to own the farm they and their parents have worked on all their lives? A suitable tax reform to this end would be to force the estates of farm owners to offer them for sale to the highest bidder. Thus, if the owner's children wanted to enjoy the advantages of family farming, they would have to outbid the tenant's children with no federal subsidy to help them. Since the tenant's children probably know more about farming and are willing to live on the farm, they would probably be able to outbid the owner's children. Still, the owner's children would suffer no loss in their own eyes. Unless the higher payment made by the tenant's children was worth more to the heirs than living on the farm themselves, they would have bid more.

This amendment is offered in jest. It is Congress' judgment that however much the tenants have *farmed* the land, they have not *owned* the land. While farm labor, in Congress' judgment, may not corrupt, it lacks the beneficent influence of ownership.

### 3. The Form of Intervivos Conveyance or Bequest

The last aspect for the decedent to consider are the conditions of special valuation that look to the form and substance of the transfer to the heirs. This aspect can be broken down into the questions of (a) coordination with the new, unified estate and gift tax; (b) avoiding conflicts of interest among the heirs with respect to special valuation; (c) dealing with concurrent and sequential gifts to donees who are not close family members; and (d) dealing with gifts in trust. My general conclusion is that whenever possible the farm should be left intact exclusively to close family members by life estates and remainders and not through trusts.

#### *a. Coordination With Unified Estate and Gift Tax*

A major change in the Tax Reform Act of 1976 is the unification of the gift and estate taxes. Under prior law, the tax rates on lifetime gifts were only three-fourths the estate tax rates and each donor enjoyed a \$30,000 lifetime exclusion.<sup>47</sup>

---

47. I.R.C. of 1954 § 2106(a)(3) repealed by the Tax Reform Act of 1976, § 2001(c)(F), effective January 1, 1976.

Under the present law, all lifetime gifts in excess of \$3,000 per donee per year are subject to the gift tax, but the donor may offset the tax by using up all or part of a lifetime credit that will grow in steps to \$47,000 in 1981. On the donor's death, the unused portion of the lifetime credit is used to offset estate taxes. In computing gift and estate taxes, one rate schedule is used, and each taxable gift (and the taxable estate) is, in effect, added to all previous taxable gifts cumulatively to determine the appropriate rate.

How does the unified gift/estate tax coordinate with the special valuation? *The key point is that special valuation does not apply for purposes of the gift tax.* Thus, for a farmer, the gift and estate taxes are not unified. For farms, inheritance is now favored over life-time gift. For example, suppose a farmer must choose whether to give his farm to his son as an *intervivos* gift or to leave it to him by will. The fair market value of the farm is \$1,000,000. Its special valuation is \$500,000.<sup>48</sup> If the farmer makes the lifetime gift, the gift taxes will be \$298,800. If he leaves the farm as an inheritance, taking advantage of the special valuation, the estate tax will be \$108,800, a saving of \$198,800!

This makes erroneous prior tax advice that sought to take advantage of lower gift tax rates and of income splitting to reduce aggregate family income taxes by creating family partnerships, trusts, corporations or co-ownership. It would seem that today the better course as far as transfer taxes are concerned is to limit any present gifts to what can pass under the \$3,000 per donee per year gift tax exclusion. The rest of the farm should be part of the estate.<sup>49</sup> The major advantage of this technique is special valuation, but a secondary advantage is deferring taxes. Since the estate tax is paid later than a gift tax, the decedent gains the interest element of the time-value of the money.

The only counter to this idea is income-splitting. The reduction in total family income taxes achieved by splitting the return-to-capital element of the farm profit among the family through a family partnership *might* outweigh the transfer tax saving. But, while this possibility exists in theory, recent low farm profits make it an unrealistic alternative. Sup-

---

48. For purposes of this example, all of the farm will be considered a taxable gift or as part of the farmer's taxable estate and the unified credit will be considered as \$47,000 for both the year of gift and the year of inheritance. The farmer is assumed to have no other property included in the taxable estate.

49. I.R.C. § 2032A only requires that the farm be subject to the federal estate tax, not that it pass by inheritance. The language of the 50/25% test speaks of property "acquired from or passed from the decedent to a qualified heir of the decedent," and the statutory history speaks of trusts with no distinction between living and testamentary trusts. *See* text following note 75 *infra*. Accordingly, the courts will probably hold the farm may be transferred by any form of transfer that leaves it subject to the estate tax. *E.g.*, by revocable living trust or *intervivos* gift of a remainder with a retained life estate by donor. The general unification of the gift and estate taxes under the Tax Reform Act of 1976 shows that Congress was disposed to treat wills and trusts evenhandedly.

pose a highly profitable farm is returning \$100,000 taxable income per year to capital after allowance of reasonable compensation for services rendered by the potential donor.<sup>50</sup> Splitting this taxable income equally among the farmer's own family and four second generation families might save as much as \$30,340 a year. To reach this result, however, one must assume that a farm netting \$100,000 a year after compensation for services is not worth so much that the gift taxes will be prohibitive.

In fact, such a farm would probably be worth well over \$5,000,000, a fair market value per acre of \$5,000 on 1,000 acres and a rental value, net of real estate taxes, of \$100 per acre. To achieve the approximately \$30,000 per year income tax saving would require taxable gifts of \$4,000,000 and a resulting federal gift tax, before the federal unified credit, of \$1,880,800. When California state gift taxes of roughly \$400,000 are added, even if the farmer's \$1,000,000 retained interest in the farm is still eligible for the special valuation, he is obtaining only a 1.5% return in income tax savings on his "investment" in gift taxes!

Thus, the effect of the special valuation in most cases is to make it highly advisable *not* to create family partnerships, corporations, beneficial interests in irrevocable trusts or other gifts of present interests in the farm, except to exploit the \$3,000 per donee per year exclusion. This is especially true because the old "best argument" for not doing so, the stepped-up basis obtained through leaving the farm in the estate, still applies to farms acquired by the decedent before January 1, 1977, to some extent. This best argument will, however, be attenuated with the passage of time.<sup>51</sup> The co-ordination of these new "carry-over basis" provisions of the 1976 Act with special valuation will be considered in the following part of this article.

It seems to me that this barrier to present gifts of farm property to family members is poor policy. If Congress' aim is to have land kept as farm land and in the farming family, there is no reason to favor inheritance over *intervivos* gift. Indeed, giving present interests in the land to the future generations would seem to be a better way to pass on the assumed advantage of farm ownership.

I think an amendment permitting special valuation for an *intervivos* gift that would have been entitled to special valuation if made by will would be a sound amendment. In effect, the farmer (and the farmer's estate) would be entitled to *one* special valuation between them. This

---

50. When a farm is divided among family members as a partnership, but the donor continues to work it, the Code requires the donor's services to be compensated. I.R.C. § 704(e)(2). This bars an anticipatory assignment of service income.

51. Under I.R.C. § 1023, on death the excess of the farm's value at death (or on the alternative valuation date) over the owner's adjusted basis is prorated by day over the decedent's holding period and the portion of the gain allocated to the portion of the holding period prior to January 1, 1977 is used to step up the farm's basis for purposes of determining gain. Thus, as time passes the fraction of the gain used to step up the basis will decrease.

would lead to little added complexity or administrative inconvenience, although the 50/25 percent test would have to be applied to the farmer's wealth at the time of gift. The fact that the gift tax is paid earlier would mean the bequest would have a time-value-of-money disadvantage for the farmer but this would be balanced by potential income-splitting advantages for profitable farms.

If the estate and gift taxes are to be unified, the unification should be complete. The amendment proposed would make the federal tax law more neutral as to the choice of *intervivos* gift or bequest.

*b. Avoiding Conflicts Among the Heirs With Respect to Special Valuation*

The problem of conflicts of interest among heirs is best explained by an example. Farmer leaves the farm to one child ("the farm child") and the residue of the estate to another child ("the cash child"). The residue is charged with the federal estate taxes. Electing special valuation will add greatly to the cash child's residual interest since all the tax savings will benefit the residual interest. On the other hand, electing special valuation reduces the value of the farm child's interest because to obtain special valuation the farm child must agree to be liable for the additional estate tax and the liability for that tax will be a lien on the farm.<sup>52</sup> The farm child's ability to convert the farm to other uses or to sell it will be restricted for fifteen years. Thus the statute practically guarantees a family conflict unless the benefit and burden are redistributed by careful estate planning so that they are borne equally by both children.

There are three ways this could be done: (1) both children could be given an equal fraction of both the farm and the cash; (2) the value of the cash and the farm gifts could be made approximately equal *after* the unequal benefit and burden of special valuation is taken into account;<sup>53</sup> or (3) the benefit and burden may be pro-rated by the executor by requiring the heirs to make appropriate agreements.

The first solution is easy, but it limits flexibility. It is likely a farmer will want to leave the farm to one child so as to avoid dividing it—compensating the other by other bequests.<sup>54</sup> The second solution assumes special valuation will be elected. While in many cases it will be obvious to all that it ought to be elected, it seems wiser to allow the heirs to decide after death whether election is a good idea or not. The third

---

52. I.R.C. § 6324B.

53. If this solution is adopted, the will must provide that unless the farm child agrees to special valuation, the cash child will be entitled to a portion of the farm child's bequest equal to the taxes that would have been saved by agreeing to the special valuation.

54. Alternatively the farmer could leave the farm in trust to one child for the equal benefit of both or adopt some other form of co-ownership with only one child doing the actual farming. I disapprove of these alternatives because they have a high likelihood of creating family conflicts between the active farmer child and the passive owner child.

solution permits flexibility but presents the decedent with a major problem—to what extent should the executor take into account the individual tax characteristics of the heirs?

To use the third method the decedent must assure that both the benefits and the burdens of special valuation are shared proportionately by each heir. To do this, the decedent must provide by will that if, in the executor's sole judgment, those benefits outweigh the burdens (considered independently of the tax brackets or individual tax characteristics of the heirs), then, any heir who will not agree to the special valuation is disinherited. This last provision would prevent an heir with a small interest from extorting a larger one by a "suicidal" refusal to agree.

The theory behind the method is clear, but how does one implement it? First, the burden of estate taxes should be prorated so that each heir bears a proportionate share. In the case of the farm child, this can be accomplished by having the executor borrow against the farm, on a non-recourse basis, the amount of the taxes prorated to the farm. This does not yet achieve equality, however, for section 2032A charges the farm child alone with liability for the "additional estate taxes" while the cash child goes free.

To achieve complete fairness, the cash child should be compelled to agree to partially indemnify the farm child if the additional estate tax is incurred so that the total tax burdens are proportional to the past benefits. The cash child would, of course, object on the grounds that the farm child will act alone in triggering the additional estate tax by converting or selling the farm but, of course, the farm child has a proportionate economic interest in not incurring the additional estate tax.

To achieve perfect fairness I think the best theoretical solution may be to provide that the executor hold the tax saving resulting from special valuation in trust for fifteen years to be used to pay the "additional estate tax" if the farm is converted or sold. After the potential liability disappears in fifteen years, the executor would distribute the trust to both children proportionately.

The method seems reasonable, but I must go on to explain why the executor should not attempt to take into account the heirs' individual tax characteristics.

### *c. Conflicts Among the Heirs Resulting From Their Individual Tax Situations*

In the last section of this article, I dealt with the problem of assuring equality among the heirs without taking into account their individual tax situations. The task of the decedent has been characterized as getting the estate into the hands of the heirs with the lowest possible estate taxes. This approach is inadequate. The future income taxes of the heirs will be affected by the lower estate taxes because their basis in the farm

will be reduced. To save a dollar in estate taxes may cost an heir more than a dollar in future income taxes.

Even though this is so, I do not know how the decedent's estate plan can solve this problem. It involves predictions as to whether the heirs or some of them will want to sell their farm interests and as to who will be the buyers. If the farm is never sold, a low basis in the farm land is of little consequence,<sup>55</sup> but the low basis will be very important if an heir wishes to sell. It is necessary to consider the coordination of the new, carry-over basis provisions of the code with special valuation.

#### (1) Co-ordination With the Carry-Over Basis Provisions

A major innovation of the 1976 Act is the use of a "carry-over" rather than a "stepped up" basis for inherited property. For example, if a farm had an adjusted basis of \$100,000 in the hands of the decedent but a fair market value of \$1,000,000 at his death, under the old rule of section 1014 the basis in the hands of the heirs would be "stepped up" to \$1,000,000. Under the new rule of section 1023, the starting point for figuring basis will be \$100,000. This "carry-over" basis will then be adjusted. Because the adjustments are different if the adjusted basis is being determined for purposes of determining a gain or a loss, the best way of dealing with them is to think of the property as having a "gain-adjusted basis" and a distinct "loss-adjusted basis."

The "gain adjusted basis" starts with \$100,000. If the decedent acquired the farm before January 1, 1977, one may then add the pre-January 1, 1977 appreciation, determined by taking the total appreciation (the actual value or the special valuation under section 2032A at the date of death less \$100,000) and multiplying this total appreciation by a fraction of which the numerator is the period the property was held before January 1, 1977 and the denominator is the total period the property was held.

While the applicable fraction will be the same whether or not special valuation is elected, the increase in basis will not. Section 1023 specifies that the "value of [the farm] (as determined with respect to the estate of the decedent . . . )" <sup>56</sup> is the starting point for the computation. Technically, this is ambiguous. Both the "fair market value" of the farm and the "use value" of the farm must be determined under section 2032A. Still, the Conference Report is perfectly clear:

For purposes of the basis adjustment the fair market value of property on that date of the decedent's death is to be determined under the special valuation for farms . . . if that rule is elected for estate

---

55. However, some of the farm real estate may be depreciable and the loss added basis will incur a tax cost through the loss of future depreciation by the heirs.

56. I.R.C. § 1023(h)(2)(A)(ii).

tax purposes (sec. 2032A) . . . .<sup>57</sup>

It is clear, then, that electing special valuation cuts down the step-up basis available for pre-1977 appreciation.

A second way that the farm's basis in the hands of the heirs is likely to be reduced by special valuation stems from the fact that since 1976 federal and state estate and inheritance taxes applicable to gain in the value of property may be added to the basis of inherited property.<sup>58</sup> Special valuation will reduce this adjustment in two ways, by reducing the "gain" and by reducing the estate taxes.

Finally, there is a third potential for loss of basis adjustment. The increases in the carry-over basis of the farm property (after taking into account the adjustment available for property acquired before January 1, 1977) are three:

- (a) An increase for Federal and State estate taxes attributable to appreciation discussed above,<sup>59</sup>
- (b) An increase to permit a \$60,000 minimum for bases of carry-over basis property,<sup>60</sup> and
- (c) A further increase in basis for certain state succession tax paid by transferee of property.<sup>61</sup>

However, none of these increases can be made if it would increase the basis of property above its "fair market value."<sup>62</sup> Again, the House Report is clear that "fair market value" for purposes of the limit is the special valuation, not actual fair market value.<sup>63</sup> It is possible to lose basis due to this limitation if special valuation is elected.

These three ways that basis may be lost, the pre-January 1, 1977 adjustment, the estate tax adjustment, and the fair market value limit lead to an important question: are there any circumstances where it would be advisable not to elect the special valuation so as to obtain a higher "gain adjusted basis" rather than save estate taxes? Consider a small estate left to two children. One is in a high income tax bracket and is likely to sell.

---

57. H.R. REP. NO. 94-1515, 94th Cong., 2d Sess. 613, *reprinted in* U.S. CODE CONG. & AD. NEWS 4118, 4252.

58. I.R.C. § 1023(e). This section is so written that by its literal terms the fraction of the total estate to be used to increase the basis would be calculated by reference to the farm's "fair market value," not its special valuation. However, the House Report speaks of "fair market value" as being the value for Federal estate tax purposes and expressly provides that if special valuation is used for estate tax purposes it is also used to determine the property's appreciation for making basis adjustments. H.R. REP. NO. 94-1380, 2d Sess. 39, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3393.

It is amusing to find a statute written using a technical term, "fair market value," whose universally accepted meaning is not applicable because the true meaning appears in a Congressional report!

59. I.R.C. § 1023(c).

60. I.R.C. § 1023(d).

61. I.R.C. § 1023(e).

62. I.R.C. § 1023(f)(1).

63. H.R. REP. NO. 1380, 94th Cong., 2d Sess. 39, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3393.

The second is in a low bracket and is not interested in selling. The saved estate taxes are low, the potential to save income taxes seems great. A footnote gives an illustrative case.<sup>64</sup> Initially, it seems an answer that the heirs are as well off if they make the special valuation even if a subsequent sale is likely. After all, the principle of the additional estate tax is to impose a tax no greater than the saved estate taxes. Thus the heirs seem to be in a position where they can't lose from the election—and stand to gain something because the disposition tax will be paid later than the estate tax. In effect, they will have an advantage of the “time-value of money.”

If only the problem were that simple! First, if the heirs elect the special valuation and subsequently sell and pay the additional estate tax, there is nothing in the code that permits them to go back and increase the carryover basis by the additional estate tax! The addition to the carryover basis is figured from the decedent's estate tax return, not from the return of the additional estate tax.<sup>65</sup> Thus, while from section 2032A's language it seems that the heirs will be left where they would have been without special valuation, the appearance is very misleading. The farm's adjusted basis would remain at the level set by the decedent's estate taxes.

A second problem is that a subsequent sale need not be a *disqualifying* sale if it is made to a close family member of the seller who will continue farming. Thus, there may be liability for the income tax but no additional estate tax.

For example, suppose a decedent leaves his farm equally to two children. One intends to stay on the farm, the other is a doctor with no desire to farm. They agree that the farmer child will buy out the doctor child. It is then necessary to make a computation of the potential in-

---

64. Assume the farm is worth \$1 million at death but special valuation gives it a federal estate tax valuation of \$500,000, saving \$150,000 in estate taxes. Assume the farm was purchased for \$100,000 on January 1, 1947 and the death occurred on January 1, 1987. The approximate new basis of the farm if special valuation is *not* elected is \$1,000,000—the sum of the \$100,000 original basis plus three-fourths of the appreciation between January 1, 1947 and January 1, 1987 (\$675,000) plus federal estate taxes (\$345,800) but not to exceed \$1,000,000. In making this computation, I have assumed the credit has been used up against lifetime gifts and there are either no state estate or inheritance taxes or they are all creditable against the federal tax.

The new basis of the farm if special valuation is elected is much lower, the sum of the \$100,000 original basis plus three-fourths of the \$400,000 appreciation that results from special valuation plus federal taxes of \$155,800. Thus the new basis before considering state estate taxes is only \$555,800. Thus, assuming there is no credit or state estate, inheritance or succession taxes, there is \$444,200 basis lost by the special valuation.

Going to the bottom line, if special valuation was elected and the heir sells the farm outside the family, the sum of the additional estate tax and the income taxes, assuming a 25% rate, is \$301,050 as compared to the \$150,000 estate tax saving.

65. Section 1023(c) provides for an increase to basis for “Federal and State estate taxes attributable to appreciation.” Federal estate taxes are defined in § 1023(f)(3) as the taxes imposed by § 2001 or § 2101. The additional estate tax is imposed by § 2032A(c)(1) itself.



come taxes the doctor child would save on the subsequent sale by not making the election. If they are greater than the estate tax savings, the children should not make the election but rather should agree to share the tax advantage by adjusting the sale price of the doctor's share of the farm.

## (2) Returning to Conflicts Among the Heirs

Suppose one child's individual tax situation makes it desirable to take the high basis and the other's makes it desirable to take the low estate tax. How can the executor solve the conflict? I recommend the executor be instructed to minimize the estate taxes considered alone unless all the children agree not to elect special valuation. I admit that this means the children will be left to resolve the conflict themselves, and their negotiations will be made extremely difficult by the fact that each will know approximately what the other has to gain or lose, but the executor cannot estimate realistically the children's tax situations. Only they know their own intentions as to the farm and can accurately predict their future tax brackets. The executor should not be required to guess.

### *d. Dealing With Concurrent and Sequential Gifts to Donees Who Are Not Close Family*

The next aspect of special valuation the tax planner must understand is to whom the farm must pass. The form by which the farm must be passed through the estate (by will or a grantor trust as opposed to *intervivos* gift) has been discussed above.<sup>66</sup> The question here is to what extent concurrent or successive interests in devisees who are not close family members may be created before special valuation is lost. The question will be asked first for legal interest and then for interests created by trust.

The starting point is the statutory provisions that restrict the special valuation by reference to the relationship of the donee to the decedent. The only statutory provisions that speak directly to who must get the farm are:

- (a) 50 percent or more of the adjusted value of the gross estate consists of the adjusted value of real or personal property (used for farming) which goes to a qualified heir, and
- (b) 25 percent or more of the adjusted value of the gross estate consists of the adjusted value of real property which (goes to) a qualified heir.<sup>67</sup>

These conditions have already been identified as the "50/25 percent test."

---

66. See note 48 *supra*.

67. I.R.C. § 2032A(b)(1)(A) and (B).

### (1) Concurrent Legal Interests

It would seem that under the literal terms of the statute, if any estate consisted entirely of a farm, and half the farm (divided by value) was left to a child and half was left to a complete stranger, special valuation would still be available for the whole farm! There is no general statutory provision expressly requiring all the "qualified real property" to be specially valued to go to the close family, although there are statements to that effect in the legislative history.<sup>68</sup>

To permit gifts to strangers to be entitled to special valuation is inconsistent with the statutory purpose, but, of itself, has little practical importance. I doubt any farmer plans to leave a farm to a stranger.<sup>69</sup> However, there is only one serious, practical problem.

Suppose a farmer has a stepchild. He has raised the stepchild as his own and the stepchild has lived on and worked on the farm all his life. The statute classifies the stepchild as a complete stranger!<sup>70</sup>

This is a strange result, brought about by the statute adopting an anachronism, a "blood-line" definition of the family rather than the social definition of people who live together.<sup>71</sup> I find this inconsistent with the policy of the statute. A family farm is a social unit, not a legal formality. In the above example, whatever magic there is about family farms has happened to the stepchild. In contrast to that stepchild, consider a child of the farmer born of a marriage dissolved long before the decedent became a farmer. This child has been raised exclusively by the farmer's former spouse who has been a lawyer in the big city, and hates farms, farming and farmers. Such a child is a "stranger" to the farm in fact, but not in the eyes of Congress.

The prevalence of stepchildren means that the problem of whether the statute really permits concurrent interests in a stranger must be answered.<sup>72</sup> The question is whether the statute means that special valua-

---

68. "[T]he real property qualifying for special use valuation must pass to a qualified heir." House Report 1380, *supra* note 5, at 22, & 3376. See also Senate Report 938, *supra* note 5, at 15, & 4041.

69. The B.Y.U. Comment, *supra* note 4, criticizes Congress for permitting gifts to a relative as distant as a first cousin twice removed. A more thoughtful criticism would be that any restraint on who may be the heir to the farmer is silly. Farmers are very unlikely to give farms outside their families (defined in a social as opposed to blood-line sense) just to tease Congress.

70. I.R.C. § 2032A(e)(2) defining "member of the family" provides that qualified heirs are "only [the decedent's] ancestor or lineal descendant, a lineal descendant of a grandparent of such individual, the spouse of such individual or the spouse of any such descendant."

It seems ironic that while a father cannot leave the farm to his stepchild, his own child may do so if born of the same mother!

71. As a scholar I anxiously await a challenge by the IRS based on an heir being the biological child of a postman, but I am sure no such claim will ever be made.

72. To raise this issue properly, the farmer would leave the stepchild so little of the farm, that the rest of the farm, going to a "qualified heir," would result in the whole farm passing the 50/25% test. Thus the farmer seeks to pass the 50/25% test while still leaving part of the farm to a statutory stranger.

tion is available for the whole farm or none of it depending on the 50/25 percent test as applied to the whole estate; or that special valuation is not available to the portion going to the stepchild in any case.

While the language of the first part of the statute supports the first interpretation, this interpretation is utterly inconsistent with both the legislative history and that part of the statute that deals with the additional estate tax. Potential liability for the additional estate tax is only imposed on "qualified heirs," not on strangers like the stepchild. It is only made absolute when the "qualified heir" ceases farm use or disposes of the land outside his or her close family. Thus, to let any farm real property that enjoyed special valuation reach a stranger would seem to free it from the fifteen year family farm use requirement. Although the government would grant a tax subsidy, it would get no quid-pro-quo.

On the other hand, the agreement of "each person in being who has an interest" in qualified real property is required for the election to be made,<sup>73</sup> not "each qualified heir," so it would seem Congress thought some interests would go to those outside the family. Nevertheless, at least in the case of *concurrent* interests the non-family person would be agreeing to the imposition of no personal liability—for only the qualified heir is made liable—and therefore to no lien. Therefore, in the case of concurrent interests there is no agreement for such a person to make!

It is this counterargument that introduces the possibility of different treatments for concurrent and successive interests. While the agreement of a non-family member is meaningless for a concurrent interest, it would be meaningful if the non-family member's followed that of the qualified heir in time. In this situation the non-family member would be agreeing to the imposition of the lien. Thus, if the successive interest in the unqualified heir became possessory within fifteen years after decedent's death, the qualified heir would "cease to use for the qualified use the qualified real property" and the unqualified heir would run the risk of having the interest sold for taxes,<sup>74</sup> but not of personal liability.

The better conclusion is that no concurrent interest, legal or equitable, should be permitted to piggy-back to special valuation. Thus, if a small field is left to a faithful, but unrelated, retainer, that small field should be valued at full fair market value, and the rest of the farm going to close family valued by special valuation, even though this common sense idea is not in accordance with the precise language of the statute. I

---

73. I.R.C. § 2032A(a)(1)(B) & (d)(2).

74. An interesting question is whether the non-qualified successor heir could sue the prior qualified heir for the loss in this event on the grounds that the liability for the additional estate tax is personal to that heir. This question should be resolved by agreement among the heirs, the successor refusing to "agree" with the government unless the qualified heir agrees to liability to the successor too.

am afraid that stepchildren must not look to their step-parents for inheritances of farms.

## (2) Sequential Legal Interests

The next dimension to the problem is that of sequential interests. These will be taken up first as a matter of life estates and then as a question of trusts.

Suppose a farmer leaves the farm to a child for life, remainders to the child's issue living at the child's death per stripes, but if the child dies without leaving issue then, to the University of California. Is the farm entitled to special valuation?

This is essentially the same question as was raised for concurrent possessory interests. Under the literal terms of the statute, the first reading, at the farmer's death the interests of the son and his issue would be weighed against those of the University of California to see if the 50/25 percent test is met for the entire farm. In contrast, under the second reading, the portion of the total value of the farm allocable to the University of California as of that time should be carved out and denied special valuation.

Here the fact that the interest of the University cannot be readily ascertained, partitioned or measured out by metes and bounds leads me to favor the first interpretation—because the quid-pro-quo will not fail. The University could agree to the imposition of the federal lien for additional estate taxes and to its enforcement if its interest became absolute within the fifteen year period and the qualified heir did not pay them. This would fully protect the interests of the United States. However, the University would never make such an agreement unless it were compelled to do so. Again, a will or trust that is set up to take advantage of special valuation should state that if the executor (or trustee) elects special valuation, each beneficiary must make such agreements as the executor requests or lose his or her beneficial interests.

However, I doubt the present statute will be interpreted to permit such devices, sensible as they are. Accordingly, I advise against creating any interests in unqualified heirs, concurrent or sequential.

The statute should be amended to permit charitable remainder interests expressly. A bequest to a charity is not part of the decedent's taxable estate, so there is no reason to seek an additional estate tax if a farm actually goes from the close family to the charity within or without the fifteen year period. The foregoing discussion will now be expanded to deal with beneficial interests in a trust.

### (3) Equitable Interests

Although the trust is an ancient and familiar device, in drafting section 2032A Congress neglected it. The statute itself speaks as though legal title, not beneficial interest, is the test and the government could be cheated out of its quid-pro-quo by the simple device of leaving land in fee to a qualified heir as trustee for the benefit of "Fifi LaFlame," "Studs Rockhard" or some other notorious interloper.<sup>75</sup> This statutory omission is of academic interest only. Although I will be watching the advance sheets for an interesting set of facts, I doubt any farmer is anxiously waiting to make such a bequest.

A more pressing problem is that of giving legal title to an unqualified heir, to a bank, for instance, for the benefit of the farmer's minor children. Under the literal terms of the statute such a devise would bar special valuation. Congress seems to have grasped the importance of permitting such gifts at the last minute. The use of such a trust can actually preserve the family farm by restricting the power of alienation, protecting against claims of creditors and so on.

Congress chose not to amend the statute, but to provide a bit of legislative history to correct the omission. The Conference Committee added two important sentences of legislative history:

The conferees intend to make it clear that the rules for special valuation apply to property which passes in trust. Trust property shall be deemed to have passed from the decedent to a qualified heir to the extent that the qualified heir has a present interest in that trust property.<sup>76</sup>

Note that the legislative history does not expressly require a "present *beneficial* interest." Accordingly, the theoretical possibility of a gift to a qualified heir as trustee for the benefit of a stranger is still open. It is only the second problem, that of the stranger-trustee that Congress seems to have considered.

The solution seems plain enough. A gift to bank X in trust for the present benefit of a qualified heir is to be judged as a gift to the qualified heir. The qualified heir would still have to use the farm as a farm for fifteen years, and, of course, both the trustee and the qualified heir (or his or her guardian) would have to sign agreements as conditions to the election. The qualified heir would agree to personal liability and to the lien. The trustee should be required to agree to the lien, and to liability as trustee to the extent of other trust property acquired from the decedent so as to provide the government with no less assurance of payment

---

75. The beneficial interest going to the stranger would have to be counted under the 50/25% test because it would have a value. Accordingly, the stranger would not be able to gain the beneficial interest in more than half the farm in any case.

76. H.R. REP. NO. 94-1515, 94th Cong., 2d Sess. 610, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4249. [hereinafter "Conference Report"].

of the additional taxes than it would have if all went to the qualified heir in fee. It would be a good idea for the trust instrument or will expressly to give discretionary power to the bank to make such agreements.

But the Conference Committee's solution creates its own problem in the area of successive equitable interests. Suppose decedent leaves the farm to lawyer X in trust for his son for life, remainders to grandchildren. The son is 80 years old. Can the 50/25 percent test be met?

If the interests of the grandchildren are classified as interests of unqualified heirs because they are not "present," they may well outweigh those of the son. One could read the legislative history to mean that the 80 year old son is the only "qualified heir" since his is the only *present* interest.

Clearly there is no policy reason to bar the special valuation under these circumstances. The courts should note that the legislative history does not expressly exclude close family members holding future interests from being qualified heirs and consider them as such if their interests follow those of other qualified heirs.

I believe this addition is not only consistent with the legislative history but also necessary to implement the policy of special valuation. Before drafting such an estate plan, however, I would seek a ruling from the Service. My own opinion is that whoever wrote that piece of legislative history meant to say "beneficial interest" not "present interest" but blundered.

*e. Co-ordination With the "Generation Skipping Transfer Tax"*

Until now I have considered gifts to children alone, only worrying about grandchildren when considering a trust with a beneficial life estate in the child followed by interests in the grandchild. This last form of devise triggers an immediate concern for the new federal transfer tax, the Generation Skipping Transfer Tax of sections 2601-2614. The problem is simple. Section 2032A makes special valuation available for Chapter 11, the estate tax only. Chapter 13 of the Code, imposing the generation skipping transfer tax, says nothing of section 2032A. Therefore, a gift to the children for life, remainders to the grandchildren may result in more total transfer taxes than two successive gifts of parent to child and child to grandchild because special valuation will not be available for the "deemed" transfer from children to grandchildren on the lapse of the life estate.

Just how serious is this problem? The new generation skipping transfer tax does not apply to the first \$250,000 shifting from each "deemed" transferor.<sup>77</sup> Therefore, if one is confident the sum of the farm and other

---

77. I.R.C. § 2613(b)(6).

property being left to each child for life, remainders to the grandchildren, will be less than \$250,000 when that child dies—and confident that the law will not be changed—there is nothing to worry about.

In most cases, however, a painstaking comparison must be made of the relative tax advantages of skipping a generation against the advantages of using special valuation. The comparison will be difficult because calculating these figures requires an estimate of when heirs will die, how much the farm will then be worth, how large their taxable estates will be, and whether special valuation will be available at that time. But I feel confident that unless the calculations are made, based on the client's best guesses, and the client decides which way to go, there will be claims by grandchildren that the estate planner negligently failed to warn the client that the special valuation is not available for the generation skipping transfer. The key point is not just that there is a problem, but that it is the type of problem only solved by taking it to the client. If gambles on the future are to be made, it is for the client to make them.

Lest the task of estimating relative tax advantages seem easy, note that the generation skipping transfer tax like the additional estate tax cannot be used to increase the basis of the farm as can estate taxes.<sup>78</sup> The problem of coordinating the now coordinated estate/generation skipping transfer taxes with the carry-over basis provisions adds a whole new dimension, the grandchildren's income tax situations. The level of complexity is now something on the order of three dimensional chess. I feel the only practical approach is to tackle situations on a case by case basis.

#### IV. CONCLUSION

To conclude this article, I offer a series of criticisms of section 2032A. The first is based on the premise that it is the wisest of tax reforms, the last, on my own opinion.

Even if one believes wholeheartedly that section 2032A will save and preserve all family farms and, with them, the fabric of our society, one must acknowledge that it is not well integrated with the other provisions of the Tax Reform Act of 1976. The unification of the gift and estate taxes, the new carry-over basis provisions and the generation skipping transfer tax all create situations where the combined result of these new provisions and section 2032A seem to conflict with the policies of both. For example, creating a barrier to *inter vivos* gifts of farm property to children does nothing to preserve family farms. Indeed, this form of conveyance would seem to encourage them.

---

78. See note 64 *supra*.

I think the answer is that those who were responsible for drafting section 2032A viewed it only in the context of the law prior to the Tax Reform Act of 1976.<sup>79</sup> If this was so, then it is likely that the task of integration will be taken up by some future Congress. The resulting amendments may require a complete revision of estate plans made on the basis of the present law.

On a second level of criticism, one may object to one aspect of the valuation formula, the exclusion of the increment of value due to expected increases in future farm profits. Of course, there are no assurances future profits will go up, or go down, or stay the same. All valuations are "speculative," but expectations as to future profits form the basis for people paying enhanced prices for farm land—and such payments are the best predictive device known. It is unfair to let farm land be valued below the best available prediction of its use value.

A third position is that family farms should be subsidized, but that section 2032A may not be the best way to do so. Consider the following argument. Section 2032A represents a tax expenditure, a subsidy for family farms of a certain amount of the public's wealth.<sup>80</sup> Much of the subsidy will be drained off by smart doctors, lawyers, accountants, dentists and other rich people who have a large estate and clever estate planner. The pathway to the estate tax shelter has been traced by this article. There is no need for the client to recognize gains or to get calloused hands. Much of what is left to the subsidy will go to farmers who have no estate tax liquidity problem. Their farms would be preserved for their families without this form of tax relief.

On the other hand, none of this subsidy will reach many of the family farms that are in trouble today. For some, there will be no federal estate tax because they are already mortgaged to the hilt. For others the tax relief will be too late. The family will have been forced off the farm long before the current generation of farmers dies. Section 2032A, therefore, helps those most who need help least. The bulk of the tax expenditure is wasted.

On a fourth level, one may agree that estate tax relief is an appropriate way to preserve farms, but disagree with its notion of hereditary privilege. The estate tax reduction rewards families lucky enough to own farms now and is therefore a barrier to farm ownership for all the other people who want to become farm owners, although they are not

---

79. The B.Y.U. Comment, *supra* note 4, appears to suffer from the same failing, but it is an excellent treatment of § 2032A in isolation.

80. The fiscal 1978 revenue loss from § 2032A was estimated at only \$14 million. House Report 1380, *supra* note 5, at 8, & 3362.

Since § 2032A is a provision that permits planning so that maximum advantage may be taken of it, and five years is the minimum statutory period to convert, say, a stockbroker into a family farmer, this estimate is probably accurate but irrelevant. It reflects the revenue loss in a year in which planning will not have made its effect felt.



barred from becoming farm laborers. Tax breaks should not follow blood lines. A disproportionate number of the blood lines of present farm owners are European. Facetiously, I argued to a colleague that section 2032A will be the grounds of the first case to challenge a federal statute under the "titles of nobility" provision of the United States Constitution. Of course there is no title as such, but there is a hereditary privilege.

Finally, my own personal view is that farmers are no better and no worse than anyone else and deserve no special favors. If farms are broken up, other farmers buy them, or, if they are sold to developers, other land will be left undeveloped. If it will not, then Congress is encouraging the current housing shortage that is hurting laborers more, I think, than estate taxes are hurting well-to-do farmers. The whole intellectual basis of section 2032A is a fallacy—an attractive fallacy—but a fallacy nevertheless.

I hope that section 2032A will have a short life. I know that however short or long its life will be, that life will be characterized by frustration and error on the part of the tax planners who seek to take advantage of it. I find that knowledge some consolation.

