

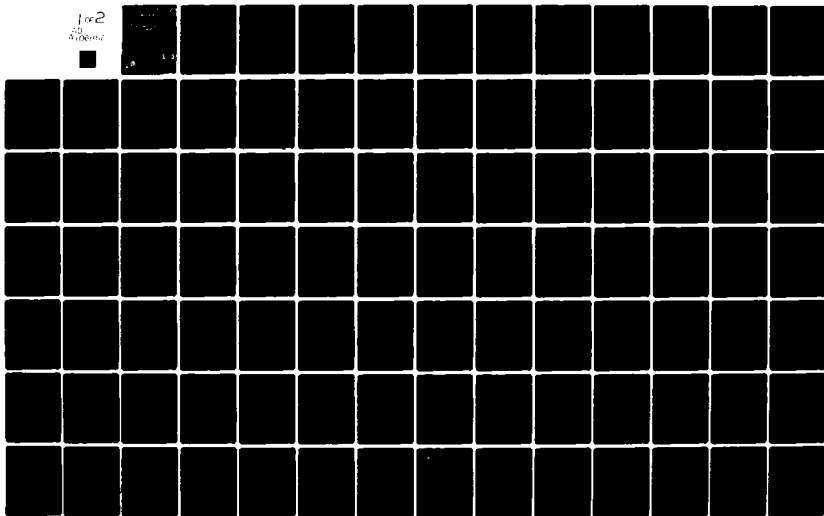
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GENERAL ACCOUNTING OFFICE WASHINGTON DC PROGRAM ANAL--ETC F/6 5/4  
SPECIAL ESTATE TAX PROVISIONS FOR FARMERS SHOULD BE SIMPLIFIED --ETC(U)  
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REPORT BY THE

# Comptroller General

OF THE UNITED STATES

## Special Estate Tax Provisions For Farmers Should Be Simplified To Achieve Fair Distribution Of Benefits.

In 1976 the Congress added two provisions to the Internal Revenue Code to prevent the forced sale of family farms to pay Federal estate taxes. One provision (section 6166) allows farm executors to take more time to pay estate taxes and the other (section 2032A) allows them to reduce the taxable value of farmland in estates.

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GAO evaluated these provisions and found that while they have reduced tax burdens on farm estates, they have not helped to halt the decline of family farming. This evaluation was conducted prior to enactment of the Economic Recovery Tax Act of 1981. Estate taxes appear to have little to do with decisions to sell family farms; GAO found no case in which estate taxes had prompted the sale of a farm. GAO also found that special use valuation is difficult to administer and comply with, its complexity has tended to restrict its use to wealthy estates, farm estates with substantial value in equipment and buildings benefit less than estates with land composing a greater share of value, the majority of its benefits are claimed by a small fraction of all farm estates, and farmers in different regions of the country are not equally able to take advantage of it. The Tax Act of 1981, however, reduces the Federal estate tax for all estates. Now fewer small farm estates will elect the provision.

GAO recommends that the Congress replace the special use valuation with an expanded and simplified version of the extended payment provision or with a flat exclusion of a specified part of farm assets.

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COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON D.C. 20548

B-204175

The Honorable Dan Rostenkowski  
Chairman, Committee on Ways and Means  
House of Representatives

The Honorable Robert J. Dole  
Chairman, Committee on Finance  
United States Senate

This report examines two provisions added to the Federal estate tax law by the Tax Reform Act of 1976 to help farm families retain farmland after the death of the owner. We made this review to determine whether the two special provisions have been effective in promoting the stated congressional objective of reducing the number of family farms sold to pay estate taxes. Information from this report was previously provided to your committees in the consideration of the Economic Recovery Tax Act of 1981.

We are sending copies of this report to the Director, Office of Management and Budget, the Secretary of Agriculture, and the Secretary of the Treasury.

*Shilton J. Jordan*  
Acting Comptroller General  
of the United States

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REPORT BY THE  
COMPTROLLER GENERAL  
OF THE UNITED STATES

SPECIAL ESTATE TAX PROVISIONS  
FOR FARMERS SHOULD BE SIMPLIFIED  
TO ACHIEVE FAIR DISTRIBUTION OF  
BENEFITS

D I G E S T

Despite hopes to the contrary, Federal estate tax provisions of the Internal Revenue Code--specifically the "special use valuation" and deferred and installment payment provisions--have not helped stem the decline of the small family farm. Special use valuation, in fact, may have added to the difficulties that already beset small farmers. The provisions are difficult for farmers and their heirs to understand and for the Internal Revenue Service to administer. The provisions risk inciting nonfarmers to purchase farmland, driving up its price and aggravating the very tendencies that the provisions were intended to alleviate. The tax savings are unevenly distributed among regions of the country and among farmers in different financial brackets. The complexity of the provisions tends to restrict their use to wealthier farmers since the complexity leads to higher estate administrative costs and risks of audit. Small farms continue to go out of operation despite the tax savings that the two provisions offer. In response to widespread complaints that the Federal estate tax unfairly burdened and forced sales of small farm estates, special use valuation (section 2032A) and deferred and installment payment provisions (section 6166, as enacted) were included in the Tax Reform Act of 1976. A portion of the Federal estate tax is now forgiven through section 2032A.

The Economic Recovery Tax Act of 1981 (ERTA) will have lessened the need for the two special estate tax provisions because it increases the unified credit to \$600,000 over a period of 6 years and provides for an unlimited marital deduction. If couples use proper estate planning, they will be able to leave tax-free estates worth \$1.2 million to heirs by the mid-1980s. The larger amounts that can be left at death and not have Federal tax paid will result in many small farm estates not having to elect special use valuation and achieving the additional tax benefits from reduced farmland valuation. The new act also consolidates the

more liberal provisions for deferred payment of estate tax owed that existed separately in the Tax Reform Act of 1976. However, small family-owned farms will still face the operating problems discussed in this report.

#### OBJECTIVES, SCOPE, AND METHODOLOGY

This study was undertaken to evaluate the effects of sections 2032A and 6166 that are intended to benefit family farms. By examining the justifications presented to the Congress on behalf of these provisions, analyzing their actual effects, and determining whether they need to be modified to improve their effectiveness, the General Accounting Office intends to point out the complications entailed in trying to aid a particular group of people through tax policy measures, especially those using the estate and gift taxes. By favoring farm estates over other estates, the two provisions induce nonfarmers to invest in farmland beyond that which now occurs. Further, the benefits of the two provisions do not reach the intended beneficiaries. Relatively large farms are deriving greater benefits (in terms of tax savings) than smaller farms, and regional differences in farmland rental practices are affecting the distribution of benefits.

GAO analyzed almost 600 Federal estate tax returns filed between 1977 and 1979 containing valid elections of section 2032A. Of these returns, 175 were randomly selected from all returns filed with reported elections of section 2032A. The remaining returns were examined during GAO's survey of target agricultural States (see appendix II). The GAO also interviewed farmers now operating farms; recent inheritors of farm estates (including several who did not use the section 2032A election); attorneys, accountants, and bank trust officers involved in farm estate probate proceedings; and IRS and Treasury Department officials. (Tax return data on elections of deferred and installment payments, section 6166, were limited, preventing detailed analysis of this provision. Chapter 2 and appendix II discuss these limitations. The GAO did compare the use of a revised section 6166 with section 2032A as an alternative for solving the farm estate's liquidity problems and ease of administration. See pp. 2-3.)

ORIGINS OF SPECIAL USE VALUATION  
AND DEFERRED AND INSTALLMENT  
PAYMENT PROVISIONS

Special use valuation and deferred and installment payment were enacted in response to two major complaints concerning the estate tax treatment of farm estates. First, advocates of these provisions argued that farm estates were unfairly taxed since they were inherently less liquid than other classes of estates. Second, advocates argued that the sale of family farms to meet estate taxes is contrary to an overriding public goal of encouraging family farms. (See pp. 11-12.)

Little reliable evidence supports the view that farm estates shoulder an unfair estate tax burden. Any class of asset is liable to a sale forced by estate taxes. Of all farm sales, 15 percent are estate executors' and administrators' sales. This share has remained stable over the last decade, despite the increasing illiquidity of farm estates as farmland increased in value compared to a relatively unchanging level of readily marketable or liquid assets. Farm economics seem much more responsible for the failures of small family farms than does the Federal estate tax. Even if farms do not bear a unique estate tax burden, the forced sale of any small family farm is contrary to a long-held policy of fostering family farming. Throughout American history, the family farm has held a valued position as a social model and economic force. This policy provides a stronger foundation for special treatment of farm estates than the fairness argument does. (See pp. 16-18.)

OPERATION OF THE SPECIAL  
FARM PROVISIONS

Special use valuation, which is a potential source of sizable tax savings for qualifying estates, is a highly complex provision. By lowering the value of an estate below its fair market value, the provision lowers the tax owed by the estate. (See pp. 21 and 33.)

To elect special use valuation a farm estate executor must establish that the decedent-owner maintained a "material participation" in the farm operation before his or her death. No absolute test of material participation exists,

however, so this requirement can create unforeseeable difficulties. Material participation by the inheritors must continue beyond the decedent's death. A full discussion of the provision is in chapter 2.

Section 2032A specifies a preferred rent capitalization formula for valuing an estate, but differences among regions in the country in typical rental arrangements have caused regional differences in the provision's use. ERTA now permits comparable crop-share rentals to be used to calculate the section 2032A value when cash rentals do not exist. (See pp. 25-26 and appendix III.)

Deferred installment payments of estate taxes provide an easy way for an inheritor of farm property (or a closely-held business) to postpone the tax for 5 years and then to pay the tax in 10 years. The tax bill is subject to a below-market interest rate of 4 percent. This provision's qualification requirements are more easily met than those for special use valuation. Furthermore, the provision and its election are not affected by regional differences in farmland markets or rental practices. The deferred and installment payment provision should be much easier to elect and to administer. (See pp. 37-38.)

#### CONSEQUENCES OF SPECIAL USE VALUATION

Electing special use valuation can reduce an estate's tax substantially. Reductions in property value typically are 40 to 70 percent of the fair market value of an estate. GAO found that on average each estate electing section 2032A saved \$59,000 in estate taxes. The share of each estate that was consumed in payment of the Federal estate tax (i.e., the effective tax rate) was cut almost in half. Not all farm estates, however, save as much from special use valuation. Large farms generally save more than small farms. As a fraction of the initial tax liability, however, the tax saving becomes relatively less important for large estates, apparently because of the limit on the deduction attributable to special use valuation. (See pp. 28-32.)

Even at this early stage of experience with special use valuation, questions have arisen concerning its ultimate effect on agriculture. All observers agree that special use valuation

creates a substantial tax saving when elected. GAO's review bears this out. In addition to the direct effect of a tax saving, though, the provision may have indirect effects that would not encourage small family farms to continue. Farmland may have become more attractive as an estate tax shelter, increasing existing incentives for nonfarmers to invest in farmland and become "tax farmers." Farm owners who already own land have a greater incentive to expand their landholdings. These investment purchases will increase the price of farmland and increase the barriers confronting tenant and newly starting farmers who do not own land. Land ownership, which has become increasingly concentrated in recent years, may become even more so under special use valuation. (See pp. 24-26.)

#### CONCLUSIONS AND RECOMMENDATIONS

The Congress should consider alternatives to the current provision. While alternatives probably cannot avoid all the problems of special use valuation, they can make it easier for inheritors to benefit and less costly for IRS to administer. (See chapter 7.)

GAO recommends that the Congress give an estate tax preference to farmers only through the tax deferral provision, with or without installment payment privileges, and repeal special use valuation. This would greatly simplify the assistance given to farm estates that incur an estate tax liability. (See pp. 53-54.)

Since the Congress retained special use valuation in ERTA, GAO recommends, as an alternative, that the section and its administration be simplified by substituting a simple exclusion of a fixed fraction of the farm estate. This would eliminate many of the problems of establishing a section 2032A value. It would also extend the benefits of special use valuation to farm estates that are composed mostly of equipment and machinery rather than farmland. (See pp. 54-55.)

#### AGENCY COMMENTS

GAO provided the Department of Agriculture, the Department of the Treasury, and the Internal Revenue Service copies of the draft report. The draft report was provided, and the comments



received, prior to passage of ERTA. Only the Department of Agriculture commented on GAO's recommendations and preferred the second alternative, with reservations. Agriculture felt that GAO's first recommendation--eliminating the special use valuation law in favor of an extended tax deferral--was less desirable to a farmer than a direct tax reduction. (See p. 55.)

Postponing the payment of a tax liability and then paying it by installments over an extended period, with low or no interest charged, amounts to receiving a "tax loan" from the Government. The length of the postponement and the interest rate that the farmer is charged can be adjusted by the Congress. (See pp. 53-54.)

The IRS emphasized that the continuing decline in the number of family-owned farms is not conclusive evidence that the special estate tax provisions have not worked. GAO recognizes that farmers face a wide range of economic, technological, and operating problems. Changes in estate tax valuation cannot alter the financial incentives and advances in farm technologies that produce these pressures to expand farms. Special use valuation has not helped stop the decline of family farms in American agriculture. Furthermore, the possible estate tax savings may push up farmland prices, lessening opportunities for small farms to establish or expand their operation. Also, the complexities of the estate tax provisions limit their use to wealthier estates.

The Treasury was concerned with the congressional intent behind section 2032A. GAO addresses this point in chapter 2 and in appendix IV. Treasury said it did not have an opportunity to fully consider the recommendations, but felt they are timely because it is currently reviewing the entire estate tax system.

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## CHAPTER 1

### INTRODUCTION

The estate tax is a tax imposed on the privilege of transferring wealth to one's inheritors. Its supporters maintain it is a fair tax, since an inheritance is an unearned gain to an heir, and that it serves the socially desirable purpose of reducing inequalities of wealth. Further, Government protection of property rights may be considered a benefit for which a charge in the form of a tax might be imposed. Since the estate tax is imposed following a person's death, it is expected to affect one's economic behavior less than an income tax. Some persons also believe that the inheritance of wealth diminishes incentives to work or to invest wisely and that opportunities for the productive use of accumulated wealth are sacrificed if ownership remains concentrated among a "lucky few."

The Federal Government has levied a progressive estate tax on the value of property owned by deceased U.S. residents since 1916. However, the Congress felt that this tax threatened the viability of the family farm: Land values, which compose such a large part of the estates of farmers who leave enough property to attract an estate tax, were likely to be so inflated that the heirs might be forced to sell the farms to pay the estate taxes. This feeling and the long standing American tradition of protecting family farms led to the passage in 1976 of two special estate tax provisions.

Sections 2032A and 6166 (as enacted) of the Internal Revenue Code, added by the Tax Reform Act of 1976, provide a new method for valuing the land included in farm estates and an extended 15-year installment option for paying the Federal estate tax. These provisions were designed to benefit agricultural producers, but may have unintended effects that are contrary to other congressional policy goals.

This study was undertaken and largely completed prior to enactment of the Economic Recovery Tax Act of 1981 (ERTA). This Act dramatically reduces the Federal estate tax for all estates. Over 6 years, the unified credit will increase sufficiently to exclude from the tax all estates valued under \$600,000; present law exempts those valued under \$175,625. ERTA further removes limits on the marital deduction allowed for surviving spouses; property left to a surviving spouse is no longer taxed. Finally, sections 6166 and 6166A, deferred and installment payment options, were consolidated, the limit on section 2032A reductions in estate value has increased, the tightly drawn restrictions on the use of section 2032A have been relaxed for farm heirs, and the top estate tax rates on cumulative transfers of estate and gifts are decreased from 70 to 50 percent as of 1985.

These estate tax changes alter the financial situation for many farm estates. Some that would have taken advantage of the two provisions may no longer have to do so, since their taxes are now lower or removed. Fewer estates will now incur any estate tax liability, so fewer farm estates will use the provisions.

In this report we consider the intended and actual effects of these two estate tax provisions. Chapter 2 contains a detailed description of the provisions. In chapter 3 we discuss the reasons why they were enacted and what they were expected to accomplish. Chapter 4 presents some findings about their actual effects. Chapters 5 and 6 discuss problems that have appeared in the law and have arisen in its administration. Chapter 7 offers our recommendations for improving the design and administration of these estate tax provisions.

#### OBJECTIVES, SCOPE, AND METHODOLOGY

This study was designed to evaluate the effects of sections 2032A and 6166 that are intended to benefit family farms. By examining the justifications presented to the Congress on behalf of these provisions, analyzing their actual effects, and determining whether they need to be modified to improve their effectiveness, we intend to point out the complications entailed in trying to aid a particular group of people through tax policy measures, especially those using the estate and gift tax.

Reducing taxes on a special group of people is the practical equivalent of paying money to them directly; in fact, such tax reductions are frequently called "tax expenditures" to emphasize their similarity to direct spending programs. Since they subtract from the resources that would otherwise be available for other public uses, it is generally accepted that such provisions should be evaluated in the same manner as direct spending programs. Although the provisions we are considering here have not been formally designated tax expenditures, we believe that the tax expenditures concept provides a useful framework for evaluating them.

We used two approaches to evaluate these provisions. First, we analyzed a sample of all Federal estate tax returns that contained special use valuation elections (see appendix II). The statistical analysis of these returns provided estimates of the size of the tax saving and its distribution among different sized estates. The sample was constructed so that these estimates were representative of all farm estates that elected section 2032A. We tried to collect a similar sample of returns containing elections of the deferred and installment payment option but were forced to abandon the attempt. <sup>1/</sup> The sample that we did collect was drawn

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<sup>1/</sup>When we started to collect returns showing an election of the section 6166 deferred and installment payment plan, we discovered that many of the elections were actually of section 6166A installment payment plans. We believe the confusion

from a population only of farm estates electing special use valuation, not from all farm estates or all farms. Drawing a sample from all farms or all farm estates would have been prohibitively expensive.

Our second major analytical tool is a set of case studies that we conducted in agricultural counties in five farm States--California, Colorado, Indiana, Missouri, and Texas. Both the counties and the States were selected to provide a representative view of farming. Within each county we examined the Federal estate tax returns for farm estates electing either section 2032A or section 6166 and interviewed the inheritors of these estates. We also interviewed farm estate inheritors who did not receive or elect these tax preferences, current farm owner-operators and tenants, local attorneys, accountants and bank trust officers, and public officials (see appendix II).

We also supplemented these two sources of information with questionnaires sent to estate tax attorneys and County Executive Directors of the Agricultural Stabilization and Conservation Service (ASCS) and interviews with both Department of the Treasury and Department of Agriculture officials in Washington and with academic researchers known for their work in this area. The questionnaires sent to the sample of estate tax attorneys and ASCS County Executive Directors were designed to determine how well understood the two provisions were and how important these groups felt the provisions were.

The analysis of sections 2032A and 6166 was completed prior to enactment of ERTA. ERTA substantially changes the base of the estate tax and the operation of the two provisions that we examined. Where possible, our report reflects these changes. Our basic findings concerning the operation of the two provisions, however, are still germane. The reductions in the estate tax, however, will make these provisions less important than they were during the time during which we examined them.

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arose because the current section 6166A was numbered 6166 prior to the Tax Reform Act of 1976. Whatever the reason, it prevented us from identifying the universe of section 6166 returns from which a sample could be drawn.

## CHAPTER 2

### ESTATE TAX PROVISIONS--A BACKGROUND

#### OVERVIEW OF THE FEDERAL ESTATE TAX SYSTEM

Although the tax liability of an estate depends on its value, the tax is reduced by available credits, deductions, and exemptions. For instance, estate expenses are deductible, generally the first \$175,625 of an estate is exempt, and if the property is left to a spouse, one-half of the adjusted gross estate or \$250,000, whichever is greater, is also exempt. Usually, an estate tax must be paid by the estate of a married person if the value of that estate, net of debts and expenses, is \$425,000 or more. <sup>1/</sup> As a result, approximately 93 percent of all estates do not owe estate and gift taxes. In fact, some tax experts believe that by adroit planning the tax can largely be avoided, so that any tax liability is "voluntary." <sup>2/</sup> Thus, the estate tax is not a major source of Federal revenue. For instance, in fiscal year 1979 estate and gift taxes generated \$5,411 million of revenue, out of total budget receipts of \$465,940 million. <sup>3/</sup> Analysts generally believe that the tax is intended to prevent perpetuating large inequalities of wealth by enforcing redistribution of the wealth at the time of death.

#### GENERAL ESTATE TAX PROVISIONS OF THE TAX REFORM ACT OF 1976

In the Tax Reform Act of 1976, Public Law No. 94-455 (hereinafter cited as the 1976 Act), the Congress made the most sweeping revisions of the Federal estate and gift tax laws since 1942. As stated by the Joint Committee on Taxation, the purpose of the estate and gift tax provisions in this Act were

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<sup>1/</sup>ERTA made several substantive changes in the two special estate tax provisions examined in this report. See the conference report on ERTA H.R. Rep. No. 97-215, 97th Cong., 1st sess., 247-255 (1981). It also increased the unified credit, in steps over 6 years, from \$47,000 to \$192,000, thus excluding estates valued up to \$600,000 immediately from the tax. It also removed the limit on the marital deduction. Increasing the unified credit and removing the marital deduction limit can allow a couple to leave an estate valued at \$1.2 million to their heirs without paying any tax under certain circumstances.

<sup>2/</sup>George Cooper, A Voluntary Tax? (Washington, D.C.: Brookings Institution, 1979).

<sup>3/</sup>Economic Report of the President, 1980, Table F-69, p. 285.



- to provide substantial relief for modest-sized estates,
- to remove tax avoidance devices from the estate and gift tax system, and
- to alleviate the liquidity problem for estates largely composed of farms and other closely-held businesses.

Tax rates were adjusted to maintain estate tax revenues.

To meet these objectives, the 1976 Act established a unified credit and rate schedule for gift and estate taxes, increased the estate tax marital deduction, provided a new installment method for paying estate taxes, and authorized special valuation rules for farm estates. In enacting the installment and special valuation provisions, the Congress intended to help preserve the family farm, an important American institution.

#### New installment plan for estate taxes

Prior to the 1976 Act, two provisions allowed estate tax payments to be deferred. First, the Code provided a year-to-year extension, not to exceed 10 years, based on a showing of undue hardship by the executor. <sup>1/</sup> This extension was available to everyone. Second, section 6166 (renumbered as 6166A in the 1976 Act) provided for annual installment payments over a period of 2 to 10 years. <sup>2/</sup> To qualify for this extension, the estate had to contain a specific amount of property in a farm or closely-held business. <sup>3/</sup> The value of such property had to amount to at least 35 percent of the value of the gross estate of the decedent or 50 percent of the value of the taxable estate.

These two provisions, however, contained several features that discouraged their use. First, the IRS had become unwilling to grant extensions based on undue hardship and thus they had become difficult to obtain. If the extension were granted, a bonding requirement was levied on the executors who remained personally liable until the entire tax was paid. Second, the installment provision of up to 10 years was thought to be insufficiently generous because it may take more than 10 years for a farm to regain its financial strength to generate enough cash to pay estate taxes. A part of the estate may have to be sold so that the estate tax could be paid. Also, some farms were not profitable enough to pay both the estate tax and interest, especially if the interest rate were high.

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<sup>1/</sup>The 1976 Act changed this to simply require a showing of reasonable cause by the executor.

<sup>2/</sup>ERTA repealed section 6166A.

<sup>3/</sup>Generally a closely-held business is either (1) a sole proprietorship, (2) a small partnership in which the decedent had at

To remedy these problems, a new section 6166 was added by the 1976 Act primarily to benefit estates consisting largely of certain kinds of illiquid assets. This section of the Code allowed tax payment for estates consisting principally of a farm or closely-held business to be spread over a 15-year period. To qualify, 65 percent of the adjusted gross estate must be an interest in a farm or closely-held business. 1/ Under this provision, the executor can elect to defer principal payments for up to 5 years from the due date of the estate tax return. Interest for the first 5 years is still payable annually. Thereafter, the principal and interest may be paid in annual installments for 2 to 10 years. A special low interest rate of 4 percent a year is charged for the tax on the first \$1 million of a taxable estate. 2/

The Congress felt that the 5-year deferral period plus the reduced interest rate should, in most cases, give the farm heirs time to raise sufficient funds to pay the estate taxes and interest without forcing the sale of the farm to satisfy the estate tax liability. 3/ Also, the Code now places a special lien on the property instead of requiring a bond by the executor. IRS now has no authority to require a bond except when the value of the property is less than the tax liability plus interest.

#### Special use valuation

Prior to the 1976 Act, section 2031, the value of property included in the gross estate of a decedent was the fair market value of the property interest on either the date of the decedent's death or, if the alternate valuation was selected, 6 months after the decedent's death. The fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. Under this valuation method, the actual use being made of the property at the time of the decedent's death does not determine its value. Rather, value is determined by the

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least a 20 percent interest, or (3) a small corporation where a decedent owned 20 percent of the voting stock.

1/ERTA amended section 6166 to permit deferred payment if at least 35 percent of the adjusted gross estate is an interest in a farm or closely-held business.

2/Regular rates of interest for deferred payments apply to the taxable estate in excess of \$1 million.

3/The Act provides that the value included in these computations is to be the value determined for the purpose of the estate tax. Thus, in the case of the farm where the executor has elected special use valuation under section 2032A, this special use valuation is to be treated as "value" for purposes of the extended payment provisions.

highest price for which the property could be sold. For example, if a farm estate could be sold for residential, commercial, or industrial use at a higher price than it commands for agricultural use, that higher price would be considered the fair market value. The expected use that corresponds to the higher price is known as the "highest and best use."

To provide tax relief for farm estates, the Congress enacted special use valuation, section 2032A of the Internal Revenue Code, authorizing an alternative valuation method. This provision permits executors to value qualifying farmland for estate tax purposes at its value in agricultural use, its so-called use value, rather than at its fair market value. 1/ Special use valuation is intended to permit the value of farmland in a decedent's gross estate to be based on its current agricultural productivity. The value of the gross estate cannot be reduced, however, by more than \$500,000 below fair market value. 2/ By limiting the reduction in estate values that special use valuation allows to \$500,000, the provision limited the benefits as well. No matter how valuable a farm may be, the tax savings could not exceed \$375,000. 3/

Since 1976, farmland can now be valued either under section 2031, at its fair market value, or under section 2032A, special use valuation. Two methods are provided for determining the

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1/ Prior to 1976, the heir was considered to have received the farm at fair market value on the date of the decedent's death. When section 2032A is elected, however, the heir's basis in the estate for income tax purposes is the lower special use value. When the land is later sold, the heir pays capital gains tax based on this lower basis. Under ERTA, the qualified heir may elect to have the basis set at the fair market value as of the date of the decedent's death when the recapture tax is paid following sale of the farm. If the heir elects this basis adjustment, the heir must pay interest on the amount of the recapture tax from the date which is 9 months after the decedent's death until the due date of the recapture tax. The interest is computed at the rate (or rates) charged on deficiencies of tax for the period involved. If the heir does not make the election and pays the interest, no adjustment is made to the basis of the property.

2/ This provision also extends to real property of a closely-held business. As this report is only concerned with farm estates, the discussion is limited to this provision as it relates to such property. Under ERTA, the maximum amount by which the fair market value of qualified real property may be reduced, as a result of special use valuation, is increased to \$750,000 for estates of decedents dying in 1983 and thereafter.

3/ The product of \$500,000 and the maximum marginal estate tax rate of 70 percent. Under ERTA, the product of the increase to \$750,000 and the lower top marginal rate of 50 percent will result in a maximum tax savings of \$375,000.

special use value. The first, called the farm method, consists of capitalizing an estimated stream of net cash rents that could be charged for the property if it were used solely as a farm. Under this method, the estimated rent is determined by taking the average annual gross cash rental that was actually charged over the past 5 years for comparable farmland in the vicinity and subtracting from it the average annual State and local real estate taxes that were charged upon that land over the same period. The special use value is then calculated by dividing the estimated rent by the average annual effective interest rate that was charged during the same 5-year period for all new Federal Land Bank loans. For example, if an average annual gross cash rental is \$35 an acre and the average annual real estate taxes are \$5 per acre, the average annual net cash rent is \$30 per acre. If the average annual effective interest rate for all new Federal Land Bank loans is 8 percent, the land will be valued at \$375 an acre (\$30 divided by 0.08).

The second method of calculating use value is called the five or multiple factor method. It is not so much a method as a listing of factors in the statute that executors may draw upon to support their valuation of the property in agricultural use when cash rent data are not available or the executor chooses not to use the farm method. The factors are:

- (1) The capitalization of income that the property can be expected to yield if used for farming for a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and similar factors. The statute does not specify what rate of interest should be used to capitalize income.
- (2) The capitalization of the fair rental value of the land for use as farmland. Again, the statute does not specify the rate of interest.
- (3) Assessed land values where the State provides a differential or use value assessment land for farmland.
- (4) Comparable sales of other farms in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price.
- (5) Any other factor that fairly values the farm property.

#### REQUIREMENTS FOR SPECIAL USE VALUATION

In order for an estate to qualify for special use valuation a six-part test must be met. First, the decedent must have been a resident of the United States. Second, the adjusted value of the farm assets, reduced by allowable unpaid debts and expenses attributable to the property, must be at least 50 percent of the adjusted value of the decedent's gross estate. Third, at least

25 percent of the adjusted value of the estate, reduced by debts and expenses, must consist of the adjusted value of real property. Fourth, the farm property must pass to a qualified heir. Fifth, the farm must have been owned by a decedent or a member of the family and used or held for use as a farm for 5 of the 8 years preceding the decedent's death. Sixth, there must have been material participation in the operation of the farm by the decedent or a member of the family for 5 of the 8 years preceding the decedent's death. 1/ For purposes of satisfying the 50 percent and 25 percent tests, the property is valued at its fair market value, not its special use value.

#### Qualifying real property

Real property may qualify for special use valuation if it is located in the United States and is devoted to farm use. In general a "farm" includes current inventory, such as livestock, grain, orchards, and fur-bearing animals; and personal property, consisting of movable items such as wagons, tractors, trucks, and corn planters. A farm also includes real property used primarily for the raising of agricultural or horticultural commodities including land and specialized buildings and facilities, such as nurseries and greenhouses, barns, and the farmhouse or other residential buildings and related improvements, if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property of the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use. On the other hand, elements of value that are not related to the farm or business use, such as mineral rights, are not eligible for special use valuation. For example, if there is an oil lease on a farm, the full value of the lease is to be included in the decedent's gross estate and cannot be valued under the special use provisions.

#### Material participation

Besides the requirement that the decedent or a member of the decedent's family must have materially participated in the operation of the farm for at least 5 of the 8 years preceding the decedent's death, 2/ a material participation requirement was

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1/Generally, it will be easier under EPTA for both decedents and qualifying heirs to meet the material participation requirements of section 2032A.

2/EPTA allows the pre-death material participation requirement to be satisfied during periods aggregating 5 years or more of the 8-year period ending before the earlier of (1) the date of death, (2) the date on which the decedent became disabled (which condition lasted until the date of the decedent's death), or (3) the date on which the individual began receiving social

also placed on the heir for a 15-year period by the 1976 Act. The Congress did not clearly define what is meant by material participation. By including the term in section 2032A, however, it is apparent that the Congress intended special use valuation to be available only to those actively engaged in farming and to direct the financial aid to farm families. Investors who have no intention of farming are therefore excluded from the benefits of this provision. (Potential pitfalls of this requirement are addressed elsewhere in this report.)

#### Recapture provision

The 1976 Act provides that if within 15 years after the death of the decedent but before the death of the qualified heir the property is disposed of to non-family members, or ceases to be used for farming purposes, or the post-death participation time periods are not satisfied, all or a portion of the Federal estate tax saving attributable to the election of special use valuation is to be recaptured. 1/ The amount of the tax saving that may be recaptured is the excess of the estate tax liability that would have been incurred if the executor had not elected special use valuation over the actual estate tax liability. This amount is called the "adjusted tax difference." A qualified heir is personally liable for this sum with respect to his or her interest in the qualified property. When property valued under section 2032A is sold before the required 15-year period and the recapture tax is applied, the heir is still responsible for the capital gains tax based on the lower special use value.

#### Special lien

The Act provides a special lien on all qualified farm real property when electing to use the special use valuation. 2/ The lien is a charge or encumbrance on the farm property and continues until the tax benefit is recaptured or until the potential liability for recapture ceases, i.e., the qualified heir dies or a period of 15 years from the decedent's death lapses. When the lien is imposed, title to the property is not held free and clear but is subject to this lien.

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security retirement benefits (which status continued until the date of the decedent's death).

1/ERTA changed this by permitting a qualified heir to elect to have the income tax basis of qualified real property increased to the fair market value when the recapture tax is paid. The recapture period is reduced from 15 to 10 years.

2/This special lien can be subordinated with the Secretary's consent.

### CHAPTER 3

#### THE ORIGINS OF SPECIAL ESTATE

#### TAX TREATMENT OF FARM ESTATES

The estate tax preferences that the Congress enacted for farm estates in 1976 were largely prompted by two complaints. First, advocates of special treatment argued that it is unfair to tax a farm estate the same as other estates of equal fair market value, primarily because a farm estate is ordinarily less "liquid"--i.e., contains fewer assets that can be readily converted into cash--at the time of the owner's death. A farm estate's fair market value, according to the advocates of special tax treatment, often overstates the value of the farm in agricultural use. The farm heirs are less able to pay the estate tax from the estate's cash or readily marketable assets than the heirs of nonfarm estates and thus are unfairly compelled to sell more illiquid assets, such as land. Second, farm groups and other observers claimed that by forcing the sale of farm estates the Federal estate tax contravenes the public policy goal of encouraging family farming. If a part of the farm has to be sold to pay the tax, the farm may be so reduced in size that it is no longer an efficient unit or able to sustain itself. Taxing farm estates less severely than others would remedy this effect and encourage family farming.

Generally, the Congress believed that when land is being used for farming by owners or their families before the owners' deaths and the succeeding members of their families want to continue farming, it would be inappropriate to value the land on the basis of its "highest and best use." To do so might discourage the continued use of property for farming purposes. The Joint Committee on Taxation stated that

Valuation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, or the closely-held business activities, not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus the heirs may be forced to sell the land for development purposes. <sup>1/</sup>

Also, where the valuation of land reflects speculation to such a degree that the price of land does not bear a reasonable relationship to its earning capacity, the Congress believed it unreas-

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<sup>1/</sup>The Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1976, H.R. Rept. No. 10612, 94th Cong., (1976) p. 537 (hereinafter H.R. 10612).

sonable to require that this "speculative value" be included in an estate devoted to farming or in closely-held businesses.

The Congress recognized, however, that it would be a wind-fall to the beneficiaries of an estate if real property used for farming were valued for estate tax purposes at its farm value unless the beneficiaries continued to use the property for farm purposes, at least for a reasonable period of time after the decedent's death. And, the Congress believed that it would be inequitable to discount the speculative values if the heirs of the decedent realized these speculative values by selling the property within a short time after the decedent's death.

For these reasons, the 1976 Act provides for special use valuation in situations involving real property used in farming or in certain other trades or businesses and further provides for recapture of the estate tax benefit where the land is prematurely sold or is converted to nonqualifying uses. Other than these very general statements of congressional intent, there is little indication in the legislative history of the reasons behind the Act's specific requirements.

The alleged tendency of the estate tax to force the sale of property may not be accidental. Some tax authorities maintain that the purpose of this tax is not primarily to raise revenue but to inhibit the transfer of large estates as unbroken units. <sup>1/</sup> Forcing estates to sell a part of their holdings is one method of serving this objective.

#### ARE FARMS UNFAIRLY BURDENED BY THE FEDERAL ESTATE TAX?

Farm estates are said to be unusually illiquid because so much of a typical farm estate's value is attributable to a single asset: farmland. If farmland itself is unusually illiquid, the case is proved. But is farmland illiquid, and if it is, does illiquidity justify preferential tax treatment?

#### Are farm estates inherently illiquid?

Only a few empirical studies have been conducted to determine whether illiquidity is a serious problem among farm estates and their findings are inconclusive. They do demonstrate, however, that farm estates are not unavoidably illiquid and thus do not warrant special tax treatment. All the studies assumed that farmland is illiquid and that executors would attempt to meet claims against the estate from other assets.

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<sup>1/</sup>See, for example, Gerald R. Jantscher, "The Aims of Death Taxation," in Death, Taxes and Family Property: Essays and an American Assembly Report, ed. Edward C. Halbach, Jr. (St. Paul, Minn: West Publishing Co., 1977), pp. 40-55.



The Contemporary Studies Project at the University of Iowa examined farm estate planning and found that

The conclusion seems inescapable that whatever liquidity problems were observed among living farmers, they constitute only a temporary condition which either tends to cure itself with the passage of time or is solved by affirmative actions of the client or his attorney at some point prior to death. 1/

In the Iowa study, the authors reported that, on average, liquid assets (cash, stocks, and bonds) composed 25 percent of the value of a probate farm estate in Iowa--enough, the authors judged, to pay all estate expenses. Farmers who were surveyed for the Iowa study, however, had only 9.5 percent of estimated gross estates in cash accounts and investments and could face estate illiquidity in the case of sudden death.

The Iowa study demonstrates that farm illiquidity may not necessarily cause unusual hardship. The illiquidity of living farmers may be "merely symptomatic of that middle stage of the family farm cycle in which most of the (living) subject farmers found themselves at the time." 2/ Furthermore, farmers were able to exert some control over the liquidity of their estates and therefore presumably could alleviate the problems that a shortage of liquidity might create.

A similar study in Illinois supports the University of Iowa findings. Examining the financial condition of farm estates, agricultural extension economist Harold Guither reported that, on average, the estates in his sample had adequate liquid assets to pay death taxes and estate costs. Guither pointed out, however, that 43 percent of the estates were not sufficiently liquid to pay the costs and taxes. "Estate and financial planning is often needed that will provide for liquid assets in order to meet tax obligations and other claims," he concluded. 3/

In testimony before the House Committee on Ways and Means in 1976, 4/ James Smith, Professor of Economics at the Pennsylvania State University, used 1972 estate tax return data provided by the

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1/Contemporary Studies Project, "Large Farm Estate Planning and Probate in Iowa," Iowa Law Review, vol. 59 (April 1974), p. 930.

2/Ibid., pp. 929-30.

3/Harold D. Guither, "Death, Taxes, and Farmland Transfers," Cooperative Extension Service, University of Illinois at Urbana-Champaign (August 1978), p. 3.

4/James D. Smith, "The Distribution and Composition of Wealth Holdings and Their Implications for Estate Tax Reform," in U.S., Congress, House, Committee on Ways and Means, Public

IRS to note differences in the liquidity position of farm and nonfarm estates. About 16 percent of the estate tax returns filed in 1973 with business and/or farm assets had a ratio of Federal estate taxes plus costs equal to 75 percent or more of their liquid assets once debts had been subtracted, compared to 4 percent for estates without business and farm assets. This ratio is used as an index of the estate's ability to pay estate taxes without the forced liquidation of less marketable assets. The data did not permit the noncorporate property and farm property to be disaggregated, however, so the figures may not be representative of farm estates.

In his testimony, Smith noted that estate illiquidity is a problem for the inheritors only if it hinders the inheritors' ability to receive the land. Inheritors who can pay the tax on an illiquid estate with either their own or borrowed funds are not as burdened as those who cannot. If the decedent's spouse is the sole inheritor of the property and is as wealthy as the decedent was, he found, using a simulation model, that the liquidity problem would largely disappear, facilitating the inheritance. Alternative wealth assumptions, different inheritors, and other more realistic (and complex) scenarios were not possible given the limits of Smith's data, however.

Available evidence thus shows that estate illiquidity may be characteristic of farmers' property holdings at some point during their lives, but it may also be corrected in time with proper financial planning. One component of such a plan might be life insurance to help pay death taxes and estate costs. Another component would be an adequate will that distributed property in the manner incurring the least taxes. A will taking full advantage of the marital deduction in the Federal estate tax or similar provisions in State estate and inheritance taxes would be such an estate planning device in many, although not all, situations. <sup>1/</sup>

#### Are illiquid estates unfairly taxed?

Advocates of estate tax preferences for farm estates argue that the problem of estate illiquidity justifies preferential treatment. It is not fair, they argue, to tax a farm estate, whose value is concentrated in assets that cannot be readily sold, as heavily as an estate whose assets may be quickly and easily sold. The farm estate is not able to pay the tax as easily as a more liquid estate.

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Hearings and Panel Discussions, Federal Estate and Gift Taxes  
94th Cong., 2d sess., pp. 1311-1330.

<sup>1/</sup>In some cases, claiming the full marital deduction may not be the best way to minimize taxes. See D. Reinders, M. Boehlje, and N. Harl, "The Role of Marital Deduction in Planning Inter-generational Transfers," American Journal of Agricultural Economics, vol. 62 (August 1980), pp. 384-394.

The Federal estate tax is levied on the net value of the estate and is not affected by the types of assets that the estate contains. An estate composed solely of a \$1 million portfolio of traded stocks (a relatively liquid estate) is subject to the same tax as an estate valued at \$1 million but composed solely of real estate (a relatively illiquid estate). Adjusting tax burdens according to liquidity differences would add complexity to the estate tax.

Liquidity is a continuous variable that rarely takes on the extreme values of the preceding illustration. Estates cannot be classed simply as liquid or illiquid. Most are liquid to some extent, lying somewhere away from the extremes of the liquidity spectrum. If the tax is to be adjusted for an estate's liquidity, tax differences must accurately reflect liquidity differences. So far, no method has been found to adjust taxes for liquidity. Consider a \$1 million estate composed of equal values of cash and real estate. How much more liquid or illiquid is it than the two estates in the previous example? By how much should the estate tax be adjusted to reflect the differences in liquidity among the three estates?

Even if an acceptable line could be drawn between liquid and illiquid estates the distinction would have no tax consequences unless it were agreed that estates of equal fair market value should not bear the same tax if they are not equally liquid. Several reasons may be offered for taxing them differently. First, the forced sale of certain illiquid assets may be more detrimental to an enterprise than the forced sale of the same value of liquid assets. That is, \$100,000 of land may in general be more nearly essential to the health of an enterprise than \$100,000 of cash. It may also happen that a forced sale never yields the full value of a good and that the forced sale of illiquid assets yields less than the forced sale of liquid ones. In order to pay taxes when due, it is argued, farm assets may have to be sold even though they would fetch a higher price if they could be held out for sale longer.

Another argument advanced for special estate tax treatment of farms is a claim that farm estates are inherently overvalued. The fair market value of farmland does not always reflect what it is worth in farming, according to this argument, but sometimes is determined by the value of the land in an alternative use. Speculation and outside investment in farmland overstate the true "worth" of a farm estate.

The price of farmland will reflect development potential only if an alternative use is more attractive than farming. If the current and prospective highest and best use of land is in farming, it is doubtful that developers will seek it for another use. Land may be purchased in anticipation of future development, of course, but it is questionable whether such speculation has been an important cause of rising farmland values.

One reason why outside investors are attracted to farmland is the tax shelter opportunities that farming affords. For instance, certain capital expenditures may be deducted immediately as current expenses, rather than depreciated over their useful lives. Federal subsidy programs vested in, or tied to, the land also attract nonfarming investors, increasing the price of farmland. Thus, programs designed to aid farmers may complicate their estate planning by adding to the price of farmland and raising farm estate values.

Several of the objections to the estate tax treatment of farms raise issues that are not unique to farming. As chapter 2 notes, some tax authorities believe that the Federal estate tax is primarily an instrument for reducing concentrations of wealth rather than a source of revenue. To achieve its objective, the tax must take wealth from those who have it. Accordingly, it is not surprising that the tax erodes the value of estates.

Any estate or inheritor may have to sell assets, reduce cash balances, or borrow to pay the estate tax. No empirical evidence demonstrates that illiquidity is an unavoidable problem peculiar to farm estates or that farm estates warrant special tax preferences. Farmers can use estate planning methods to provide adequate funds for the payment of estate taxes, as by purchasing life insurance, just as other types of businesses may do. Nor do farm estates appear to be victims of unfair valuation. The claim that tax equity requires unique estate tax rules for farmers is difficult to sustain. The decision to impose an estate tax is inevitably also a decision to force some inheritors to forego a part of their inheritance.<sup>1/</sup> For many reasons, however, farming has long received special consideration in the making of public policy.

#### SPECIAL ESTATE TAX TREATMENT OF FARMS IS CONSISTENT WITH AMERICAN AGRICULTURAL POLICY

Farming, especially family farming, has always occupied a unique place in American economic, political, and social life. The economic and political importance of steady farm production has been recognized since the founding of the Republic, and farm life has had a profound influence on our way of life and social values. American agricultural policy has attempted to encourage family farming and family farm ownership. This goal provides a stronger justification for special tax preferences than the equity arguments do.

Estate tax preferences for farm estates may help achieve several objectives. They may be used to help the agricultural sector of the economy become stable and moderate fluctuations in agricultural production. They may serve some social goals, such as encouraging families to remain in farming. They may help slow the conversion of farmland into other uses. Reducing estate

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<sup>1/</sup>See also chapter 2.

taxes may promote all of these objectives, as well as provide a tax expenditure to farm inheritors.

The role of the Federal estate tax in the decline of family farming

The burden that the Federal estate tax places on farm estates is not the main reason why many small family farms go out of business. Operating problems encountered by farmers and changes in agriculture are much more likely to prompt the sale of farms when farmers die. The difficulty of establishing the new farm management, disagreements among heirs, and distance of inheritors from the farm location may also discourage retaining the property. Technological advances in farming have created incentives for innovative farmers to enlarge their operations by buying out their neighbors. Many of these expanded farms have been organized as family-owned corporate farms, conferring considerable financial advantages on the owners and promoting the acquisition of additional farmland. This drive to expand pushes up the demand for the relatively fixed supply of farmland. As a result, farmland prices increase and farm ownership and successful operation become less likely for new farms or families owning small farms. <sup>1/</sup> The opportunity to realize the capital gains that had accumulated during the decedent's lifetime can also be a significant inducement for the heirs to sell the estate. Farmland values have increased dramatically in the last decade. According to the USDA's Economics, Statistics, and Cooperatives Service, the average value of an acre of farmland increased 85 percent nationally between March 1974 and February 1979, following a 60 percent increase between March 1969 and March 1974. <sup>2/</sup>

Small family farms are disappearing as American agriculture changes. Increased opportunities for nonfarm employment and decreased requirements for farm labor have caused a sizeable loss of population in farm areas over at least the past 50 years. The fraction of the U.S. population that lives on farms has declined, from 24.9 percent in 1930 to 3.6 percent in 1977. Farm employment has declined during the same period, from 12,497,000 to 4,152,000. In 1930 over 6.5 million farms were operating, by 1977 the number had fallen to 2.7 million. Over the same period the average farm grew from 151 acres to 300 acres. Farm productivity also grew. The index of farm output per worker hour (1967 = 100) rose from 16 in 1930 to 34 in 1950 and 171 in 1977.

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<sup>1/</sup>For an extended discussion of these points see U.S. General Accounting Office, Changing Character and Structure of American Agriculture: An Overview, CEDD-78-178 (September 26, 1978).

<sup>2/</sup>The increases have not been even across all States. Appreciation rates ranged from 158 percent in Indiana and Minnesota to 22 percent in Arizona and Nevada between 1974 and 1979. See U.S. Department of Agriculture, Agricultural Finance Outlook (November 1979), p. 6.

No evidence suggests that the Federal estate tax has played other than a minor role in promoting these changes. Fred Woods and Charles Sisson, for example, have said that "it is difficult to find evidence of major aberrations in the behavior of farm families which might have been caused by the . . . estate tax laws" before the 1976 Tax Reform Act. <sup>1/</sup> Voluntary sales and trades have been the predominant form of farm transfers during the 1970s, according to the Department of Agriculture's statistics in table 1. Sales by administrators and executors comprise a much smaller share of all farm sales, according to these data. Since 1969 they have accounted for about 15 percent of all farm transfers each year, less than the roughly 20 percent common in the 1960s. In his study of Illinois farm estates, Harold Cuither reported similar findings:

Land sales made to settle estates did not occur frequently. When such sales were made, the reasons varied. Most often, the reason was to divide funds among the heirs. This happened in about 8 percent of the cases studied. Next was paying estate and inheritance taxes, which occurred in about 6 percent of the estates. Other reasons given were to enable one heir to buy out others, to pay off debts on property, and to comply with the terms of the will. <sup>2/</sup>

The preferences contained in the 1976 Act are not generally successful as a land use planning device designed to keep land in farming. First, the tax is infrequently imposed. Farmland will bear a tax once--or possibly twice--each generation. Furthermore, since the decedent does not bear the tax, its effect on the farmland's use is uncertain. Family relationships and financial circumstances during the decedent's life may well play much more important roles in determining land use than a death tax. If the family decides to maintain a farm through several generations, they probably will take the necessary steps to anticipate the tax.

#### SUMMARY

Special estate tax treatment of farm estates is best viewed as a method used by the Federal Government to encourage families to continue owning and operating family farms after the death of the owner. The preferential treatment reduces the chance of farm estate shrinkage due to the tax. The other reasons for preferential treatment appear weaker. Farm estates are not treated unfairly under the estate tax. Although some farm estates are

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<sup>1/</sup>W. Fred Woods and Charles A. Sisson, "The Tax Reform Act of 1976 and American Agriculture," Tax Notes, vol. 5 (August 29, 1977), p. 5.

<sup>2/</sup>Cuither, p. 2.

Table 1  
Number and Share of Farm Sales by Type of Transfer, 1969-78  
(thousand farms) a/

<u>Year</u>	<u>Voluntary Sales and Transfers b/</u>	<u>Forclosures and Bankruptcies</u>	<u>Inheritances and Gifts</u>	<u>Administrators' and Executors' Sales c/</u>	<u>Total d/</u>
1969	30.6 68%	1.0 2%	4.6 10%	7.2 16%	45.1
1970	27.8 67%	1.6 4%	4.4 11%	6.5 16%	41.4
1971	28.7 67%	1.4 3%	4.7 11%	6.6 15%	42.7
1972	34.0 71%	1.4 3%	4.4 9%	6.8 14%	47.9
1973	41.0 73%	1.3 2%	4.2 8%	8.1 14%	55.9
1974	41.2 71%	0.9 2%	6.0 10%	8.3 14%	58.3
1975	32.3 68%	1.3 3%	5.4 11%	7.2 15%	47.8
1976	28.1 66%	1.5 4%	5.6 13%	6.3 15%	42.7
1977	28.0 65%	1.4 3%	6.0 14%	6.5 15%	43.0
1978	26.9 65%	2.0 5%	5.4 13%	6.3 15%	41.7

a/United States, excluding Alaska and Hawaii, years ending March 1 for 1969 through 1975 and February 1 for 1976 to 1978. For totals may not equal 100 due to rounding and the miscellaneous and unclassified sales that are included in total farm sales.

b/Includes contracts to purchase, but not options.

c/Includes all other sales in settlement of estates.

d/Includes miscellaneous and unclassified sales, and sales for delinquent taxes (0.3 per thousand in 1969).

Sources: U.S. Department of Agriculture, Agricultural Statistics 1978, "Farm Transfers" table 612.

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sold in satisfaction of death taxes and estate administration expenses, their number is small and the pressure to sell may be no different from the pressure on nonfarm estates. The very imposition of a tax on an estate will often require some of the value to be given up. Further, farm estates do not appear to be unavoidably illiquid or cash-starved. While illiquidity is often characteristic of farm operations, proper financial and estate planning techniques should be adequate to alleviate the condition in most cases.

Preferential estate tax treatment of farm estates illustrates how an instrument designed to serve one policy goal is sometimes modified to serve another. The Federal estate and gift tax exists to serve certain redistributive objectives. Estates incurring an estate tax are inevitably reduced in value, although the tax may be lessened or avoided and the tax burden mitigated by effective estate and financial planning. Special use valuation and deferred and installment payment options have been introduced, however, because a possible effect of the estate tax--sale or shrinkage of family farms--is inconsistent with American agricultural policy, a goal of which is fostering family farms.



CHAPTER 4  
CONSEQUENCES OF SPECIAL  
ESTATE TAX PROVISIONS FOR FARM ESTATES

Despite congressional intent, special use valuation has not helped stop the decline of family farms in American agriculture. Farmers and their heirs continue to face pressures to expand their operations or to sell their land to other farmers who are expanding or to investors. Changes in estate tax valuation cannot alter the financial incentives and advances in farm technology that produce these pressures. Changes in the estate tax, however, can increase the incentive for a large farm to expand.

While electing special use valuation can reduce an estate's tax bill, the option appears to have other, undesirable consequences. The election may add to the administrative burdens of the IRS and estate executors and may force inheritors to deal with complex unanticipated statutory requirements. <sup>1/</sup> Furthermore, the possible estate tax savings may push up farmland prices, lessening opportunities for small farmers to establish or expand their operation.

While the Federal estate tax forces few farm estates onto the market, the tax burden on an estate can be sizeable. <sup>2/</sup> Farmers are becoming more aware of the taxes their estates may bear as they observe the value of their land increase. As a result, many farmers are paying more attention to their estate and financial plans. For many farmers, however, even a well prepared plan may not be sufficient to accomplish the property distribution they desire following their deaths.

SURVEY OF TAX PROVISIONS' EFFECT

In order to evaluate the contentions concerning the effects of Federal estate taxation on family farming, we conducted a survey of farm communities and farm estates that had used section 2032A valuation in filing Federal estate tax returns. <sup>3/</sup> (The survey methods are described in appendix II.) We addressed these questions during the survey:

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<sup>1/</sup>ERTA should decrease the administrative burden on IRS associated with section 2032A. Increasing the unified credit and removing the marital deduction ceiling will eliminate many estates from the estate tax base, decreasing the number electing special use valuation.

<sup>2/</sup>The tax burden will be decreased by ERTA, however.

<sup>3/</sup>This survey was conducted before passage of ERTA.

1. Had the Federal estate tax so burdened farm families that they could not continue to operate their farms?

2. Have sections 2032A and 6166 been instrumental in preventing forced sales of family farms?

3. What other effects, if any, have the two provisions had on family farming?

4. What has the cost of special use valuation been (measured by foregone tax revenues), and how have the benefits of the provision been distributed among different sized farms?

Although we did not document any sales forced by the Federal estate tax during our survey, over half of the inheritors believe that sections 2032A and 6166 were instrumental in avoiding the sale of some or all of their farm property. Of the 274 electing inheritors that we interviewed in the five target States, 47.6 percent said that they probably or definitely would not have been able to retain the farm without the special provisions. Slightly less than 40 percent of the inheritors, however, felt that they probably or definitely could have kept their shares of the inheritance without using the special provisions. However, because the electing heirs were not selected randomly, these findings may not be applicable to all farm inheritors.

	<u>Percentages</u>	<u>Cumulative frequency</u>
Definitely no	20.0	20.0
Probably no	27.6	47.6
Subtotal	47.6	
Undecided	13.1	60.7
Probably yes	27.6	88.4
Definitely yes	10.9	99.3 <u>1/</u>
Subtotal	38.5	

1/Figure does not include 0.7 percent who refused to respond.

We do not know how many of these inheritors would have been able to borrow money to pay the estate tax. Very few inheritors interviewed (21 percent) elected the section 6166 deferred and installment payment schedule.

#### Farmers may not effectively use available estate planning methods

Farmers may not be taking full advantage of estate planning devices that can reduce their estate taxes and ensure that their property is distributed in the manner they desire. Seventy-five

percent of the ASCS County Executive Directors who responded to our questionnaire felt that estate planning by farmers was inadequate. Only 10 percent felt that farmers paid sufficient attention to estate planning.

Eighty-four percent of the estate tax returns examined in our survey had wills attached, indicating that decedents made some effort to plan the disposition of their estates. We cannot say, however, if as large a fraction of farmers in the general population prepare wills because we selected our sample from returns containing apparently valid elections of special use valuation or deferral of estate tax payment and not from all farms.

The Contemporary Studies Project at the University of Iowa found some evidence that farmers' knowledge of estate planning may be limited. The attorneys they interviewed were almost evenly divided among three categories:

- those attorneys who believed that their clients were knowledgeable about estate planning,
- those who believed that their clients were not knowledgeable, and
- those who believed that their clients were becoming more knowledgeable.

The opinions of the third group are unclear. We do not know if the attorneys believe that their clients are moving from poor to better understanding of estate planning or from a good to a superior understanding.

Several reasons may explain the farmers' lack of effective estate planning. To prepare an estate plan, including a will, a farmer must spend money now for a future event, and one that many persons find distasteful to contemplate. This spending competes with other claims on income that may seem more pressing, offer an immediate return, and be more appealing than confronting the prospect of death. Another possible reason for inadequate estate planning is that many farmers may not realize how wealthy they are. Property tax valuations may understate the fair market value of a farm, providing one possible source of confusion. Furthermore, since the capital gains on farmland are not realized until the farm is sold, farmers may base their net worth estimate on current cash earnings or potential cash earnings from continued farming and disregard capital gains. 1/

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1/The use of proper estate planning will allow couples to leave tax-free estates worth \$1.2 million to heirs by 1987, as a result of changes to the unified credit and the marital deduction brought on by ERTA.

## SPECIAL USE VALUATION MAY HAVE UNINTENDED CONSEQUENCES

Special use valuation may create problems that were not anticipated at the time of the 1976 Act's passage. For example, while the Federal estate tax explicitly treats farm and nonfarm estates differently, it may also implicitly treat some farm estates differently from others. Some farm estates may not benefit at all from the provision. The different treatment of farmland in the estate tax may cause changes in the market for land, which may make it more difficult for a small farmer to purchase land.

### Not all farm estates gain from section 2032A

The special use valuation provision favors those who own land, not necessarily those who actively farm. As chapter 2 notes, a landowner's estate may qualify for special use valuation if the landowner or a qualified family member materially participated in the operation of the farm. The landowner did not have to be an active farmer (i.e., a farmer who is physically involved in farm operation)--assuming financial responsibility may help qualify the estate for special use valuation in some cases. <sup>1/</sup> The wealth of a so-called "contract" farmer, <sup>2/</sup> or "custom" farmer, however, may be concentrated in farm machinery and structures that are not eligible for special use. As appendix III notes, contract farming is common in many areas of the country.

Since special use valuation necessarily benefits only estates containing land, the provisions may promote greater concentration of farm wealth than would otherwise be the case. The qualified heirs of farmers who owned land receive the benefits of use valuation, giving them a substantial advantage over the heirs of contract or custom farmers whose bequests are mostly of assets other than land. Assisted by this tax advantage, farmland owners may be able to expand their holdings. Special use valuation thus may contribute to increased concentration of land ownership by decreasing the opportunities for contract or custom farmers and others with little or no land holdings to purchase farmland. Although section 2032A's effect on the concentration of farmland

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<sup>1/</sup>Chapter 2 addresses the qualification requirements of section 2032A. Assuming financial responsibility for an operation is one of several tests for material participation in that operation. Further, financial risk (i.e., ownership) in the farm operation is a necessary condition for proving that the estate was used in a "qualified use," as section 2032A requires. For a more complete explanation, see chapter 2 of this report or H.B. Hartley, "Final Regs. under 2032A: Who, what and how to qualify for special use valuation," Journal of Taxation, (November 1980), pp. 306-12.

<sup>2/</sup>Contract farmers generally rent the lands they farm.

ownership cannot be gauged because too little time has passed since section 2032A was enacted, the effect sketched above is a plausible outcome. 1/

The risks and costs associated with electing special use valuation also affect farmers differently. The original delay in issuing IRS regulations to administer the section, the prospect of a lengthy audit and exposure to tax recapture, the placing of a tax lien on the inherited property, and the additional appraisals and high quality legal representation that the provision requires create risks and costs that a large farm can bear more easily than a small farm. 2/

#### Cash rent capitalization

The cash rental capitalization formula for special use valuation 3/ may also create inequities. Estates in regions where it is uncommon for farms to be rented for cash have more often been unable to use special use valuation than estates located elsewhere. While ERTA now permits use of crop share rental data and might seem to alleviate this inequity, the approach still entails several problems. First, while the crop share itself may be stable over time (i.e., neither the agreed shares nor the harvestable yield change during several years), the cash equivalent of the crop share will fluctuate substantially, depending on commodity prices. While land values rarely change dramatically over a short time, commodity prices may change very rapidly. Second, farmland owners and renters might be reluctant to disclose their exact share rental agreements to permit the special use value of another farm to be calculated. Third, a wide assortment of crop share arrangements could exist for a single property, making it difficult to compare rents among different properties. The renter's obligations could vary, for example, as could the owner's involvement in management decisions or the sharing of financial risk between renter and owner.

Cash rents, when available, generally do not share these drawbacks. First, cash rents do not vary with commodity prices and need not be converted to a cash equivalent. Second, although owners and renters may be as reluctant to disclose cash rental data as they are to disclose share rental data, cash rental data are already collected by the USDA. Even if these data do not re-

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1/The decreased estate taxes resulting from ERTA probably will affect this scenario, but too little time has passed to be sure of how it will do so.

2/For a discussion of farm size, see U.S. Department of Agriculture, A Time to Choose: Summary Report on the Structure of Agriculture, (Washington, D.C.: Government Printing Office, 1981), pp. 41-69.

3/Section 2032A(e)(7). See chapters 2 and 5 for explanation of this formula.

fer to exactly "comparable" farmland, as required by section 2032A (see chapter 6 for a discussion of the comparability issue), the USDA data can be used as a standard for comparing the reliability of any comparable rents that are obtained. Since cash rent agreements normally do not require the landowners to manage the farms or to assume any financial risks, the cash rent reflects the value of the land rather than the owners' services.

#### Provisions lock in ownership

Another effect that the special provisions may have is to "lock in" some ownership of some land. Farmers who wish to sell their land and equipment and retire or heirs who would like to sell the land may now decide to keep it and thus reduce estate taxes. If the farmer/landowner continues to materially participate in the farm operation until his or her death and the inheritors do the same afterwards, the estate tax may be reduced. If the provisions discourage sales of farmland to people outside the decedent's family who would have established their own family farm, however, the provisions encourage concentration rather than family farming.

#### THE LARGEST ESTATES MAY BENEFIT MORE

Several attorneys and economists believe that the special use valuation option favors large, wealthy estates that are already able to pay the Federal estate tax, other death taxes, and estate administrative expenses or to arrange financing for these debts. For example, Professor Roland Hjorth argues that "the present economic characteristics of farmland, federal income tax law, and now the federal estate tax law all portend the emergence of a landholding elite class in America." <sup>1/</sup> He concludes that the provisions will not save the family farm. "Indeed, it seems more probable that section 2032A and 6166 will contribute to the decline and continuing demise of the number of family farms." <sup>2/</sup> Hjorth notes several reasons for believing this:

- (1) Both special use valuation and the deferred and installment payment option will increase demand for the limited supply of farmland, increasing its price.
- (2) Landowners benefit, but not tenant or contract farmers.
- (3) Large farmers benefit more than small farmers, enabling them to expand further.

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<sup>1/</sup>Roland L. Hjorth, "Special Estate Tax Valuation of Farmland and the Emergence of a Landholding Elite Class," Washington Law Review, vol. 53 (1978), p. 662.

<sup>2/</sup>Ibid., p. 612.

- (4) Farmers who want to sell land are persuaded not to do so but to act as landlords. 1/

In addition, Hjorth notes that the provisions open new problems in other areas:

They complicate estate planning by making it more difficult to draft marital deduction clauses in wills, and by making post-mortem administration and planning extremely burdensome. Because they apply only to the estate tax, they interfere with the general policy behind the 1976 Act of treating inter vivos and testamentary transfers similarly for transfer tax purposes. Finally, because their advantages are available only to families which have a member who participates materially in the operation of the farm or ranch, relatives of persons who inherit or own land will find it easier to rent land than will persons who are not so related. 2/

Since the concept of preferential farm use valuation is not novel, previous experience with its use for property tax purposes may indicate how effective a similar provision may be in the Federal estate tax. States have used similar provisions to prepare farm property tax assessments for years.

One examination of these property tax provisions has concluded that farmers can benefit from property tax use valuation, particularly if their land is located on the fringe of an urban area. 3/ The study concluded that the provisions have little importance in determining land use since they do not alter the basic financial motivation to use land productively.

This conclusion is supported by a report from the Council on Environmental Quality. 4/ The report found that differential property tax assessments are effective and politically popular methods of conveying tax savings to participating landowners. As land use planning tools, however, differential property tax assessments are "inefficient and expensive" for several reasons, among them the fact that the burden of property taxes is only one of many factors affecting a farmer's decision to sell, and a reduction in property taxes will deter few farmers from selling.

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1/Ibid., pp. 612-3.

2/Ibid., p. 613.

3/Robert J. Gloudemanns, Use Value Farmland Assessments (Chicago: International Association of Assessing Officers, 1974).

4/Council on Environmental Quality, Regional Science Research Institute, Untaxing Open Space, Executive Summary (Washington: Government Printing Office, 1976), p. 6ff.

SPECIAL USE VALUATION CAN SIGNIFICANTLY REDUCE  
FEDERAL ESTATE TAXES

Farm estates that elect special use valuation will generally enjoy substantial Federal estate tax savings, an advantage that tax advisors have been quick to point out. In 1977, for instance, it was noted in the Brigham Young University Law Review that

In areas where urban development pressure on farmland prices is strong, the formula permits a drastic reduction in the value of farmland for estate tax purposes. 1/

By August 1980, over 6,000 estates had used the special use valuation. This option greatly reduced the estates' values and in turn lowered estate taxes. We estimate that the annual revenue loss from special use valuation is over \$150 million since each estate in our sample saved about \$59,000. 2/ The average value of the taxable estate with special use valuation was approximately \$278,000, or just under 60 percent of the average fair market value of \$465,000. The effective tax rate (Federal estate tax paid divided by taxable estate) was cut nearly in half, from 17.3 percent to 10.8 percent of fair market value (see table 2). Our annual revenue loss estimate does not differ greatly from the Treasury's most recent estimate of \$140 million. 3/ Both estimates, however, are much larger than the annual loss of \$14 million that was expected when the provision was enacted.

If one assumes that these revenue loss estimates of approximately \$150 million per year are accurate, the cost is about 3 percent of current estate and gift tax collections. 4/ Still, these amounts are small in comparison with direct Federal payments to farmers. In 1978, for example, such payments totaled \$3,030 million in 1978, according to the Department of Agriculture. 5/

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1/"The Family Farm and Use Valuation-Section 2023A of the Internal Revenue Code," Brigham Young University Law Review, vol. 1977 (1977), p. 368.

2/Between August 1979 and August 1980, the latest period for which data are available, 3,074 estates elected special use valuation.

3/Harry L. Gutman, U.S., Congress, Senate Committee on Finance, Miscellaneous Tax Bills V, hearings before the Subcommittee on Taxation and Debt Management, March 4, 1980.

4/Federal estate and gift tax receipts totaled \$5,411 million in 1979, according to the Economic Report of the President, 1980.

5/U.S., Bureau of the Census, Statistical Abstract of the U.S., 1979 (Washington, D.C.: Government Printing Office, 1979), p. 696.



Table 2  
Profile of Estates Filing Returns  
Containing Elections of Section 2032A  
Estates of Decedents Dying in 1977 and 1978

	<u>Fair Market Value</u>	<u>Special Use Value</u>
Total Gross Estate	\$626,578	\$418,846
Taxable Estate	\$465,170	\$278,179
Federal Estate Tax	\$110,125 <u>a/</u>	\$ 50,402
Effective Tax Rate <u>b/</u>	17.3%	10.3%
Liquid Assets <u>c/</u>	\$ 74,265	\$ 74,265
Life Insurance Proceeds <u>d/</u>	\$ 7,861	\$ 7,861
Mortgages	\$ 23,753	\$ 23,753
Other Debts	\$ 15,457	\$ 15,457
Estate Administration Expenses	\$ 19,244	\$ 19,244

a/ Estimate based upon GAO or IRS calculation of estate taxes of the sample estates, if they were valued at fair market value.

b/ Federal estate tax divided by taxable estate value.

c/ "Stocks and Bonds" (Form 706 Schedule B) plus "Mortgages, Cash and Notes" (Form 706 Schedule C).

d/ "Insurance on Decedent's Life" included in the total gross estate value (Form 706 Schedule D).

Source: Average or mean data from a sample of IRS Forms 706 containing I.R.C. Section 2032A elections. See appendix II for a description of the sample.

Tax saving from section 2032A  
depends on estate size

The benefits of special use valuation are more concentrated among the larger estates in our sample. Nearly 60 percent of the benefits are received by nearly one-third of the estates. Forty percent of the total tax saving accrued to estates valued between \$500,000 and \$1,000,000 although these estates were only 24 percent of all estates sampled. Thirty-four percent of the tax saving went to estates valued between \$250,000 and \$500,000. Table 3 shows the distribution of the tax saving among sample estates electing special use valuation.

As table 3 indicates, the average tax saving increases with the value of the estates. Estates valued over \$1,000,000 saved an average \$152,856, while estates valued under \$250,000 saved \$16,152.

We expected that the tax saving from special use valuation would be largest among large estates. First, many small estates incur no Federal estate tax liability, even when valued at fair market prices. Second, the saving is proportionate to an estate's marginal estate tax rate, which is higher for a larger estate. Third, large estates are more likely to take advantage of special use valuation than small estates, since they are able to bear the costs and risks of the election. <sup>1/</sup>

A concentration of the special use valuation benefits among the richest estates parallels the concentration of farm subsidy benefits among the rich farmers. In his 1971 study of farm subsidies, Charles Schultze found that the concentration of farm production among a small share of the farm population and the vesting of subsidies in land combine to prevent small-scale farmers from obtaining a large share of the subsidies.

Whatever the advantages or disadvantages of the farm subsidy program, it is not a welfare program in the sense of transferring income to low-income families. The bulk of the subsidies accrue to that small group of farmers with net incomes averaging \$20,000. And because the value of the subsidy tends to get reflected in farmland prices, the subsidies are gradually trans-

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<sup>1/</sup>As estate size grows, however, the portion of the estate tax that can be avoided by "use" valuation decreases. Electing "use" valuation will eliminate the entire tax only for relatively small estates. Larger estates can achieve savings but cannot avoid the tax entirely. Further, the 1976 Act limited the decrease from fair market value to \$500,000, effectively capping the tax saving for the largest estates. Their total tax bill can continue to grow with estate value, though, so the capped tax saving becomes relatively less important.

Table 3  
Distribution of Tax Saving by Estate Value

<u>Fair Market Value of Taxable Estate</u>	<u>Number of Estates</u>	<u>Total Tax Saving</u>	<u>Percent of Total Tax Saving a/</u>	<u>Average Tax Saving</u>
\$100,000 to \$250,000	47	\$ 759,151	7	\$ 16,152
\$250,000 to \$500,000	72	\$3,456,197	34	\$ 48,003
\$500,000 to \$1,000,000	42	\$4,057,853	40	\$ 96,616
Over \$1,000,000	12	\$1,834,270	18	\$152,856

a/Total may not add to 100 percent due to rounding and excluding two estates valued under \$100,000.

Source: Special sample of estate tax returns. See appendix II.

lated into capital gains for long-term holders of land, while recent purchasers and renters receive a much smaller benefit, losing at least part of the subsidies in higher carrying costs or rents. 1/

This "small group of farmers with net income averaging \$20,000" produced three quarters of all farm product sales in 1969, although they numbered only 19 percent of all farms. Schultze did not determine to what extent differences in farm income were attributable to differences in subsidies, however.

Liquidity of estates electing  
special use valuation

Data collected from our sample of Federal estate tax returns tell us something about the liquidity and debt condition of farm estates. Liquid assets (cash, stocks, and bonds, as well as mortgages owed to and notes held by the decedent) amounted to 13.4 percent of the fair market value of the average taxable estate. The debts of the decedent, including mortgages, operating loans, and personal loans, were 7.9 percent of the taxable estate at fair market value.

Thus, the liquid assets of an average estate in our sample would have been adequate to pay the outstanding debts but not the debts and the Federal estate tax. The data reveal nothing, of course, about the ability or willingness of the inheritors to obtain loans to pay the tax, to use their own funds to pay the tax, or to use Federal estate tax provisions to postpone the date of tax payment and pay the taxes by installment. Loans have been a common method of financing the tax bill, although their availability and cost vary greatly over the business cycle.

Our sample is not representative of all farm estates, since it only includes estates that elected special use valuation, and therefore inferences from the sample cannot be blithely extended to the full population of farm estates. We have no basis for speculating how the liquidity position of other estates differs from that of electing estates.

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1/Charles Schultze, The Distribution of Farm Subsidies: Who Gets the Benefits? (Washington D.C.: Brookings Institution, 1971), p. 3.

## CHAPTER 5

### MAJOR CONCERNS RELATED TO SPECIAL ESTATE TAX PROVISIONS AND THEIR EFFECTS ON FARMS

Efforts by the drafters of the 1976 Act to distinguish between "tax" and "real" farmers and to confine estate tax preferences to the latter created an unusual pattern of statutory exclusions and complexities. The special estate tax provisions do not contain carefully delineated distinctions between landowners who hold farmland as investors and the bona fide farmers who operate farms. Therefore the operating farmers must be aware that the restrictions designed to exclude the investors are ambiguous and could cause their estates to be disqualified from electing special use valuation.

#### BENEFITS OF THE "USE" VALUATION APPROACH

The capitalized net cash rent method of valuing qualified farmland for those electing special use valuation is attractive because (1) the method of valuing the land is explained in the statute and (2) the taxable estate is substantially reduced. One starts with the average annual gross cash rental for actual tracts of comparable local farmland and subtracts the average State and local real estate taxes for the same comparable land. The result is then divided by the average annual effective interest rate charged on new Federal Land Bank loans. The interest or discount rate is considerably important in this procedure because small differences in this rate may give rise to large differences in the dollar value of the decedent's estate. <sup>1/</sup>

#### What is the importance of the discount rate?

The discount rate specified in section 2032A(e)(7), the 5-year average of regional Federal Land Bank loan interest rates, is the rate chosen by the Congress to convert future farm earnings into a present value. Present value calculations are commonly performed in financial analyses to find the current worth of an asset that will produce income in the future. The discount rate links the present value to future income by telling how much more valuable present funds are than future funds. A high discount rate means that an investor is much less interested in distant payoffs than short-term returns. Discount rates also reflect expected inflation and the investment's riskiness.

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<sup>1/</sup>ERTA permits substitution of net share rentals for cash rentals in the calculation of "use" valuation for farmland if the executor cannot identify actual tracts of comparable farmland in the same locality that are rented for cash as the decedent's farm property. Chapter 6 discusses problems that could be encountered using net share rentals.

Present values are normally calculated by the formula 1/:

$$PV = \frac{C_1}{1 + r} + \frac{C_2}{(1 + r)^2} + \dots + \frac{C_N}{(1 + r)^N}$$

where  $C_1, C_2, \dots, C_N$  are the earnings or cash flows in years

1, 2, . . . , N,  $r$  is the discount rate, and PV is the present value of the earnings. If the earnings are constant over time and are expected to continue indefinitely, the present value formula becomes

$$PV = \frac{C}{r}$$

where  $C$  is the constant level of earnings or cash flow. This second formula is the one used for special use valuation under section 2032A(e)(7). The earnings,  $C$ , are set at the 5-year average of rents for comparable land, less property taxes.

Determining the present value of future farm income is one of the three common ways of valuing a farm; the present value method is not used solely for special use valuation. 2/ A conventional appraisal, however, has recourse to other approaches to determine farm value. The replacement cost method sets the value of the farm at the cost that would be incurred if the land, buildings and other improvements, and equipment had to be replaced today, making some allowance for equipment depreciation. The comparable sales technique establishes the value of an estate by considering the sale prices of similar properties and then adjusting those prices to reflect any significant differences between the properties and the estate. For example, if a farm estate is similar in every respect to a recently sold farm except in the quality of its irrigation system, the estate's value would be the sale price of the second farm plus or minus the correction for the difference between the irrigation systems.

In conventional appraisal methods, present value calculations are used in conjunction with other estimates. If the present value is much different from other estimates, the appraiser ordinarily looks again at the predicted income and the discount rate to make sure they are reasonable. Thus, while the selection of the discount rate is subjective, the rate alone does not determine the farm's value.

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1/Most financial analysis textbooks provide a complete explanation of this formula.

2/Determining the present value of future income is frequently called the "income capitalization" method.

Because electing the capitalization alternative of section 2032A(e)(7) prevents using other methods of valuation, considerable attention has been paid to the discount rate in proposals to change special use valuation. 1/ If the discount rate were reduced, the special use valuation estimates would increase and the tax saving would be lowered. The debate over the appropriate rate is described in the next section. The rent capitalization formula also requires that comparable rents be found. The most significant problem relating to rents is finding a comparable farm that is being rented for cash. The implications of this problem are discussed in the next chapter.

In early 1980 the Treasury Department proposed revising the rent capitalization formula to make it reflect more clearly the value of the farm as farmland. Treasury's position was that the formula caused farm use value to be significantly understated because the interest or discount rate, which is the effective interest rate charged by the Federal Land Bank, was too high for the discounting purpose here. A former Deputy Tax Legislative Counsel for Treasury said farms having no potential use other than farming are being valued at a substantial discount (from 23 percent to 76 percent) under the formula. Also, he said that section 2032A was estimated to cost \$14 million per year when enacted; however, current figures show the cost may be as much as \$140 million per year. Treasury believed that a more realistic rate would be the greater of either 4 percent or the annual rate of return on equity from farm property rather than the current Federal Land Bank loan rate. 2/ The annual rate of return on equity would be determined on a State-by-State basis from the Department of Agriculture's annual statistical publications, "State Farm Income Statistics" and "The Balance Sheet for The Farming Sector," by subtracting Government payments from net farm income and dividing the difference by proprietors' equities. Their proposal would modify the formula so that the valuation of a farm under the section 2032A formula would approach the farm's fair or current market value. 3/

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1/The "five-factor formula," I.R.C. Section 2032A(e)(8), is the only alternative procedure for replacing the capitalization formula for use valuation. Chapter 2 contains a description of section 2032A(e)(8).

2/The Federal Land Bank loan rate as of June 1981 ranges from 8.21 percent in 1977 to 9.66 percent in 1981 depending on the decedent's date of death and the Federal Land Bank district in which the estate is located.

3/H.L. Gutman, hearings before the Subcommittee on Taxation and Debt Management, pp. 396 and 400. Also see H.L. Gutman, Treasury Department written statement before the subcommittee, pp. 6-10.

A lower discount rate means higher estate values, however, and for this reason the proposal faces strong opposition. The current discount rate reflects (as best as any one rate can) the costs that farmers face in borrowing. In a sense, the price that a farmer is willing to pay to borrow reflects the value placed on continuing to operate the farm. The rate may also reflect some of the risk associated with farming.

Selecting an "appropriate" or "proper" discount rate is always a difficult process that requires some subjective assessment of preferences for short- and long-term returns, of the risk that a future stream of income will not continue, and of expected inflation. In this case, no reasons exist for preferring either the current 5-year average loan rate or, as Treasury proposed, the estimated return on equity. The discount rate under current law has been around 9 percent since the 1976 law became effective, while the Treasury estimated the return on equity to be 4 percent.

The choice between these two rates, or between these and other alternatives, rests on the policy goals of special use valuation and the size of the estate tax revenue loss that results from different discount rates. Treasury's proposal, for instance, would reduce the capitalization rate for special use value by about half and reduce the revenue losses. How much revenues would increase is difficult to predict.

#### POOR PROGRAM DESIGN OR EADLY PERASFD LFGISLATION?

The operating farmer must be aware of the restrictions in the law that are designed to exclude nonfarm investors. The qualification criteria in section 2032A are supposed to restrict special use valuation savings to active farmers whose estates consist primarily of farm assets. Sections 6166, 6166A, and 2032A do not definitely distinguish between nonfarm investors and bona fide operating farmers. <sup>1</sup>/ Problems arise because the Code (1) contains an imprecise definition of active farmers, (2) excludes some estates of active farmers from the benefits of section 6166 when they elect special use valuation, and (3) does not contain a liquidity test.

#### Liquidity and percentage eligibility requirements

The full-time owner-operator of a family farm, which includes a large amount of real property devoted to farming, can generally satisfy the requirements of section 2032A with no estate planning. A business that includes a moderate amount of farmland with a wide difference between its fair market value and special use values can also readily meet the 50 and 25 percentage requirements of section 2032A by using estate planning techniques and qualify for special use valuation. Whether a decedent's estate meets the

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<sup>1</sup>/ERTA repealed section 6166A.



percentage requirements or not tells nothing, however, about its liquidity.

#### SIMILAR PROVISIONS HAVE DISSIMILAR REQUIREMENTS

Section 6166A, which permits estate taxes to be paid by installments over 10 years, was in the Code long before the Tax Reform Act of 1976 was passed. The 1976 Act added the provision for a more favorable 4 percent interest rate and payment-extension and deferral that are found in the new section 6166. In order to qualify for the estate tax deferral under new section 6166, not only must an estate include an interest amounting to at least 20 percent by value of a closely-held business, including a farm or a ranch, but also the value of the interest must amount to at least 65 percent of the adjusted gross estate. The requirement under new section 6166 is a strict 65 percent test that features a more liberal installment payment of estate tax with a much lower rate of interest than under the older provision, which has been retained and redesignated as section 6166A. The test for section 6166A was left at 35 percent. For an estate to qualify for an estate tax deferral under section 6166A, it must include an interest that exceeds only 35 percent of the value of the gross estate or 50 percent of the taxable estate. It is unclear why a new section 6166 was added instead of using and merging the best features of the old and the new sections. 1/

It has been reported that estates that qualify for the privilege of paying their taxes over a 15 year period have encountered problems with earlier Revenue Rulings used to determine qualification under section 6166A, the 10-year installment payment. 2/ Some IRS districts contend that Revenue Rulings, which preceded the 1976 Tax Reform Act, are applicable to new section 6166. "Section 6166 allows an executor to elect to extend payment of part or all of the portion of the estate tax which is attributable to a closely-held business interest (as defined in section 6166(b)(1))." 3/ Some sole proprietors have had difficulty meeting the trade or business requirement in section 6166(b)(1) stemming from the earlier Revenue Rulings when the farm is leased by a sole proprietor. For a farmer to qualify, some IRS districts contend that qualification requirements are as rigorous as those for section 2032A material participation. At the IRS national level, the interpretation has been that a farmer who is a sole

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1/ERTA consolidated the most liberal provisions of sections 6166 and 6166A. Section 6166A has been repealed and section 6166 was expanded to cover all estates in which the value of an interest in a closely-held business exceeds 35 percent of the value of the adjusted gross estate.

2/Revenue Rulings 75-365, 75-366 and 75-367. For additional discussion of this matter see chapter 6.

3/IRS Regulations Section 20.6166-1(a).

proprietor and rents the land must be engaged in an active business or trade to meet the trade or business requirement. In the case of a partner or shareholder, section 6166 does not require a partner or shareholder to be involved in any way in the management or operation of the business.

THE DIFFICULTIES THE PERCENTAGE RESTRICTIONS  
CREATE COULD BE SUBSTANTIAL

Executors electing special use valuation can choose among three provisions for deferring the payment of estate tax and then paying it by installment. <sup>1/</sup> The executor's choice depends on how large a percentage of the adjusted gross estate is composed of farm property. The requirements of these provisions that must be satisfied differ from those for special use valuation. If special use valuation is elected, the reduced value of real property must be used in calculating whether an estate meets the 65 percent test of a section 6166 deferral or the 35 percent test of a section 6166A deferral. The qualification requirements for special use valuation include the 50 percent and 25 percent tests. The restriction that at least 50 percent of the adjusted value of the decedent's gross estate must consist of the adjusted value of real and personal property that is used in farming attempts to address the farm liquidity problem. The reduction in the value of a farm business due to the election of special use valuation may prevent a farm estate from qualifying for the privilege of paying taxes by installments because the reduced value of the decedent's interest in the business is less than 65 percent of the adjusted gross estate. An election under 6166A for installment payment of estate taxes may be disallowed if special use valuation reduces the value of the decedent's interest in the business below 35 percent of the adjusted gross estate or 50 percent of the taxable estate.

It was reported that the reason for adding section 6166 in 1976 was that 6166A had been inadequate to deal with the liquidity problems faced by estates in which a substantial portion of the assets consisted of an interest in a closely-held business or other illiquid assets. It appears that the stricter 65 percent test excludes nonfarm investors from the benefits of the more liberal provision; however, the interaction with section 2032A may also cause bona fide farmers to lose the section 6166 benefits.

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<sup>1/</sup>Under section 6161, the IRS may extend the time for payment of the tax for a period not to exceed 12 months. The extension will be granted on a reasonable cause basis.

## CHAPTER 6

### PROBLEMS ARISING FROM THE LAW

#### UNRESOLVED PROBLEMS AFFECT EXECUTION

Executing sections 2032A and 6166 has not been easy or entirely successful. Certain problems relating to valuation methods, material participation, and liens prohibit some and discourage others from receiving benefits of the law.

Although the provisions were enacted in January 1977, final regulations were only issued in July 1980. The complexity of the provisions and lack of final IRS regulations for the past several years has not only created confusion and controversy but also increased the workload on IRS and added a burden on the people wanting to use the provisions.

#### Valuation methods contribute to uncertainty

Section 2032A provides two approaches for valuing farmland: the more attractive formula or farm method and the five or multiple factor method. Although the Congress intended that executors should be able to value farmland with reasonable certainty, subjectivity is still present in the calculations. The two approaches and a "catch-all" factor included in the multiple factor method contribute to the uncertainty in farm valuation.

##### Formula method

In discussions of section 2032A(e)(7) the Congress stated that:

The special farm valuation method is provided to permit the executor, in many situations, to achieve a substantial amount of certainty in arriving at use valuation for farmland as well as to eliminate non-farm factors in valuing farmland. Since this method involves a mathematical computation in which the amount of the annual rental may in many cases be determinable with reasonable certainty [emphasis added] and the capitalization rate is determinable, this method should offer three advantages. First, it should reduce subjectivity, and thus controversy, in farm valuation. Second, it should eliminate from valuation any values attributable to the potential for conversion to non-agricultural use. Third, it should also eliminate as a valuation factor any amount by which land is bid up by speculators in situations where non-agricultural use is not a factor in inflated farmland values. <sup>1</sup>/

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<sup>1</sup>/H.R. 10612, p. 540.

According to IRS regulations, once the executor of an estate has elected to use section 2032A the values of farmland eligible for the special valuation are determined by the formula or so-called "farm" method, unless the executor elects otherwise. The formula method sets the value of the land equal to the average annual cash rental for comparable farmland (net of State and local real estate taxes) divided by the average annual effective interest rate for all new Federal Land Bank loans. Average annual rent and interest rate is the average of these quantities over the five most recent calendar years before the decedent's death.

This formula appears to simplify the calculations, but considerable controversy remains regarding comparability, crop share agreements, real estate taxes, and interest rates. For example, the cash rent depends on the meaning of the terms "comparable" and "locality," neither of which is defined in the statute. Where is comparable land to be located? In the same county, adjacent counties, throughout the State, or in adjacent States? What constitutes comparable land? Must it be identical in all respects--acreage, crops, soil composition, water availability, and yields? The statute gives no answers. IRS regulations specify factors to be considered in determining comparability, but the factors are still subjective. An unreasonable, narrow definition of comparability and locality would greatly limit the number of estates using the formula method. Representatives of the legal and accounting profession told us that IRS' interpretation of comparable cash rental is too strict and often requires identifying identical land tracts.

The requirements that rentals must be cash rentals means that in-kind rental or crop sharing agreements are excluded. In 1978, the proposed IRS regulations provided that where no comparable real property is leased solely on a cash basis, crop shares could be used for determining cash rental value. However, its final regulations provided that crop share rentals may not be converted to cash rentals and used in the formula method. This denies the formula method to a major portion of the Nation where crop share agreements predominate and cash rentals are rare. Attorneys and appraisers find it difficult to find comparable cash-rented land. In addition, many farmers who rent their land for cash are reluctant to disclose the rent they charge. One agricultural economist from Purdue University describes cash rentals as being difficult to obtain on an individual farm or county basis; however, USDA publishes State average rents annually, and estimates are available for some crop reporting districts. The economist proposed that the USDA estimates be used to estimate the cash rent of a given

farm and those comparable to it by using crop yields or yield ability based on soils. 1/

Under ERTA a farm estate may be valued under the formula method by using net crop share rentals rather than cash rentals. However, a tax attorney representing the Illinois Bar Association testified before the Subcommittee on Taxation and Debt Management that the present form of the proposed bills might still deny special use valuation to many farmers. 2/ He said that IRS' first set of proposed regulations required crop share information that could only be obtained by inspecting the private income tax returns and records of a neighboring farmer. He said it would generally be impossible to persuade a neighboring farmer to divulge this information or to find an appraiser who would attempt to obtain it. This tax attorney proposed that in cases where there are no comparable farms rented on a cash basis in the locality, the executor should be permitted to determine crop share rental based upon areawide averages of net crop share rental for farms of comparable soil quality. 3/ Under ERTA and prior law the farm estate is to be valued using the multiple factor method when no comparable land is available from which a cash or share rental can be determined.

An article by two Iowa State University agricultural economists points out that converting crop shares to a cash rent equivalent would raise several questions regarding price, yield, and costs. First, what price should be used? The price for the crop or crops could be the actual price received, harvest time price, or some average market price. Using actual price may cause problems because the crop may have been stored and not sold, and land values might be based on marketing decisions rather than land productivity. Second, what yield should be used? Yield could be based on actual yields, average county yields, or long-term average yields. Third, how are costs accounted for in the computation?

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1/J.H. Atkinson, "Estimating Cash Rental Rates for Indiana Farmland," in "Use Valuation of Farmland for Estate Purposes in Indiana: I.R.C. Section 2032A(e)(7)-(8)," by Gerald A. Harrison in Proceedings of Symposium on Farm Estate Issues Raised by the Tax Reform Act of 1976, U.S. Department of Agriculture, FSCS-73, (Washington, D.C., 1979), pp. 40-42.

2/Robert M. Bellatti, U.S., Congress, Senate Committee on Finance, Miscellaneous Tax Bill V, hearings before the Subcommittee on Taxation and Debt Management, March 4, 1980, pp. 386-387.

3/Farmland tenancy or rental is common in many parts of the United States. Someone other than the owner operates the land through the use of leasing arrangements or a farm manager. Three major

Various procedures are used to handle harvesting, drying, storage, and depreciation costs. <sup>1/</sup>

Five or multiple factor method

The alternative to the formula method--the five or multiple factor method--merely increases the uncertainty in farm valuation. The factors are:

- capitalizing income over a reasonable period of time under prudent management using traditional cropping patterns for the area,
- capitalizing the fair rental values of farmland,
- assessed land values in a State that provides a differential or use-value assessment law for farmland,
- comparing selling prices for other farms in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price, and
- any other factor that fairly values the farm.

Besides the ambiguity and uncertainty created by the last factor, confusion is increased because no weights are assigned to the various factors, and there is no guidance on which factor will be used to resolve conflicting values. The two capitalization formulas, expected income and fair rental values of the land, leave open the question of what capitalization rate is appropriate.

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types of farm leases are recognized: the crop share, the livestock share, and the cash lease. The landowner's involvement and participation in the farm business is greatly different under these lease types. Under the crop share lease the landowner receives a share of the crops, usually one-third, two-fifths, or one-half of the gross rent share. The landowner generally shares proportionately in seed, fertilizer, and other expenses. It is a useful method whereby two or more persons or families (the tenant, landowners, or investors) share the cost of land, labor, capital, and management in organizing and operating the farm business. Generally the livestock share landlord shares equally with the tenant all farm income and most variable costs and is a virtual partner. Under the cash lease the rent is usually a fixed number of dollars with no participation in operating costs by the landowner.

<sup>1/</sup>Michael D. Boehlje and Neil E. Harl, "Use Valuation Under the 1976 Tax Reform Act: Problems and Implications," in Symposium on Farm Estate Issues, pp. 9-10.

A witness testifying before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee said that this five factor formula does not appear to be either beneficial or workable in the case of the average family farm. He maintained that for all practical purposes special use valuation is not available to a family farm unless it can be valued under the mathematical formula. 1/

One IRS group manager stated that the IRS favors the comparable sales factor because they more clearly reflect the value of the farm as farmland. According to the IRS manager, farmers and ranchers, as well as attorneys and accountants, resist this approach since in many cases it produces the same result as fair market value. Furthermore, farming is often the highest and best use of land in a farming area, so any element of speculation relates to agricultural value, not development potential. Under these circumstances, the five or multiple factor method would not provide any tax relief to inheritors of a farm.

#### Qualifying property other than land

Another problem with valuation involves qualifying property other than land. As noted in chapter 2, qualifying property includes the farmhouse or other residential buildings and related improvements located on the farm if the buildings are occupied on a regular basis by the owner, a lessee, or employees to operate or maintain the farm. Although such property qualifies for special use valuation, the law contains no explanation of how to value these improvements.

#### Meeting material participation requirements

One of the most important requirements in section 2032A is that of material participation, both before and after the decedent's death. The Congress scarcely explained, however, what material participation should be taken to mean. The only reference to the matter appeared in a publication by the Joint Committee on Taxation:

whether there has been material participation by an individual in the operation of a farm or closely held business is to be determined in a manner similar to the manner in which material participation is determined for the purposes of the tax on self-employment income with respect to the production of agricultural or horticultural commodities under present law. 2/

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1/Robert M. Bellatti, Miscellaneous Tax Bills V, p. 386.

2/H.R. 10612, p. 538.

The Congress noted that if, for example, the decedent had owned real property that was leased to a partnership for use as a farm in which he or she and two children each had a one-third interest in profits and capital, the real property could qualify for special use valuation. However, if the property is used in a trade or business in which neither the decedent nor a member of the family materially participated, the property would not qualify. 1/ Apparently special use was not to be available to non-operating farm investors or to anyone not actively engaged in farming. While it is clear that the Congress wanted the decedent or the heir to be active in farming, it is unclear how active or in what manner. 2/ The IRS guidelines for material participation are found in Revenue Ruling 57-58 and the final regulations that contain several examples of material participation. Since the ruling states that each case must be decided on its own facts, material participation remains undefined. More concrete examples are given by IRS in the Farmers Tax Guide, which states that a farmer has materially participated in the operation of a farm if any of the following are done:

Test One. The farmer does any three of the following: (1) advance-pays or stands good for at least half the direct costs of producing the crop; (2) furnishes at least half the tools, equipment, and livestock used in producing the crop; (3) advises and consults with his tenant periodically; and (4) inspects the production activities periodically.

Test Two. The farmer regularly and frequently makes, or takes an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.

Test Three. The farmer works 100 hours or more, spread over a period of 5 weeks or more, in activities connected with producing the crop.

Test Four. The farmer does things which, considered in their total effect, show that he is materially and significantly involved in the production of the farm commodities.

Only the third test really provides definitive limits to remove subjectivity in measuring material participation. The other three tests still leave material participation to be administratively

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1/U.S., Congress, House, Joint Committee on Taxation, H. Rept. 94-1380, 94th Cong., 2d Sess., August 2, 1976, p. 23.

2/ERTA contains a number of changes that ease material participation requirements for special use valuation, particularly relating to active participation and 8-year periods that precede and succeed the death of the decedent.



determined and create uncertainty in estate planning. Also, under these guidelines, it is possible for non-operating investors to qualify for special use valuation either by crop sharing or the hiring of farm managers, a result seemingly contrary to congressional intent. 1/

These guidelines provide general rules to landowner's participation when leasing farmland on a crop share or cash rent basis. When the landowner conducts the farming activities, proving material participation is no problem. The material participation issue becomes relevant under a lease arrangement because the landowner is no longer the operator and receives income in the form of a rental. In a leasing arrangement it is very important for participation purposes that the landowners or qualified members of their families actually participate to a material degree in the farming operation.

A recent article in the Brigham Young University Law Review points out two problems with the postmortem material participation rules. 2/ One complication arises during the 8-year periods that precede and succeed the death of the decedent. The persons whose activities must satisfy the material participation requirements are the decedents or their family members prior to the decedents' deaths and the qualified heirs or their family members subsequent to the decedents' deaths. This shifting of reference points for material participation may prove to be a problem for the unwary not familiar with the provision's complexities. For example, the requisite material participation prior to the decedent's death can be supplied by the decedent's first cousin, but if land passes to the decedent's son or daughter (the qualified heir) the tax savings under section 2032A will be recaptured unless the necessary participation is furnished by a member of the son's or daughter's family, which does not include the decedent's first cousin. In this example the provisions may disrupt continuity in operation of the decedent's farmland. In order to avoid recapture the heir or a member of his or her family is forced to assume a material degree of participation and the decedent's first cousin will probably be forced to quit using the land. 3/

Another problem of the postmortem participation rule is illustrated by the qualified heir's ability to obtain interest-free deferral of estate tax payment in which the decedent has continuous material participation and ownership during the 5

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1/Internal Revenue Service, Farmers Tax Guide, and Social Security Regulations, sections 1224-1233.

2/"The Family Farm and Use Valuation," pp. 406-7.

3/A crop share lease arrangement could be developed that meets the material participation requirements and allows the first cousin to still farm the land. The definition of family member is expanded by ERTA to include lineal descendants of the surviving spouse who are not descendants of the decedent.

years preceding his or her death. If special use valuation is elected and the land passes to a qualified heir and remains in farm use but the heir makes no attempt to satisfy the material participation requirement, the tax saving is recaptured three and a half years after the decedent's death. Since no interest is charged on the additional tax, the heir enjoys what may be a sizeable benefit for postponing payment of a part of the estate tax for more than 3 years. This sort of loophole does not encourage the preservation of family farms. 1/

The 8-year period during which the qualified heir or family member must actively farm the land for at least 5 years includes years before the decedent's death as well as after the death. A potential problem could arise where the decedent's estate qualified for special use valuation but in the last 2 years there was no material participation by the decedent or a family member. Should the qualified heir or his or her family members fail to materially participate one year after the decedent's death, the five-of-eight rule would be violated. Qualified heirs and family members who live far from the farmland and where the probate process is taking several years could be faced with such a problem.

Under current law, one cannot materially participate in the operation of a farm if one employs an agent or manager, unless the agent or manager is a member of one's family. This exception is significant and makes the benefits of section 2032A available not only to the owner-operator who actually lives on the farm but also to the landlord who lives off the farm and to those with indirect ownership (those having the required interests, in partnerships, corporations, and trusts). However, certain widow(er)s and small children who inherit a farm may be incapable of material participation because no family member is available to run it. Thus, these heirs, whose only means of operating the farm is through an agent, are not eligible for special use valuation.

Another obstacle of meeting the participation requirements may be a lack of records. Farmers normally do not maintain adequate records proving their material participation before their death, especially if they had no idea that such proof would be required.

#### LIENS COULD RESTRICT CREDIT AVAILABILITY

In the case of estates electing section 2032A, IRS files a special tax lien on all qualified farm real property where an election has been made for an amount equal to the additional tax that will be due if special use valuation is subsequently

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1/If a recapture tax is imposed, ERTA appears to close this loophole by requiring the heir to pay interest on the amount of the recapture tax.

revoked. IRS can subordinate the lien if the Government's interests are adequately protected after the subordination. 1/

Some attorneys told us that these special liens can make it more difficult for farmers to get loans to finance farm expansion, especially when the Federal Government's interest is not subordinated to other interests. Federal tax liens on section 2032A property can affect financing because these liens are subordinated for farm operation, but not for farm expansion purposes.

#### Personal liability

Another potential problem associated with the liens is a requirement that all heirs to the section 2032A property must sign an agreement of personal liability for additional tax in the event of early disposition or early cessation of qualified use. If any inheritor refuses, the section 2032A election is disallowed. Thus, those heirs with only a small interest may be unwilling to sign an agreement and deny other heirs from electing special use valuation.

#### SECTION 2032A CONSIDERED DIFFICULT TO UNDERSTAND AND ADMINISTER

Those involved with farm estates consider the section 2032A provisions to be too complex and difficult to administer. 2/ Probate judges commented that the special provisions are so complicated that most people have difficulty understanding them. A farmer's credit association official said he has attended several meetings where attorneys have tried to explain the special provisions and, in his opinion, the provisions are far too complicated. Attorneys and agricultural economists also commented that section 2032A is too complex and should be revised to make it easier to understand and less difficult to qualify for eligibility.

According to IRS personnel, section 2032A has increased their workload. For example, IRS appraisers must make their own appraisals for both fair market value and farm use value. One district had a minimum need of two appraisers to verify that the special use values were proper. The IRS official said the cost to hire an appraiser for a case can range from \$3,000 to \$35,000, and their region only had about \$300,000 available in total for such needs. According to one district official the section 2032A case workload has caused a reduction in the number of estate tax returns audited. Special use valuation adds between 30 percent and

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1/The special liens for the estate tax that is deferred under sections 6166 or 6166A may be subordinated less readily than the liens associated with special use valuation.

2/Enactment of ERTA will significantly reduce the number of estates having to pay estate taxes and using the special estate tax provisions. A direct result will be reducing IRS's administrative workload.

50 percent to the time it takes to audit a return. At another district, IRS attorneys must spend a minimum of 10 extra hours on every estate return that contains special use valuation. In one case more than 100 hours had been spent on the return and some problems were still unresolved.

Before the final regulations were issued, IRS district offices occasionally differed in how they administered the provisions. One district at first allowed executors to use a county average cash rental developed by a State university because getting a 5-year average cash rental was difficult. Now this district requires executors to use actual cash rentals. Other districts we visited never allowed any county or statewide averages of cash rental to be used, just actual cash rental.

The formula method has given rise to other inconsistencies. One certified public accountant reported that IRS had interpreted that the formula cannot be used when the highest and best use of the land is in farming, and that in this circumstance farmlands will have to be valued by the comparable sales method rather than by the capitalized rental formula method. 1/ One IRS regional reviewer of estate tax returns said that this was how he had interpreted the Act and that he had instructed all districts in the region to follow that interpretation. Subsequently the IRS national office advised the regional commissioners in August 1979 that the Treasury had determined that an estate may elect special use valuation even when farming is the highest and best use for the property.

IRS officials maintain that the regulations concerning special use valuation must be followed closely, especially in matters concerning material participation and comparable cash rentals. Many attorneys and tax practitioners think that IRS is interpreting the law too strictly in order to disqualify special use value elections. One attorney said that the IRS agent auditing his client's return said the comparable leased property used in calculating use value must have the same soil type and topography. If the land had improvements, then the comparable leased property should have essentially identical improvements. This requires the same number of waste acres in each tract, the same hills, slopes, gullies, terraces, etc. Likewise, if the property had a homestead consisting of a house, barn, machinery shed, and granary, a comparable homestead should have the same sort of improvements in the same state of repair and age. The attorney said it would be an expensive exercise in futility to try to meet IRS standards, which means in effect that identical, not comparable, real estate must be used.

Determining the degree of comparability and the extent of material participation is subjective in nature, and therefore IRS districts could be inconsistent in their treatment of these is-

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1/James Moore, "Farmers caught between Congress, IRS," Farmer & Rancher, (Gainesville, Fl.), May 31, 1979.

sues. The IRS national office and regional offices must continually monitor the regions and districts to ensure that districts are consistent in their administration of special use valuation.

#### QUALIFYING FOR SECTION 6166 COULD BE DIFFICULT

No statutory definition of trade or business appears in section 6166. Some IRS districts use criteria similar to the material participation requirements contained in section 1402 or section 2032A. 1/ And some districts apparently require that the decedent must have materially participated in the operation of the business before death. These practices have made it difficult for some farm estates to qualify for section 6166. This is a particular problem for farm estates operating as a sole proprietorship and may be a very serious problem for retiring farmers.

The IRS has not expressly incorporated material participation as a requirement for eligibility under section 6166, nor has it provided a clear definition of what is a trade or business. As a result, IRS district offices administer section 6166 differently.

#### SUMMARY

Sections 2032A and 6166 have been difficult to administer and difficult to comply with. 2/ IRS personnel, attorneys, accountants, agricultural economists, and others agree that the law is too complex. The formula method produces more realistic values if the interest rate is a reasonable rate of return on equity from farm property rather than the effective interest rate charged by the Federal Land Bank. Except for the first factor--the capitalization of income over a reasonable period of time--the multiple or five factor method creates ambiguity and uncertainty. 3/ If comparable cash rentals are not available, the farm

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1/Generally, there are two requirements for material participation--(1) a formal arrangement and (2) actual activity. Section 1402(a)(1), dealing with earned income for Social Security, provides that the decedent must materially participate. Section 2032A, while adopting the definition of material participation of section 1402(a)(1), allows material participation by either the decedent or a member of the decedent's family. IRS rulings generally do not treat the management of income-producing properties as a trade or business.

2/The changes to the estate tax provisions contained in ERTA will continue to be difficult to administer and difficult to comply with.

3/Although we feel that the five factor method should be abandoned for farm estates, some of these factors might still apply to closely-held businesses.

estate might use the capitalization of income method to determine the special use value.

Material participation requirements for the two provisions are inconsistent. Section 2032A requires certain parties to materially participate in the operation of the farm before the decedent's death and after, while section 6166 does not. As the provisions now stand, non-operating owners benefit from the law as well as the owner-operator.

To help owner-operators, revisions should be made so that the law's benefits are more narrowly directed. Also, procedures for obtaining more realistic and consistent farmland values are needed.

## CHAPTER 7

### CONCLUSIONS AND RECOMMENDATIONS

As it now exists, special use valuation and the deferral and installment payment provisions have not helped slow the decline of small family farming. One reason why they have not is that the Federal estate tax has had little to do with the changes that are transforming American agriculture. While inheritors of family farms benefit from the estate tax savings, no evidence clearly demonstrates that they would have been forced to sell the farm estate if these tax preferences had not been available. The demise in recent years of many small farms, most of which were family operations, appears to be due not to the burdens placed on them by the Federal estate tax but rather to a constellation of economic and technical forces that have affected all farmers, not only those who inherit their farms. Small operators are generally less able to exploit technological advances than large operators, and many have been forced out of business. Farmers also differ considerably in their managerial skills. Since the best farm managers have incentives to expand their farms, the farm failures attributable to inadequate managerial skills are concentrated among small farms.

We believe that these estate tax provisions should be viewed as instruments for delivering Federal assistance to American farmers--as aid programs embedded in the Federal estate tax--and evaluated by the same criteria that are used to evaluate direct Federal spending programs. Like so many other Federal programs that aid American agriculture, these provisions, particularly special use valuation, reflect the special importance attached to farming, particularly small family farming, in American social and economic life. Today farmers are eligible for a wide assortment of Federal assistance programs, including subsidized loans, federally sponsored research and information services, and preferential treatment under the Federal income and estate tax systems. These farm programs are designed to promote certain objectives--maintaining a diversity of farm ownership is one of them--and should continually be scrutinized to ensure that they are effective.

Although we were unable to find evidence that special use valuation has helped keep any small family farms in existence, the provision undoubtedly does ease estate tax burdens on some farm families and is a source of financial assistance to the farm sector. However, special use valuation has proved to be complex in practice. (Chapters 2 and 6 discuss the sources of its complexity and ambiguity.) As a result of this complexity, the provision is costly to comply with and to administer. A simpler alternative would make it easier for farmers to receive assistance and would relieve the IRS of some of the burden of administering this program.

A more serious worry prior to ERTA, however, was that special use valuation may have actually accelerated the decline of family farming rather than assisting and encouraging its continuation. Because this complicated provision is costly to use, larger farms were the major beneficiaries. Many small family farmers lack the sophistication or the access to the skilled, professional services that would be required to plan for its use. In addition, even when small farms used the provision, we found that the dollar amount of benefits that large farms received were typically greater than the amount that small farms receive.

Because of changes enacted in ERTA, it appears likely that there will be fewer small farm estates electing section 2032A, special use valuation. A direct result will be a decrease in the administrative burden on IRS in handling estates that have made this election. Many small farms will be able to avoid paying Federal estate tax because of the increase in the unified credit and an unlimited marital deduction. The wealthier farm estates will still have to resort to using the special estate tax provisions with their inherent complexities.

Much of the complexity of special use valuation stems from the restrictions that were incorporated in the statute to limit benefits to a certain group of farm estates, that is, the estates of persons who were actively engaged in farming until their death and whose family heirs wish to continue farming the same property. These restrictions are contained in the material participation requirements of section 2032A. The Congress' decision to limit the benefits of the program in this manner is essentially a policy decision and we therefore make no recommendation to the Congress to consider relaxing or tightening these restrictions. <sup>1/</sup> A tradeoff obviously exists between the cost and complexity that these restrictions add and the desire of the Congress to focus the benefits of the program on a particular group in the population in order to increase its effectiveness without adding to its cost in foregone tax revenues. It is important to realize, however, that at least some restrictions are necessary not only to keep costs down but also because in the absence of restrictions nonfarm investors would be attracted by the tax savings. Their demand for farmland would drive its price up, encourage farmers to sell their property and leave agriculture, and make it more difficult for successful family farmers to expand their operations by purchasing more land. In that case the program might actually disserve the goal of encouraging smaller family farms to continue in operation and accelerate their decline.

In preparing the following recommendation, we assume that the basic structure of the Federal estate tax would remain much as it is today. Enactment of the Economic Recovery Tax Act of 1981 has resulted in several major changes in the transfer tax structure

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<sup>1/</sup>ERTA contains a number of changes that ease material participation requirements for special use valuation.



and has lessened the need for the two special estate tax provisions. The Act would phase in over 6 years an increase in the unified credit and at the end of the phase-in there would be no tax on estates under \$600,000. The marital deduction for gifts and bequests to spouses will be unlimited. No transfer tax will be imposed on transfers to a spouse, no matter how large the transfer. The use of proper estate planning techniques will allow couples to leave tax-free estates worth \$1.2 million to heirs in 1987 and subsequent years.

#### RECOMMENDATIONS TO THE CONGRESS

If a tax preference for farm estates is to be preserved, we recommend that the Congress replace special use valuation with a simpler alternative. The simplest alternative would be a modified version of the current tax deferral and installment payment provisions, sections 6166 and 6166A. Postponing the payment of a tax liability and then paying by installments over an extended period, with interest charged at below-market interest rates or with no interest charged at all, amounts to receiving a "tax loan" from the Government and as such is a valuable privilege. A "tax loan" provision has the clear advantage of being easier for taxpayers to understand than special use valuation. Disputes between the taxpayer and IRS over the amount of the tax lien are less likely than under special use valuation, which provides no method for settling disputes over the fair market value of the estate. 1/ Since IRS has established procedures for collecting deferred taxes, the deferral and installment payment provisions are less complex than special use valuation.

A tax deferral and installment payment provision can be made as generous or meager as the Congress desires by adjusting the length of the postponement of payment or the interest rate that the farmer is charged. Section 6166 now permits a 5-year delay before the first tax payment is due, then permits the tax to be paid in ten annual installments. Only interest is charged during the first 5 years. Thereafter interest is charged on the unpaid balance at a concessional rate of 4 percent per year. Forgiving the tax is merely the extreme case in which payment is deferred indefinitely and no interest is charged at all.

No matter what is done with special use valuation, sections 6166 and 6166A should be consolidated in a single section containing features of both, but more closely resembling section 6166. 2/ If section 2032A is repealed and all the estate tax benefits for

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1/Since there is no immediate tax liability, such disputes may not be settled by the courts, yet the size of the tax saving depends on the fair market value estimate. Without knowing the tax saving, IRS cannot guarantee the recapture through a tax lien, as section 2032A requires.

2/ERTA has consolidated the estate tax payment provisions, basically following section 6166.

farmers are delivered through a new tax deferral provision or a consolidated deferral and installment payment provision, the Congress may wish to enlarge the assistance delivered through the new provision and make it greater than the assistance that is currently delivered through section 6166. If the assistance will be greater than that given currently, the Congress may wish to consider further restricting eligibility.

Replacing special use valuation with a new tax deferral plan would alter the distribution of benefits that are delivered to farmers through the Federal estate tax system. All estates that qualified for the deferral privilege would receive a benefit equal to a fixed fraction of their estate tax liability. Under special use valuation qualifying estates receive a benefit that varies as a fraction of their tax liability. In general, smaller estates receive a larger benefit--if expressed not in dollars but as a fraction of their tax liabilities--than larger estates. Accordingly it may seem that substituting a tax deferral provision for special use valuation would skew the distribution of benefits away from small estates and toward large estates. We believe, however, that many more small farm estates will be able to take advantage of a new tax deferral provision than now take advantage of special use valuation and therefore that a larger fraction of all the assistance delivered by the program will flow to small estates than flows to them now.

Since the Congress decided to retain special use valuation rather than replace section 2032A with an enlarged tax deferral plan in ERTA, we recommend that it simplify the section and its administration by substituting a simple exclusion of a fixed fraction of the farm estate. For example, 30 percent--or whatever fraction the Congress chose--of the fair market value of all farm assets could be excluded from the estate tax base. Such a change would eliminate the complexity that now attends the calculation of an agricultural use value for farmland. The most reliable method of calculating this value is based on cash rentals paid for the use of similar farmland nearby. Under ERTA, crop share rentals may be used where rental agreements are commonly expressed in crop shares rather than cash; this method of calculating a use value entails a new set of problems, as chapter 4 notes. Many of the problems of establishing the section 2032A value would be eliminated if a fixed fraction of the fair market value of farm assets were excluded from the estate tax base.

This method would also make benefits available to farm estates that are composed mostly of equipment and machinery rather than farmland and that cannot now qualify for special use valuation. In general, it would tend to eliminate differences in the benefits received by estates that now depend on the fraction of the estate's assets that are in the form of land.

If section 2032A were revised in this manner, small estates would continue to be eligible for a larger benefit, expressed as a fraction of their estate tax liability, than large estates,

just as they are now. A larger fraction of the total program benefits might flow to small estates, however, if the simplification of the provision encouraged more of them to take advantage of it. 1/

#### AGENCY COMMENTS

We sent copies of our draft report to the Department of Agriculture, the Department of Treasury, and the Internal Revenue Service. Their comments are included in full in appendix IV, together with our responses. The report was modified in response to certain of the agency comments. The draft reports were provided to the agencies, and their comments received, prior to passage of the Economic Recovery Tax Act of 1981. The following discussion concerns only the most significant agency comments and our evaluation of them.

The Departments of Agriculture and Treasury hold different views of the Congress' intent in passing the special use valuation provision. Agriculture believes that the Congress adopted special use valuation as a means of providing tax reductions to keep land in farming. Treasury believes that the Congress was concerned with the problems created by highest and best use measurement of value, and the focus of special use value was to relieve valuation pressures on family farms.

Only the Department of Agriculture commented on our recommendations. Agriculture took exception to our alternative to eliminate the special use valuation provision in favor of a modified version of the current tax deferral and installment payment provisions. Agriculture's view is that the proposal would tend to benefit the larger estates more than their smaller counterparts, and investors would structure their estates to receive the benefits.

We believe that the modified deferred and installment payment provision, if adopted, would not necessarily attract investors if the eligibility requirements were structured to prevent nonfarm investors from abusing the tax loan privileges.

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1/Changes in ERTA will likely result in very few small estates requiring the benefits of section 2032A by the mid-1980s, since the expanded unified credit and marital deduction will allow virtually all estates to avoid the tax entirely.

THE ESTATE TAX LAW AFTER  
THE TAX REFORM ACT OF 1976

UNIFIED RATE SCHEDULE

Under prior law, there were two rate schedules, one for estate taxes and one for gift taxes. The gift tax rate schedule was three-fourths of the estate tax rate schedule. In adopting a unified rate schedule in 1976, the Congress recognized that the tax burden should be the same whether transfers are made during life or at death. In part this is because the benefits of lifetime transfers are available only for wealthy individuals who are able to afford such transfers. Generally, those of small or moderate wealth need to retain their property until death to assure their financial security.

Under the unified rate schedule for gift and estate taxes, the tax rates ranged from 18 percent of the first \$10,000 in taxable transfers to 70 percent of taxable transfers over \$5,000,000. 1/ As the total dollar value of all taxable gifts increases, the rate or percentage of tax also increases, and estates begin to be taxed at the rate, or percentage of tax, continued from where the gift taxes stop. 2/

UNIFIED CREDIT

Under prior law, separate exemptions were provided for estate and gift taxes. The exemption for estate taxes was \$60,000. The gift tax exemption was \$30,000. The 1976 Act replaces these exemptions with a unified credit, applied equally to estate and gift taxes. Having similar concerns when adopting a unified rate schedule, the Joint Committee on Taxation noted

1/ERTA reduces the maximum gift and estate tax rates over a 4-year period from 70 to 50 percent.

2/For example, an \$8,000 taxable gift in one year followed by an \$8,000 taxable gift a year later and a taxable estate of \$24,000 5 years later would have its taxes computed as follows:

		<u>Tax computation</u>	<u>Tax</u>
First gift	\$ 8,000	\$ 8,000 x 0.18 tax rate	\$1,440
Second gift	\$ 8,000	\$ 2,000 x 0.18 tax rate	\$ 360
		\$ 6,000 x 0.20 tax rate	\$1,200
			<u>\$3,000</u>
Taxable estate			
	\$24,000	\$ 4,000 x 0.20 tax rate	\$ 800
		\$20,000 x 0.22 tax rate	<u>\$4,400</u>
			<u>\$5,200</u>

that "it would be more equitable if a unified credit in lieu of an exemption were available on an equal basis without regard to whether the transfers were made only at death or made both during lifetime and at death." The Congress felt that tax liability should not depend on the method used to transfer the property from one generation to the next.

In its attempt to benefit modest-sized estates, the Congress recognized that at a given level of revenue cost, a tax credit confers more tax savings on small- and medium-sized estates than a deduction or exemption, which tends to confer tax savings on large estates. This is because an exemption reduces the taxable estate, with the result of a lower rate of tax at the highest tax level. A credit, however, reduces the amount of total tax due by applying a dollar-for-dollar reduction of calculated tax. <sup>1/</sup>

#### INCREASED MARITAL DEDUCTION

Prior to 1977, the marital deduction allowed for property left to spouses of up to one-half the value of the adjusted gross estate. The 1976 Act changed this to the greater of one-half the adjusted gross estate or \$250,000, increasing the deduction allowed to smaller estates. <sup>2/</sup>

This change was enacted because the Congress believed that a decedent with a small- or medium-sized estate should be able to leave a minimum amount of property to the surviving spouse without paying estate taxes. After combining the effect of the marital deduction and unified credit, an estate with a surviving spouse would pay no estate taxes on estates of less than \$370,000 in 1977, \$384,000 in 1978, \$397,000 in 1979, \$411,000 in 1980, and \$425,000 in 1981. <sup>3/</sup>

The example on p. 58 illustrates the effect of the increased marital deduction and unified credit for a \$300,000 estate with estate expenses of \$10,000.

In analyzing the effect of these changes, the House Ways and Means Committee reported that at 1977 levels, 110,000 of 131,000 estates of \$300,000 or less would be made nontaxable by these provisions. In addition, 4,000 of 21,000 estates between \$300,000 and \$1,000,000 would be nontaxable. Overall, the 1976 Act was

<sup>1/</sup>As a result of the unified credit, fewer estates have to file estate tax returns.

<sup>2/</sup>ERTA removed the quantitative limits on both the gift and estate tax marital deduction.

<sup>3/</sup>ERTA increased the unified credit to an equivalent deduction of \$600,000 in 1987 and beyond.

## APPENDIX I

## APPENDIX I

projected to reduce estate taxes by \$1,200 million and \$1,167 million of this amount would be in reduced estate taxes for those estates of \$1 million or less.

	Estate before <u>1977</u>	Estate in <u>1977</u>
Gross estate	\$300,000	\$300,000
Less: specific exemption	\$ <u>60,000</u> \$240,000	Does not apply
Less: expenses	\$ <u>10,000</u>	\$ <u>10,000</u>
Adjusted gross estate	\$230,000	\$290,000
Maximum marital deduction	\$ <u>115,000</u>	\$ <u>250,000</u>
Taxable estate	\$115,000	\$ <u>40,000</u>
Tax computaton	\$20,700 plus 30 percent of the amount over \$100,000	\$3,800 plus 22 percent of the amount over \$20,000
Amount of tax	\$25,200	\$8,200
Unified credit	Does not apply	\$-30,000
Tax due from estate	\$25,200	None

REVIEW, SCOPE, AND APPROACHES

To obtain data for our study, we

- reviewed Federal estate tax returns with I.R.C. Section 2032A or 6166 elections and recorded asset/debt condition, size, and other characteristics of the farm estate and the amount of tax saved by electing the provisions; <sup>1/</sup>
- interviewed farmers in ten selected counties in five States;
- interviewed farm heirs who elected the provisions;
- interviewed farm heirs who did not elect the provisions;
- mailed questionnaires to a nationwide sample of Agricultural Stabilization and Conservation Service (ASCS) County Executive Directors; and
- mailed questionnaires to a nationwide sample of estate attorneys.

We reviewed Federal estate tax returns in order to estimate the cost in foregone tax revenues of section 2032A and the distribution of the tax savings among wealth classes. These returns also provided data on the liquidity position of farm estates. We conducted interviews and distributed questionnaires to obtain various people's views about the importance of special use valuation, section 2032A, and the deferred and installment payment provisions, sections 6166 and 6166A, in estate plans. These interviews also provided information about

- property owners' plans for distributing their property during life and at death and the extent to which these plans were affected by the Federal estate tax; and
- effects of estate taxes upon the transfer of property at death, both before and after the Tax Reform Act of 1976.

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<sup>1/</sup>Most of the Federal estate tax returns had not been audited by IRS. If IRS had completed an audit, we recorded data as shown on the audit report. Otherwise, we recorded the data as shown on the return. In those cases where IRS had not estimated the tax saving (on Form 6111), we did so by using information in the estate tax return file.

NATIONWIDE SAMPLEEstate tax returns electing section 2032A

IRS provided us with a magnetic tape identifying all Federal estate tax returns filed between June 1978 and August 1979 that elected section 2032A (3,088 returns contained this election). From this tape we randomly selected 300 returns and ordered a copy of the case files from IRS. We received 280 of the 300 cases. Of the 280 that we received, we completed a data collection instrument on 175. No data collection instrument was completed for the other 105 because the case did not involve a farm, the case was erroneously included as a section 2032A election, or the case file did not contain sufficient information for us to complete a data collection instrument.

Estate tax returns electing section 6166

We were not able to select a reliable nationwide sample of estate tax returns containing section 6166 elections. As chapter 2 of the report notes, this section was added by the Tax Reform Act of 1976 and replaced a previous 10-year deferred payment option. The Act renumbered the previous section 6166 as (new) section 6166A. Upon examining returns filed since 1976, when this section renumbering became effective, we discovered that many returns apparently containing (new) section 6166 elections actually contained elections of section 6166A (the old section 6166). As a result, we decided not to continue sampling returns with section 6166 elections. We believed that it would be unreasonably expensive and time-consuming to identify the total population of section 6166 elections, as a statistical sample would require.

SELECTION OF PEOPLE FOR INTERVIEWSCounty Executive Directors

From the 3,053 ASCS county offices, we randomly selected 400 for mailing questionnaires to the county executive director. In addition, we expanded the sample to include the leading agricultural counties by their average value of land and buildings per farm. Of these 103 leading counties, 16 were already in our sample of 400. Therefore, our total sample was 487. Out of 487, we received responses from 472.

Estate Attorneys

From the American Bar Association, we obtained a list of 5,454 attorneys who had identified themselves as frequently involved in estate administration and taxes. We randomly selected 472 to receive questionnaires. Out of the 472, we received responses from 335. Many of the respondents, however, had no experience with farm estates or section 2032A.



SELECTION OF STATES

We began our review by selecting States where we could review a sample of estate tax returns, interview heirs of estates, and interview farmers. We wanted a cross section of States that were representative of regional agriculture and farm activities. Criteria for selection included whether

- the State has a significant number of estates electing special use valuation, section 2032A; and
- farming is a major industry in the State.

Based on these criteria, we selected five States. We then talked to U.S. Department of Agriculture and State Land-Grant College and University personnel and selected two counties in each State that represented farm activities for the region as well as the State. The States and counties selected were: California, Monterey and San Joaquin; Colorado, Logan and Kit Carson; Indiana, Wayne and Elkhart; Missouri, Chariton and New Madrid; Texas, Castro and Comanche.

SELECTION OF ESTATE CASESSection 2032A

For our selected States we obtained a listing of all section 2032A estate cases from the applicable IRS District Offices when we visited them in November 1979. To ensure that the sample results could be used to provide estimates for the entire State, we either selected all section 2032A cases (in districts with smaller workloads) or we selected returns randomly (in larger districts). Using this approach, we selected 259 of 668 cases and completed a data collection instrument for each case.

Section 6166

At the district offices, we also tried to obtain a listing of farm estates with section 6166 elections in order to make a random selection of cases. Such a listing was not available at all locations; therefore, we selected a number of the available farm estates with the section 6166 election. At the five districts, we reviewed 30 farm estate cases where only section 6166 were elected. We also reviewed 36 cases where both sections 2032A and 6166 were elected.

SELECTION OF PEOPLE FOR INTERVIEWSFarmers

We interviewed 105 farmers in our ten selected counties who met the following criteria:

1. Farm or ranch is a viable economic unit.

2. Value of the farm or ranch is generally in the range of \$300,000 to \$800,000 in assets.
3. Farm or ranch is owner-operated.
4. Farm operation represents regional or State farming.

These farmers were not selected randomly. We obtained names from the USDA county officials and talked to those willing to answer our questions.

#### Electing heirs

From the estate case files we identified individuals who received an interest in section 2032A, or section 6166 property, or both and tried to interview one heir per case. We interviewed 276 heirs who had elected section 2032A, section 6166 provision, or both.

#### Non-electing heirs

We interviewed 54 heirs who inherited farmland in 1976 or earlier and 55 heirs who inherited farmland after January 1, 1977, who did not elect the provisions. These heirs were not selected randomly. We obtained names from the USDA county officials or from county probate records and talked to those willing to answer our questions.

#### LIMITATION ON CASE STUDY APPROACH

We obtained some of our data using random selection techniques (scientific or statistical sampling). Data obtained by using a scientific sampling plan permitted us to draw conclusions about the sample population. The following surveys were based on a scientific sampling plan: selection of section 2032A estate cases at the IRS District Offices; selection of the nationwide sample of estate returns using section 2032A; selection of ASCS County Executive Directors; and selection of estate attorneys.

Data not obtained by a scientific sampling plan represent a qualitative case study and any interpretations are restricted to the particular locations or individual circumstances examined. The following surveys were case studies: selection of section 6166 cases, selection of electing farm heirs, selection of non-electing heirs, and selection of farmers.

#### METHODS OF ANALYSIS

Because the quantitative and qualitative information involved was diverse, we used a range of analytical methods. For example, from the statistical sample of estate tax returns we were able to develop a detailed profile of the estates and the tax saving. In other instances, such as the interviews conducted with farmers, the data collection effort was aimed at developing

reliable background information. This background enabled us to develop case studies for the 10 counties listed earlier.

Data obtained from the nationwide sample of estate tax returns were analyzed to estimate the size of the total revenue loss due to section 2032A, a "profile" of the average farm estate electing section 2032A, and the distribution of the tax savings. The estimated annual revenue loss was calculated as the product of the mean tax saving and the annual number of returns.

The profile of estate tax returns containing section 2032A elections (see table 2) was compiled using mean (average) values of the variables on the table (total gross estate, taxable estate, etc.). Estate shares (e.g., liquid assets) are based on sample means.

Finally, the sample estates were grouped by estate size to estimate the distribution of the tax losses (table 3). The apparent link between increasing estate size and a larger average tax saving was supported by finding that the correlation between the fair market value of the taxable estate and the tax saving was 0.76. (A 0.59 correlation was observed between the special use value of the taxable estate and the size of the tax saving.) While the correlation coefficients alone do not prove a direct causal relationship between the size of estate and the tax saving, they are consistent with the observations reported in the report's text and with our expectations.

ASCS County Executive Director and estate attorney questionnaires were tabulated to determine the respondents' opinions on how effective estate planning by farmers has been and how effective sections 2032A and 6166 would be in encouraging continuation of family farms.

The remaining questionnaires were not analyzed in as much detail. While the estate tax returns collected at IRS district offices constituted either a full count of all returns in the district or a valid sample of the returns, <sup>1</sup>/ we did not rely on them for any part of this study except for the State case studies. (See appendix III for these studies.) We did compare the national sample of returns with these district office returns; no significant differences were observable. Other questionnaires were used to gather background information for qualitative case studies rather than quantitative analysis.

All calculations were performed with the Statistical Package for the Social Sciences (SPSS). Since this is a commonly used statistical software package, we did not test any of the calculation methods.

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<sup>1</sup>/The decision to sample or collect data for all returns was based on the number of returns at the IRS district office.

FARM STATES AND COUNTIES REVIEWEDCALIFORNIAFarm products

California is the leading farm State in the country with nearly 10 percent of the Nation's cash receipts from only 3 percent of the Nation's farms. Its agriculture is unique in that farms produce a wide range of crops with no single dominating commodity. The major agricultural products in terms of dollars were cattle and calves, followed by milk and cream, cotton, and grapes and hay. The combined acreage of principal crops in 1979 totaled 9.4 million acres with 49.2 million tons of harvested farm production.

Farm income

The average California farm was estimated at 538 acres in 1979 and valued at \$503,900, including buildings. Gross cash receipts from farm marketing for 1979 totaled \$12.1 billion.

Land transfers and values

California, which is the third largest State in the continental U.S. with a land area of 100.2 million acres, had an estimated 32.8 million acres in farms in 1978. Sixty-two thousand farms in the State have annual sales of agricultural products of \$1,000 or more. The State average value per acre as of February, 1980 was \$1,123. The average value of land per acre for nonirrigated land ranges from \$320 for rangeland to \$1,210 in the San Joaquin Valley for cropland in 1980. Irrigated land ranges from \$1,000 for pasture to \$4,900 for truck and vegetables in the Central Coast area, which includes northern Monterey County. Special crop acreage draws as high as \$17,200 for avocados and \$11,900 for lemons.

The average farm size increased from 454 acres in 1969 to 493 acres in 1974, according to the 1974 Census of Agriculture. Also the number of farms decreased significantly during this period. It is generally agreed that the trend is toward fewer and larger farms. According to the USDA Landownership Survey of 1978, over 75 percent of the farm acreage in California is owned by sole proprietors or family businesses.

Farmland leasing practices

The 1974 Census of Agriculture reports that 18.1 million acres of farmland were leased and about 15.3 million acres were owner-operated. In a recent study of 211 large-scale farm opera-

tors in California, <sup>1/</sup> it was found that four out of five of the operators lease land and those leasing land lease about 50 percent of the land they farm. By dropping or adding leases, the farm size changes rapidly. Because cropland in California is very expensive and mortgage loan interest rates are at high levels, leasing is perhaps the most expeditious method for rapid farm expansion.

GAO county level  
work in California

Farms located in Monterey and San Joaquin Counties were selected for our interview work. We selected these counties because the agriculture and ownership is diverse.

In terms of farm income for 1979 Monterey ranks eighth out of 30 counties. In terms of land value it was fourth in 1978. Farmers here do well compared to others in the rest of the State. Farming has the highest use value for land in the county except in small areas around towns and recreation areas located in the southern part of the county. The farmers have to be aggressive to make a profit: farm debt is high, farms are irrigated, crops are diversified and rotated, and farms are worked year round. The vast majority of the farms raise vegetables with lettuce as a major crop.

According to the 1978 Census of Agriculture, the average farm in Monterey County is over 1,100 acres and the value of the land and buildings is well over \$1,000,000.

San Joaquin County has approximately 4,100 farm operators and farm size averages 200 acres; however, over half the farms in the county are under 50 acres. Their value is under \$250,000 and annual income is under \$20,000. Farmland values in the county have a built-in speculative value. As a result, a farmer cannot economically buy land for agricultural purposes in comparison to Monterey County where very few farm sales or conversions to nonfarm use occur. Most farms in Monterey County are acquired by inheritance.

San Joaquin County agriculture is more diverse than Monterey's, no one crop predominates; the majority of farm products are fruits, nuts, vegetables, field crops, and dairy products.

Monterey County, California

Monterey County, located in the central coast area of California known as the Salinas Valley, is among the top counties in

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<sup>1/</sup>Don Villarejo, Getting Bigger: Large Scale Farming in California, California Institute for Rural Studies, Inc. (Davis, Calif., 1980), pp. 10-11.

the country in agricultural productivity. Self proclaimed "Salad Bowl of the World" for its vegetable production, it has been the Nation's leading warm weather producer of lettuce since the 1920s. Agricultural production in 1978 totaled \$658 million, of which vegetables accounted for \$457.7 million.

Nearly all farms in the county are privately owned, most have been inherited from the previous generation. In 1974, only 11 percent of the 1,120 farms in Monterey were owned by corporations and these were mainly small family corporations. These family corporations lease and farm almost all farmland in the county. Farmland is mostly owned by landowners who do not farm but have annual cash rental contracts with local farmers. The farmers who are operators have a minimum investment of \$100,000 to \$300,000 in basic farm equipment. Over 90 percent of the farming is cash rent, according to one estimate. Its popularity has increased in recent years; rentals have increased from an average of \$200 to over \$600 per acre in just 4 years. Farmers and landowners who cash rent in this type of operation do not qualify as owner operators as required by section 2032A. Some of the reasons for the preponderance of cash rentals are:

- The risk of owner operated farming are high because of the the weather and market fluctuations.
- Cash rental contracts are good bank collateral for loans.
- Many farm owners are not interested in operating the farm or are too old.

We found no evidence to show that section 2032A prevents forced sales in Monterey County, nor could we find any evidence of forced land sales. According to officials in the county, farms typically pass from generation to generation and very little farmland is sold because the price is very high for the return from agriculture. The county clerk estimates that less than 5 percent of the 90 or so probate sales held each year are farms. According to one judge, even when probate farm sales occur they are nearly always for the convenience of the heir or to pay inheritance taxes, but only rarely to pay estate taxes. Furthermore, he told us that one can usually borrow money on the property so that a sale is almost never essential.

#### San Joaquin County, California

Most farms in San Joaquin County are operated by small farmers. A growing number of families are moving on to small tracts, usually less than 10 acres, and farming the land for supplemental income. Approximately two-thirds of the farmers reside on the farmland they operate while only a small number of the farms are corporately owned.

The county has a wide diversity of farms, and their values vary by location and type of crops. San Joaquin County provides

a wide variety of farming, and no one type of agriculture dominates. The many types of farming grosses over \$500 million in annual sales. Larger farmers tend to grow specialty crops, such as tomatoes, lettuce, asparagus, and onions.

The land in San Joaquin is undergoing change. For example, prime farmland is being converted for other uses. In addition, small farms are slowly being bought out by other farmers or subdivided into less efficient "country homes." These homes, placed on lots of less than 10 acres, are meant for the occupant to enjoy country living. Since the country homeowner is not dependent on farm income, the land is farmed less intensively or may be taken out of production. Industry is also moving into the area and many new housing developments are being built. Local government has taken steps to slow this trend, but land prices may already be too high for young farmers trying to buy land.

We found no evidence that farmers are being forced out by estate taxes. According to a county probate judge, less than 1 in 50 probates involve the sale of farmland; and then only rarely is it to pay estate taxes.

We believe children are leaving the farm in San Joaquin County. During our review, we interviewed 10 farmers. Six of the ten said they bought their farms while the other four inherited part or all of their farms. Nine of the ten farmers had children over 18 years old, and seven of the farmers believed their children would continue to operate the farm after death. Of the 22 children of these farmers, however, only 3 children were actually farming.

## COLORADO

### Farm products

Colorado ranked among the top 10 States in producing 19 crop and livestock items for the Nation. Wheat ranked first among field crops for the State. Colorado ranked sixth in the country in the production of winter wheat in 1978. Livestock and related products is the major contributor to the State's farm revenues.

Winter wheat on fallow is an agricultural concept started in the arid West in the 1930s to conserve moisture and soil nutrients. Its purpose is to store 2 year's rainfall for 1 year's crop. One-half of the land is used for growing a crop of wheat planted in the fall for harvesting the following spring, while the other half is left unseeded after plowing to absorb and store moisture for planting the following fall.

The major wheat producing counties are located in the eastern half of the State. Some counties are considered typical of the State's cropping pattern. Counties mostly in the northeast-

ern corner of the State are considered typical of the northern plains region's cropping that covers Kansas and Nebraska.

#### Farm income

The 1977 net farm income for farm and ranch operators in the State of Colorado averaged \$6,730 per farm. <sup>1/</sup> Realized gross farm income has increased from 1971 through 1977, except for 1975 and 1976, and total net farm income increased from 1971 through 1973 and began to decline from 1974 through 1977.

#### Land transfers and values

Under a new definition--places with annual sales of agricultural products of \$1,000 or more--initiated in 1975, there were 27,300 farms totalling 38.6 million acres or an average size of about 1,400 acres. A loss of over 2 million acres in farms has been reported between 1960 and 1979. Much of this loss is through alternate development and through economic and natural pressures. However, increased production on less land has resulted from irrigation.

According to the 1974 Census of Agriculture the average value per acre of land was \$188 resulting in an average farm value of \$264,000. Since 1974, land prices have more than doubled to \$378 per acre, which means that an average Colorado farm or ranch is worth over \$500,000.

#### Farmland leasing practices

Discussions with State agricultural officials and others showed that the use of crop sharing agreements was fairly well institutionalized throughout the State. Cash rentals for grazing land were common, but cash rentals of cropland were difficult to find. The predominant form for lease of cropland was crop share with one-third of the crop going to the landowner and two-thirds to the farm operator.

#### GAO county level work in Colorado

Our interview work was conducted at farms located in Kit Carson and Logan Counties. For purposes of this review, we selected one county typical of the winter wheat cropping pattern for the State and one typical of the regional winter wheat cropping pattern. The 1974 Census of Agriculture reported that the average farm size in Kit Carson County was about 1,600 acres with

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<sup>1/</sup>This average was calculated on 29,000 farms of 10 or more acres with sales of \$50 or more, as reported in the "1979 Colorado Agricultural Statistics."



## APPENDIX III

## APPENDIX III

400 farms located in the county. In Logan County the average size reported was about 1,100 acres with 500 farms located there. 1/

### Kit Carson County, Colorado

Kit Carson County is located in the east central part of Colorado with its eastern boundary along the Kansas border and with 99 percent of the total land area in farms. Land in the western portion of the county is in wheat and cattle grazing, while the eastern portion is used more for diversified crops, such as corn, barley, sugar beets, alfalfa, and beans, because of pivot irrigation.

The typical farmer in Kit Carson County was considered to be financially well-off at the time of our interview work in 1980. Recent grain embargo sales, high interest rates, and high production costs may result in many farmers facing large financial losses after this year's operations are over.

The county's population increased by approximately 3 percent from 1970 to 1975. No significant conversion of farmland was reported. A county agricultural official said that family-type farms are prevalent, some are partnerships but most are family-type corporations. Existing farmers are the largest buyers of farmland. Most of the county's farmers were aggressive, rather than conservative, meaning that they wanted to get more production out of what they had and add additional land to their original farm.

The 1974 Census of Agriculture reported that about 38 percent of the farms were fully owner-operated, 43 percent were partly owner-operated, and about 19 percent were operated by tenants. We were advised that there were some cash rentals, but primarily farm agreements were based on crop shares. It was estimated that between 15 and 20 percent of the land was held by absentee land-owners; that is, owners who lived outside of the county.

Most of the farmers we interviewed either inherited or purchased some of the land they owned from a relative and, in all but one case, owned additional lands. A majority farmed more land than they owned.

### Logan County, Colorado

Agriculture in Logan County is characterized by family farming of winter wheat on fallow as the main crop. Over the last 10 years irrigated agriculture has increased dramatically with corn, sugar beets, beans, and hay increasing in their importance.

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1/Based on farms with sales of \$2,500 and over.

## APPENDIX III

## APPENDIX III

Logan County farmers are financially well off. Five out of eight farmers we interviewed have incomes of \$20,000 or more. Four out of eight farmers have debts of over \$100,000. And seven out of eight farmers had property assets of over \$300,000. The 1974 Census of Agriculture provides the following profile: average net income per farm, \$18,482, and average value of land and buildings, \$212,768.

The family farm is the dominant form of agriculture in Logan County. In fact, most farmers owned property as sole proprietors or in joint tenancy. County officials stated that the county was a very stable area of farming, with farms passing from generation to generation. The largest buyers of farmland are existing farmers; however, there is a low turnover of agricultural land and few transfers to non-family members. Even new farmers just getting started are mainly from Logan County farming families.

### INDIANA

#### Farm products

Corn has traditionally been the leading cash crop in Indiana; however, soybeans replaced corn in 1978 as the leading source with cash receipts of almost \$900 million. Indiana produces a wide variety of crops including grains, fruits, and vegetables and ranks tenth in the country for all commodities including crops and livestock. Our review of State agricultural statistics showed that Indiana could be divided into four major types of farming areas (1) cash grain, (2) mixed farming, (3) meat animals and grain, and (4) meat animals and dairy.

#### Farm income

Total net farm income was \$659 million in 1978. From 1968 to 1978 Indiana was well below the national average net income per farm except for 4 of the 10 years. Net income expressed as a percentage of average farm value decreased during 1976-78 because average farm value increased at a faster rate than net farm income.

#### Land transfers and values

Indiana has experienced decreases in the number of farms and increases in the average size of farms. From 1976 through 1979, Indiana's farms decreased in number at the rate of 1,000 a year. The majority of farmland transfers are made to neighboring farmers for the purpose of enlargement. As of November, 1, 1979, the average value of farmland in Indiana was \$1,561 per acre.

#### Farmland leasing practices

Agricultural representatives in Indiana told us that cash rental of farmland is the most common leasing practice in the

State. The average gross cash rent per acre was \$91.70 in 1979. The rent-to-value ratio of farmland was 5.3 percent for the year ending March 1, 1979.

GAO county level  
work in Indiana

Farms located in Elkhart and Wayne Counties were selected for our interview work. Agricultural officials in Elkhart County categorized the type of farming in their area as conservative. Wayne County agricultural officials consider the type of farming in their county as middle-of-the-road, between conservative and aggressive.

We asked farm lending institution officers to estimate the average net farm income in their areas. The estimates ranged from \$10,000 to \$15,000 compared to the reported State average of \$7,000. The loan officers at Federal Land and commercial banks estimated that average farm debt ranged from \$120,000 to \$200,000 per farm. The estimates of debt to asset ratio ranged from 25 to 43 percent.

Elkhart County

Elkhart County agricultural officials estimated the current average farm size in the county to be from 150 to 175 acres. Farms are traditionally smaller than the State average because they are livestock intensive, thus requiring less land. One group of conservative farmers use horses for field work, which limits the size of their farms to 120 acres.

The region in and around Elkhart County has many family farms and farm size has only increased slightly in the past few years. There is crop share farming throughout the area and demand for rental farmland is high. Light industry in the area has helped keep family farms going because many farms are not large enough to support parents and several grown children. With family members working in the plants and helping out on the farm after work, the farm can remain a viable, family-held, economic unit.

The light industries also helped some people get into farming. In the past, it was not unusual for workers to buy or rent a few acres and farm after work. Gradually these part-time farmers would increase their acreage until they could leave the factory and devote all of their time to farming. The high cost of land and equipment now makes this virtually impossible.

Wayne County

Estimates of average farm size by Wayne County agricultural officials ranged from 170 to 210 acres with an additional 100 acres rented. Most farms in the area are family operated and

### APPENDIX III

### APPENDIX III

officials felt that Wayne County farmers are making a decent living. There are about 900 active farmers in the area and 300 of these are full-time operators.

One bank official said that there is a trend toward farm owners renting their land through a farm manager. This arrangement minimizes the owner's risk because income is guaranteed. Cash renting of land is a common practice at \$75 to \$100 per acre with about 5 percent of the land rented for cash. There is a shortage of rental land, even though land rentals are high.

In the majority of cases, farmland is passing from generation to generation. Most farm sales that occur during probate are because none of the heirs are interested in farming. In cases where it is financially impossible to raise enough money to keep the farm at time of death, it is usually due to poor management on the part of the decedent. The farms that are being sold are purchased by other area farmers. The inflated land prices are caused by area farmers bidding against each other for the limited amount of available land.

One local banker said that one way to slow the escalating land prices would be to make lending practices oriented toward income rather than a farmer's assets. He also felt that less emphasis should be placed on keeping poorly managed farms in the family, while more attention should be given to helping young farmers with proven abilities get into farming.

### MISSOURI

#### Farm products

Farming is Missouri's largest industry with over 32 million of the State's 44.6 million acres in farms in 1978. Crops grown in the State are as varied as the climate and terrain. Missouri is located far enough north to be in the southern edge of the corn-belt and far enough south for cotton and rice to be grown. The major crops are soybeans, hay, corn, wheat, and grain sorghum. Most of these crops are used to support the large livestock population in the State, but a substantial portion of some crops is sold as cash grain.

#### Income

Total cash receipts from sale of Missouri crops and livestock reached a record high of \$3.6 billion in 1978. Total net farm income the previous year was \$740.3 million. The debt-to-income ratio remained relatively constant over the years 1973

#### Land values

Farmland values in Missouri increased from 255 to 300 percent between 1970 and 1978. The average value per acre of

land and buildings during the same period increased from \$396 to \$674. Nearly 80 percent of the farmland sold in the State is bought by neighboring farmers or tenants of the farm being sold. As of November 1, 1979, the average value of farmland in Missouri was \$757 per acre, which was less than half in comparison to the rest of the corn belt region States.

#### Farmland leasing practices

Crop sharing is common in Missouri, while cash rental is rare. With the exception of the "Bootheel" area of the State, very little land is cash rented. Missouri landowners and tenants talk about cash rent but very few use it, probably less than 10 percent, because the landowner generally receives more income from a crop share agreement. The "1979 Missouri Farm Facts" showed annual gross cash rent per acre of cropland at about \$50 and pastureland at about \$23, as of March 1978.

#### GAO county level work in Missouri

Farms located in New Madrid and Chariton Counties were selected for our interview work. New Madrid County is in the southeastern part of Missouri. Much of this area was once a vast swampland forest until drained and cleared in the 1900s. Chariton County is located in the Missouri Valley, and the land is well suited to crop production. During the 1960s, a number of dikes and dams were built along the Missouri River which opened up large areas of land for farming.

The land in the Bootheel area is now in intensive agricultural use. Labor is in short supply resulting in substitution of capital for labor with an investment of over \$100 per acre for mechanization. Tenant farmers, as well as owner operators, are caught in a cost price squeeze because costs have risen, production has remained stable, and prices have fluctuated. Area agricultural officials have stated that generally the farmers who have owned their land for a number of years are doing better financially than farmers who have purchased their land in recent years. Heavy debt is very common for this area with an increase of about 17 percent in 1979 over 1978 in average outstanding debt. Most farmers are reported to be fairly liquid at this time, especially if they have owned their land for some time.

The Bootheel includes large and small farms, and from the standpoint of the numbers of farms, it is actually an area of predominantly small farmers. Off-farm employment is an important factor with over 40 percent of the Bootheel area farmers reporting some off farm income.

Soybeans are the largest crop, while cotton was once the major crop. The average number of acres farmed is currently about 750 acres compared to 450 acres 10 years ago. The farms are getting larger to take advantage of the greater efficiencies

of farm machinery. A typical larger farm will employ one to five hired hands for long periods. Most of the tenant farmers are "over equipped" but when landowners want to rent land, they want their tenant operators to have enough good equipment to farm without relying on custom combines or cotton pickers.

The land in the Bootheel area is predominantly family owned and passes from generation to generation. Much of the land is rented out to tenants by the landowners. Little change in ownership is occurring. The smaller tracts are about the only land sold. Tenant demand for land continues to be quite strong.

Since the 1940s, the population in the Missouri Valley has been declining due to the consolidation and mechanization of farms and the decrease in the size of the average farm family. In 1969, over half the farm operators worked off their farms with over one-third working 100 days or more per year.

Crops have been very good in the last several years in the Missouri Valley Region. One agricultural official said that older farmers in the region have done very well financially in comparison to the rest of the State. They have good income because they have owned the land for many years. Young farmers who are newly started are in a precarious position because of the large amounts of debt they have incurred. A Missouri Valley Study Committee felt one of the problems facing agriculture in their area was attracting and keeping young farmers. Most of the farmers in the area are in their 50s.

The landownership pattern in the region varies from large commercial farms to small residential farms, where farming is either part-time or for noncommercial purposes. The trend is toward consolidating small farms into large commercial enterprises that are highly mechanized. The number of smaller farms under 260 acres has been declining over the years. Often neighboring farmers buy off portions of land being sold. Outside investors are not currently buying much of the farmland sold in the region.

#### New Madrid County

The two major crops in the county are cotton and grains. Family ownership is the predominant form of landownership. Much of the land is owned by cotton gin operators who rent their land to tenants on a crop share arrangement. Over half of the land in the county is farmed by tenants.

A typical farm family consists of a husband, wife, and two or three children. He would farm about 500 acres, own about 100 acres, and rent the rest on a crop share basis. Because of the scarcity of cash rentals, no published figures exist. Generally crop sharing arrangements between tenant and landowner are as follows: grains--the landowner pays one-third of the fertilizer

costs and receives one-third of the profits; cotton--the landowner pays one-fourth of the fertilizer costs and receives one-fourth of the profits.

The farmers in New Madrid County are considered to be aggressive because of increasing use of irrigation for the purpose of increasing production. Also, a tenant farmer must be a good producer or the landowner will rent to someone else.

The fair market value of the typical farm would be between \$350,000 to \$400,000 with land prices varying from \$1,600 to \$2,200 per acre depending on its quality. The tenant farmers we interviewed owned machinery and equipment worth over \$150,000. A typical farmer in the county would net about \$30,000 to \$40,000 annually on a gross of \$80,000 to \$100,000.

One official described the farmers as not being heavily in debt, owing less than 50 percent of the value of their assets, considering the value of the land which has been increasing. The farm use value of the land for agricultural production was estimated at approximately half the present selling price of the land.

Most of the cotton gin operators are members of families who have owned the farm for many years. Very few new farmers are in the county because sons are usually taking over the father's farm operation.

#### Chariton County

Chariton County typifies the general type of agriculture in Missouri other than the Bootheel area. The farmers in the county diversify their production by raising different grains, livestock, and hogs. Many farms in the county have been owned by the same family for over 100 years. The average farmer's age is about 55 years old, and these older farmers who own their land and equipment are doing better financially than the farmers who have recently purchased land.

A January 1979 survey of 57 farmers in the county showed that average assets of these farmers was \$845,000 and liabilities were \$50,000. The farmland is worth between \$700 to \$2,000 per acre depending on the quality of the soil. A typical farmer in the county is farming about 320 acres. Reportedly about one out of three acres in the county is rented. Only about 1 to 2 percent of the rented land is on a cash rental basis.

Land values have been increasing and the rise can be attributed to farmers wanting to add acres to their farm to make more efficient use of their modern equipment. Not much land in the county is sold and many of the farms stay in the same family for many years. Very little land is sold to persons living outside of the county.

TEXASFarm products

The soils of Texas range from hard clay to sandy loam, but 83 percent of Texas land, 139.8 million acres, is in agriculture. Major crops include vegetables, milk, fruits, nuts, honey, cotton, eggs, and grain. Pastures and feedlots are located in nearly all of the State's 254 counties. One of the States most important agricultural products is cattle, and Texas ranks first in the Nation. Texas is also one of the Nation's leading producers of peanuts. Over 350,000 acres in 114 counties are allotted to peanut production. Cotton accounts for over 10 percent of the State's total agricultural income.

Farm income

The agriculture industry adds \$24 billion annually to the Texas economy. In 1978 cash receipts for all commodities totaled \$7.9 billion, and total net farm income was estimated at \$1.02 billion.

Land transfers and values

Over the past 20 years, the average farm size has increased, and it is quite common for a farmer to have over \$250,000 invested in land, buildings, and equipment. Some farmers have formed partnerships for financial reasons, but the majority of farms are still one owner operations.

In 1977 the average Texas farm was over 700 acres. During the last 10 years, the number of farms has dropped by 19,000, with 4.2 million acres lost from agricultural production. In 1977, the average value per acre of land and buildings was \$294, which has increased to \$388, as of November 1, 1979. This means that average farm values exceed \$250,000.

GAO county level  
work in Texas

Farms located in Comanche and Castro Counties were selected for our interview work.

The largest allotment of peanuts is in Comanche County, which encompasses 17 percent of the State's peanut acreage. The 1978 agricultural income for Comanche County was \$60.5 million with production divided almost equally between livestock and crops.

Castro County is an irrigated farming area located on the High Plains area. It was selected for our review because of its diversified agricultural production. The county's agricultural sales in 1978 totaled \$167 million. Crops accounted for \$62 million of the sales, and livestock and their products accounted for the remaining \$105 million. Texas is the Nation's leading



upland cotton producer, and Castro County accounted for 42,500 bales of Texas' 1978 production of 3.8 million bales.

### Comanche County

According to 1979 Soil Conservation Statistics, Comanche County has 2,500 farms and ranches. The largest is 22,000 acres, but the average size, according to the 1974 Census of Agriculture, is 390 acres valued at \$116,000. Most of the counties' farms and ranches are managed by 1,700 operators, and the remaining are run by part owner operators and tenants. Ranchland sells for \$300 to \$400 per acre. Dry land for peanut production may sell for \$600 an acre, while irrigated land will cost from \$700 to \$800 per acre. In some cases buyers have paid \$1,000 per acre for irrigated land to be used for pecan orchards.

The largest single agricultural commodity is peanuts, accounting for 64 percent of crop sales and 30 percent of total sales. Peanut production came from 1,150 farms operated by 418 owners, operators and tenants. The average peanut farm size was 147 acres.

We were told that land has not been converted to nonagricultural uses, and cropping patterns have remained stable over the past 10 years. The only significant change has been conversion of some peanut land to pecan orchards.

We had also been told that most of the land was family owned and passes from generation to generation, but only 4 of the 12 farmers and ranchers we interviewed had inherited land from a relative. The 1974 Census of Agriculture reports the average farmer's age was 53; 24 percent were semiretired or over 65; and 70 percent were 45 or older. The 1974 Census also shows that 38 percent of the county's farmers and ranchers received the majority of their income from off-farm sources.

Although there is no significant conversion of land to nonagricultural uses, a corporation is buying Comanche County's prime peanut land for conversion to pecan production. In 5 years this company, which is owned by 200 to 300 investors, mostly from outside the county, has bought approximately 10,000 acres that is being used for tax shelter purposes. Most of the corporation's purchases were small, heavily indebted peanut farms, and the owners saw selling as a way of getting out of debt. Comanche County residents prefer the family operations because the families are part of the community and, unlike the outside investors, provide income to the local community.

Ranchland is usually leased on a cash rent basis. The majority of farm leases are on a crop share basis in which the owner shares some of the risk with the operator and receives one-quarter of the crop and the operator three-quarters. Some elderly or farmers in poor health have been leasing land outside of the family for several years.

According to one county agricultural official, there were probably more farm sales in the past few years because of illiquidity; however, he could not think of any forced sales due to taxes. Most heirs at time of death chose to sell. Many heirs want to continue farming, but as land is divided among heirs, the farm units become smaller and smaller, and it becomes harder to make a profit. Sales of this acreage would probably go to the highest bidder. With the limited amount of land available, and the corporation with outside stockholders bidding prices up, other farmers are unable to expand their operations.

#### Castro County

Castro County's cropping patterns have changed over the past 5 years from grain sorghum acreage to corn when a corn starch processing plant was constructed in the county. In 1978 there were 624 farms in the county and the average farm size is 923 acres. The 1974 Census of Agriculture shows average farm land values at \$415 per acre making the average farm worth over \$380,000 in land and buildings. Interviews with farmers indicated that 1979 land values are now up to \$1,000 per acre, making the average farm worth from \$900,000 to \$1,000,000.

Individuals or families own 88 percent of the farms in Castro County. The farmers we interviewed generally owned land jointly with their spouse, and at least part of the acreage was inherited or purchased from a relative. All of them worked exclusively on the farm. Most farmers own part or all of the land they farm.

County agricultural representatives believe that landownership in the county is fairly stable. Very little land is available for expansion or for new farmers to get started. Most farms are family owned and pass from generation to generation. County officials are unaware of any land sales by heirs in recent years and sales that have taken place were not related to the death of the owner. They were not aware of any tax forced sales.

Renting is a common practice with cropsharing used almost exclusively. Most acreage is rented on a one-third to two-third crop share basis.

The number of farmers in the county increased over the past 20 years because of irrigation development. However, the last 5 years have shown a decrease of about 15 percent as farms have become larger. This trend can be partially explained by the fact that recent years' poor crops have forced more land sales.



DEPARTMENT OF AGRICULTURE  
OFFICE OF THE SECRETARY  
WASHINGTON, D. C. 20250

0 6 JUL 1981

SUBJECT: Comments on GAO Draft Report entitled, The Effects of Special Estate  
Tax Provisions on Family Owned Farms

TO: Henry Eschwege, Director  
Community and Economic Development Division

This report assesses the effects of the special use valuation law on the transfer of family farms from one generation to another. It reviews the points of the law in a comprehensive manner and discusses the major concerns and problems arising since the law's enactment in 1976. While much of the discussion in the report has been seen before, new descriptive statistical information is introduced. The statistical information and analysis provide a useful overview of the benefits accruing to farm owners who elect the special use provisions. The report indicates that farm owners who elect the special use provisions receive a significant reduction in their tax bills. The findings are consistent, from a tax point of view, with the Congressional intent of providing tax reductions to facilitate the perpetuation of land in farming. The study does not, however, measure the extent to which land has been kept in farming, the primary intent behind the enactment of the law. (Committee on Ways and Means Report #94-1380, p. 22; and Supplemental Report of the Committee on Finance #94-938, part II, p. 15).

Summary Comments

The special use valuation law (section 2032A of the Internal Revenue Code) allows qualified estates to value their real property at its "use" rather than its "fair market" value, thus reducing the burden of estate taxes. Congress was concerned that high values for farmland near urban areas were creating artificially high estate tax liabilities that were forcing the owners and heirs to sell to development interests. Advocates of the provisions also argued that farm estates were unfairly taxed since they are inherently less liquid than other classes of estates and that forced sales to pay estate taxes are contrary to encouraging family farms.

Since its enactment in 1976, the special use valuation law has proved to be a valuable tool for reducing estate taxes for owners of farmland. Some of these farms would undoubtedly have remained in farming without the use of special laws. Others may have been sold for development because the owners could not meet all of the special requirements stipulated under the law. Most farms have been sold for non-estate tax related reasons. The majority of those farms sold remain in farming.

The GAO report finds that the number of farm estates sold to satisfy estate tax obligations is low. This finding is consistent with other recent research findings in this area. Apparently, most of the estate tax related farm sales are incurred to compensate nonfarm heirs. The GAO report also concludes that farm estates do not appear to be "unavoidably illiquid or cash-starved." The

Mr. Henry Eschwege

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report concludes that estate and financial planning can alleviate potential estate tax problems of illiquidity. The findings indicate that while farm owners do not appear to be taking full advantage of estate planning devices, some planning does occur prior to transfer.

Many farmers have benefited from the special provisions. The report suggests, however, that the special use valuation law may have unintended effects. The law benefits those who own land and "may promote greater concentration of farm wealth than would otherwise be the case." Heirs of farmland owners tend to receive an advantage over those who inherit farm machinery or nonfarm assets. The report also concludes that the law may increase the attractiveness of farmland as a tax shelter, encourage nonfarmers to invest in farmland, and push up land prices.

Section 2032A has been criticized by many for being too complicated and benefiting primarily the wealthy. The GAO report supports these contentions. Major restrictions were developed in the original law to prevent nonfarm investors from taking advantage of the special law. However, some bona fide farmers have found themselves closed out as well. The GAO report outlines some of the definitional and restrictive problems of the law. The report concludes that the law should be revised (assuming it remains in effect).

#### Comments on Specific GAO Recommendations

#### **I. THE SPECIAL USE VALUATION LAW IS EXTREMELY COMPLEX; BOTH COMPLIANCE AND ADMINISTRATION ARE COSTLY**

GAO RECOMMENDATION A: Eliminate the special use valuation law in favor of an extended program of tax deferral.

The Department has reservations regarding this recommendation. A tax deferral would generally be less desirable to a farmer than a direct tax reduction. The net impact on farming that such a law might have is unclear. If farmers are particularly vulnerable to the estate tax because they lack liquidity, then a loan, payable in installments at a highly subsidized interest rate, would ease the burden. Of course, special use valuation currently reduces farm tax liabilities and farmers can elect to pay the remaining tax liability in installments on top of these savings.

The GAO proposal would tend to benefit the larger estates more than their smaller counterparts. Such a proposal, however, would probably allow more smaller farms to qualify for section 2032A than is presently the case. An extended tax deferral program, or "tax loan," would be easier to administer and less subjective than current special use valuation law. However, the structure of the tax savings in the form of subsidized loans may encourage nonfarm investors to buy farmland. Such investors could structure their estates to receive the benefits simply because the primary component of their estate has been converted to farmland. This would further encourage the separation of ownership and management; as long as the value of the farm assets comprised the minimum percentage of the total value of the estate, the owner could take advantage of the subsidy. The landlord could supplement the value of the nonfarm portion of the estate with returns from the farming operation and the tax savings from the subsidy. Such incentives could create upward pressure on land values. Tax loss farming would be encouraged, contributing to the misallocation of resources and potentially lower productivity. The Department strongly believes that this is not in the best interest of agriculture.

Mr. Henry Eschwege

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To prevent nonfarm investors from abusing the tax loan privileges, restrictions would have to be imposed. There is no reason to assume that such restrictions would ease the administrative and eligibility problems currently associated with the special use valuation law.

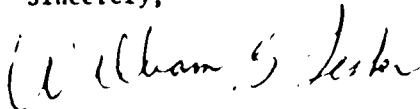
GAO RECOMMENDATION B: If the special use valuation law remains in existence, it should be changed such that it provides for a simple exclusion of a fraction of the value of the farm estate.

The Department has reservations regarding this recommendation but finds it preferable to recommendation A. This proposal would clearly simplify a law which is extremely complex. More farm owners could take advantage of the law. In addition, since the exclusion would be applied to the farm estate, holdings in the forms of equipment, livestock, and machinery would be considered in distributing tax savings. This would be particularly helpful to those who rent the land they farm. Incentives to distort capital investment would also be reduced. While some farm estates would receive potentially smaller tax reductions, more farms would be able to use the provisions. Administrative and compliance costs would be significantly reduced and Congressional intent would be better served.

Thus, this proposal would improve the special use valuation law. This proposal would be even more equitable if implemented in the form of a credit, thus yielding similar benefits to all farms regardless of size.

However, assigning a fixed fraction of the estate's fair market value as its taxable base would not generate a "use" value. Rather, a pure preferentially-applied value would be used. It is questionable whether the current law creates a use value or some value lower than fair market value. The GAO proposal would strip the law of its intent to determine a true value for farmland by replacing the mathematically derived value with an arbitrary preferential treatment.

Sincerely,



Assistant Secretary  
for Economics

GAO response

The Department of Agriculture states that the study did not measure the extent to which land has been kept in farming. We believe that preferential treatment reduces the chance of farm estate shrinkage due to the tax. It is less successful as a land use planning device. The sale and conversion of farmland for alternative use is the result of many other pertinent factors, not necessarily because of the Federal estate tax. Our major objective was to study the liquidity situation of a farm family at the time of death and the effectiveness of special estate tax provisions in relieving any liquidity problems that could threaten continuation of the family farming business.



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY  
WASHINGTON D C 20220

JUL 09 1981

Dear Mr. Anderson:

Thank you for the opportunity to review the General Accounting Office draft report entitled "The Effects of Special Estate Tax Provisions on Family Owned Farms."

We would like to make a general observation and two specific points with respect to the draft report. However, before proceeding, we wish to compliment you and your staff on an excellent, thorough and thoughtful analysis of this difficult area.

Our general observation concerns the summary of Congressional intent behind section 2032A. The draft report separates this intent into two parts: a concern with the highest and best use measurement of value, and a concern with "speculation" in general. (See pages 3-2, 3-10.)

We believe the Congress was concerned only with the problems created by the highest and best use measurement, not with other, nondefined factors leading to speculative value. The legislative history (H.R. Rep. No. 94-1380, 94th Cong., 2d Sess. 21, incorporated by H.R. Rep. No. 94-1515, 94th Cong., 2d Sess. 607 (statement of managers) (1976)) refers to speculation, but we believe this reference is to the speculation inherent in applying a highest and best use measurement, that is, speculation as to other uses for the property. Speculative value in general is not addressed in the legislative history, and we find no indication of what it could have been intended to mean. If the references in the draft report are to speculation reflecting increases in value due to inflation, then the analysis would apply equally well to a number of nonfarm assets such as jewels and paintings. Since the focus of section 2032A was to relieve valuation pressures on family farms and real property in closely-held businesses, and the specific problem addressed was "speculation" as to highest and best use, we conclude that only the highest and best use issue is addressed by the statute.

Our two specific points relate to statements in the draft report.

First, at page 2-10, the report indicates that Congress did not define what is meant by material participation. This

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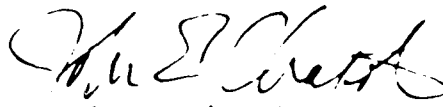
is not entirely accurate. Section 2032A(e)(6) provides that material participation "shall be determined in a manner similar to the manner used for purposes of paragraph (1) of section 1402(a) (relating to net earnings from self employment.)" The final regulations under this section follow this instruction and, we believe, provide substantial guidance in applying this requirement.

Second, the report indicates at page 4-10 that where it is uncommon for farms to be rented for cash, these farms are "often unable to elect special use valuation." This statement should be modified to indicate that where there are no comparable cash rents, farms are unable to use the formula or farm method. Such farms are, however, eligible to use the multiple factor method in section 2032A(e)(8) if the other requirements of section 2032A have been met.

Because the administration of the tax laws is exclusively within the jurisdiction of the Internal Revenue Service, we have no comment with respect to the draft report's observations as to problems in administering section 2032A.

Finally, we have not had an opportunity to fully consider the recommendations for legislative change made by the draft report, but they are timely since we are currently engaged in a review of the entire estate tax area.

Sincerely,



John E. Chapoton  
Assistant Secretary  
(Tax Policy)

Mr. William J. Anderson  
Director  
General Government Division  
General Accounting Office  
Washington, D. C. 20548



GAO response

The Department of the Treasury believes that "the Congress was concerned only with the problems created by the highest and best use measurement, not with other, nondefined factors leading to speculative value." The legislative history includes the report of the Staff of the Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1976," (H.R. 10612, 94th Cong., P.L. 94-455) (1976). On page 537, the report states that "where the valuation of land reflects speculation to such a degree that the price of the land does not bear a reasonable relationship to its earning capacity, the Congress believed it unreasonable to require that this "speculative value" be included in an estate with respect to land devoted to farming or closely held businesses.

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## COMMISSIONER OF INTERNAL REVENUE

Washington DC 20224

JUL 6 1961

Mr. William J. Anderson  
Director, General Government Division  
General Accounting Office  
Washington, DC 20548

Dear Mr. Anderson:

This responds to your request for comments on your draft report entitled, "The Effects of Special Estate Tax Provisions on Family Owned Farms." We are generally in agreement with your findings concerning the complexity of the special use valuation provisions from the standpoint of comprehensibility and administrability. The continuing decline in the number of family owned farms is not conclusive evidence, however, that the special estate tax provisions have not worked. Even though their numbers continue to diminish, the success of these provisions should be measured by whether the estate tax ceases to be a contributing factor to sales of family owned farms or, otherwise, an onerous burden on farm estates.

In reviewing the draft report, we identified several technical or administrative matters upon which we have the following comments:

On page 4-8, both the text and the footnote indicate that the "at risk" requirement is part of the material participation test. This statement is not correct. "At risk" is part of the qualified use requirement.

The statement in the first paragraph on page 4-10 is misleading since, in fact, estates in regions where it is not common for farms to be rented for cash can still elect a special use valuation, even though they cannot take advantage of the cash rental provision.

The discussion on pages 6-15 and 6-16 concerns the cost of administering the special estate tax provisions and the effect on workload and grade structure of Service personnel. While we agree that some cases containing IRC section 2032A issues may take longer to examine than cases not containing such issues, we estimate that the overall Service cost in administering these provisions does not exceed \$500,000 annually. Averaged

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Mr. William J. Anderson

over all estate tax cases in districts where such issues are most common, the limited time this adds per case has been incorporated into our examination planning and would not serve to reduce the number of returns for which examinations have been planned. Furthermore, we do not plan to create a higher grade structure in any district office to handle such cases.

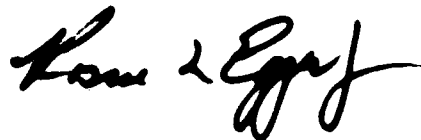
On page 6-19, there is a recommendation that the multiple five factor for valuation should be eliminated, except for the first factor which capitalizes income over a reasonable period of time. However, it is not apparent from the report what advantages would be gained by ignoring fair market value as a measure.

Because of the problems encountered in the field regarding the application of section 2032A before the final regulations were issued, a directive was sent to the field on May 9, 1978, to the effect that all section 2032A cases were to be suspended until publication of the substantive and procedural provisions of the regulations. Subsequently, on August 15, 1979, the field was advised that they could close section 2032A cases based on proposed section 2032A regulations.

While it is not appropriate for us to comment on the legislative recommendations in the draft report, we do appreciate this opportunity to comment on the administrative aspects addressed in your draft report.

With kind regards,

Sincerely,



GAO response

The Internal Revenue Service agreed with our findings but felt that the continuing decline in the number of family owned farms is inconclusive evidence that special estate tax provisions have not worked.

We believe that the Federal estate tax burden on farm estates is not the main reason why many small farmers go out of business. Other problems, such as operating problems encountered by farmers, changes in agriculture, or the heirs' desire to sell the estate and realize the capital gains are much more likely to prompt the sale of farms when the owner dies.

In commenting on the inequities due to regional differences in the use of special use valuation, IRS said that in regions where it is not common for farms to be rented for cash, estates can still elect special use valuation, even though they cannot take advantage of the cash rental provision. We agree that when an estate is not able to elect special use valuation using the more favorable cash rent method the estate may elect any of the methods under the section 2032A(e)(8) multiple factor method. Our fieldwork demonstrated, however, that estates in these regions face obstacles to electing special use valuation that other estates do not and thus are less often able to take advantage of section 2032A in practice.

The IRS points out that it is not apparent what advantage would be gained by ignoring fair market value as a measure to be used for valuation, as a result of GAO's recommendation to eliminate the multiple factor method, except for the income capitalization approach. Eliminating the multiple factor method would not ignore fair market value. In the absence of a section 2032A election, the fair market value of an estate determines its taxable basis, along with allowable deductions and exclusions. Thus, we believe it is confusing to rely on "fair market value" to determine "special use value," since the Congress intended "special use value" to be lower than "fair market value."

We state that the "at risk" requirement is part of the material participation test. The IRS said that this statement is not correct because "at risk" is part of qualified use. We have added material to chapter 4 explaining that "financial risk" is needed to establish that a farm estate was used for a "qualified use." Essentially, this means that the decedent was "at risk" in operating the farm (i.e., the decedent owned the farm). We should note, however, that the "assumption of financial responsibility" to which we refer in the text is indeed one test of the decedent's "material participation" in the farm operation.

#### APPENDIX IV

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In commenting on the cost of administering the special estate tax provisions and their effects on workload and personnel, IRS said that some cases may take longer to examine when they contain IRC Section 2032A issues and that overall cost in administration does not exceed \$500,000 annually. The time it adds to a case is limited and has been incorporated into their examination planning and would not serve to reduce the number of returns for which examinations have been planned.

We found that IRS officials in the field contend that a shift of audit priorities has resulted because of 2032A issues. Estate tax cases that were previously examined would be set aside or not as closely audited. The major cost of 2032A will be the additional expense now being incurred by farmers and ranchers for proper professional advice from attorneys and accountants on preparation of elaborate documentation and the restructuring to the farm business for the purpose of how to avoid the estate taxes by qualifying for special estate tax provisions.

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