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David A. Bratt
University of Kentucky

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NOTE

MATERIAL PARTICIPATION AND THE VALUATION OF FARM LAND FOR ESTATE TAX PURPOSES UNDER THE TAX REFORM ACT OF 1976

There is one difference between a tax collector and a taxidermist—the taxidermist leaves the hide.

-Mortimer Caplan, former
Director Bureau of Internal
Revenue¹

INTRODUCTION

The estate tax provisions of the Tax Reform Act of 1976 allow for special use valuation of farmland for inheritance tax purposes.² The election of the special use valuation, which allows valuation of farmland *as* farmland, could prove to be a

¹ TIME, Feb. 1, 1963, at 13.

² I.R.C. § 2032A. The Kentucky legislature recently enacted similar legislation. The legislature amended the state's inheritance tax law so as to accord special farm-use valuation to farms passing in the estate of a decedent dying on or after July 1, 1978. KY. REV. STAT. § 140.152, .300-.360 (Supp. 1978) [hereinafter cited as KRS]. The Kentucky provisions closely parallel the federal statute. Compare KRS § 140.300-.360 (Supp. 1978) with I.R.C. § 2032A. Land that has been in agricultural or horticultural use for the five years prior to decedent's death and which passes to qualified heirs may be assessed at its special, farm-use value. If, within five years after decedent's death, the land is sold to non-qualified heirs or taken out of agricultural or horticultural production, recapture provisions are triggered. If the land has been specifically valued for ad valorem tax purposes, then that special value is used for inheritance tax purposes; otherwise, the farm-use value of the land is to be determined according to the provisions of KRS § 132.010(9).

There are three major differences between the Kentucky provisions and I.R.C. § 2032A. First, the class of qualified people to whom the land may pass is defined more narrowly in Kentucky. While I.R.C. § 2032A defines qualified heirs as the lineal descendants of the decedent's grandparents and those descendants' spouses, the Kentucky provision defines a qualified person to be the decedent's spouse, children, or children's spouses. Second, the land must have been used for agricultural or horticultural purposes for five years prior to the death of the owner and, to avoid recapture, must be used for such purposes for only five years after the owner's death. Unlike the federal provision, the five years must be consecutive and unbroken. Finally, the Kentucky provision does not require material participation by either the decedent or the qualified person during any period of ownership. The Kentucky provision is not designed strictly to benefit only the *family* farm; it applies to any land used for agricultural or horticultural purposes.

great benefit to the family farm. Although there are numerous requirements, one requirement is of particular importance for estate planning purposes and for planning the use of the land by the heir or devisee. There must be material participation in the operation of the farm both by the decedent or a member of his family during the years before the decedent's death and by a member of his family in the years after the decedent's death. Because there must be material participation in at least five of the eight years prior to decedent's death, the farmer who wishes to pass the family operation to the next generation, or perhaps to grandchildren, must be aware of the requirement in the early stages of estate planning. It is not possible to create prior material participation after death nor to forecast the date of death; therefore one may not defer until that nebulous tomorrow the planning for material participation that the estate tax laws require be done today.

This note will examine the material participation requirement of section 2032A. The examination will encompass the legislative history of the provision, an overview of section 2032A, a definition of material participation, an evaluation of the material participation requirement, and estate planning ramifications.

I. LEGISLATIVE HISTORY

The massive Tax Reform Act of 1976³ made important changes in federal estate taxation. Congressman Al Ullman, Chairman of the House Ways and Means Committee, characterized the estate tax package as "one of the most important aspects of this whole legislation."⁴ Some provisions of the package engendered lively debate,⁵ but on one principle most congressmen agreed—tax relief was due the family farmer.⁶ One

³ Pub. L. No. 94-455, 90 Stat. 1520 (1976).

⁴ 122 CONG. REC. H10,263 (daily ed. Sept. 16, 1976) (remarks of Rep. Ullman).

⁵ See the debates in the House on the carryover basis provision, 122 CONG. REC. H10,264-75 (daily ed. Sept. 16, 1976), and in the Senate on the Nelson-Packwood amendment proposing a special tax credit for family farms and small businesses, 122 CONG. REC. S13,590-608 (daily ed. Aug. 5, 1976).

⁶ See, e.g., the remarks of various participants, especially Senators Kennedy and Nelson and Representatives Conable and Keys. 122 CONG. REC. S13,598-605 (daily ed. Aug. 5, 1976); *Id.* at H10,264-71 (daily ed. Sept. 16, 1976); and HOUSE COMM. ON WAYS AND MEANS, ESTATE AND GIFT TAX REFORM ACT OF 1976, H.R. REP. NO. 1380, 94th Cong.,

manifestation of this general sentiment is the provision for special valuation of farm realty based on its actual use⁷ rather than its highest and best use.⁸

A. *The Problem Addressed by Congress*

During the post-World War II years, the number of farms in the United States decreased by over two million.⁹ The prognosis is that 200,000 to 400,000 farms will be lost during the

2d Sess. 188 (1976), reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3356, 3438 [hereinafter cited as H.R. REP. No. 1380, with page citation to the U.S. CODE CONG. & AD. NEWS].

While the legislators could agree with the principle of relief for the farmer, they could not always agree on the form relief should take, as evidenced by their debate over the Nelson-Packwood amendment. 122 CONG. REC. S13,590-608 (daily ed. Aug. 5, 1976).

⁷ The valuations must be based on use of the real property for farming purposes . . . within the locality but not necessarily the specific activity carried on by the decedent or family member. Thus if the land could be used for a more profitable agricultural activity than the one to which the land is actually being used and other comparable land is being so used, the special use value will apparently be based on the more profitable agricultural activity.

M.L. Fellows, *Supplement on the Tax Reform Act of 1976*, 116, in F. COLSON & D. KAHN, *FEDERAL TAXATION OF ESTATES, GIFTS AND TRUSTS* (2d ed. 1977) [hereinafter cited as COLSON & KAHN *Supplement*].

COLSON & KAHN *Supplement* offers a thorough, thoughtful, and precise treatment of I.R.C. § 2032A.

⁸ Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003, 90 Stat. 1520 (1976); I.R.C. § 2032A. As the title, "Valuation for Purposes of the Federal Estate Tax of Certain Real Property Devoted to Farming or Closely Held Businesses," suggests, Congress also sought to benefit the small business.

It should be recognized also that farm property owned in partnership, by a close corporation, or by a beneficial owner of a trust might also qualify for special use valuation. I.R.C. § 2032A(g) provides that the Secretary of the Treasury "shall prescribe regulations setting forth the application of this section . . . in the case of an interest in a partnership, corporation, or trust." The proposed regulations do give attention to such indirect ownership situations and make it clear that both the decedent and qualified heir must take an active role in the farm operation in order to qualify. 43 Fed. Reg. 31,040-41 (1978) (Proposed Treas. Reg. § 20.2032A-3(b), (e)).

⁹ 122 CONG. REC. H10,273 (daily ed. Sept. 16, 1976) (remarks of Rep. McCollister).

During the post-World War II period, the number of farms in Kentucky was reduced from 238,501 in 1945 to 102,053 in 1974, a loss of 136,448 farms. Although the average farm size increased from 83 acres to 141 acres during the same period, more than five million acres were removed from agricultural production. U.S. BUREAU OF THE CENSUS, DEPT. OF COMMERCE, 1974 CENSUS OF AGRICULTURE, vol. I, pt. 17, KENTUCKY: STATE AND COUNTY DATA, Table 1, at I-1 (1977) [hereinafter cited as 1974 CENSUS OF AGRICULTURE].

next twenty years.¹⁰ Congress believed that the federal estate tax contributed to the decline of family farms in two ways. First, the estate tax exemption levels had not been adjusted to account for the inflation in land values.¹¹ The farmer who bought a modest farm of 300 acres at \$100 per acre in 1942 had, at that time, an estate within the \$60,000 basic exemption.¹² During the ensuing years inflation increased the value of his farm, causing his estate to exceed the exemption levels¹³ and be subject to federal estate tax.¹⁴ However, inflation did not add to the farmer's real wealth. The estate tax had not been intended to tax such modest estates. As one legislator put it, the estate tax burden was now falling on the "farmer with an old Chevy."¹⁵

Second, the estate tax laws required the estate to be valued at its fair market value.¹⁶ The actual value of land is a

¹⁰ 122 CONG. REC. S13,606 (daily ed. Aug. 5, 1976) (remarks of Sen. Bentsen); 122 CONG. REC. H10,272 (daily ed. Sept. 16, 1976) (remarks of Rep. Bedell).

¹¹ 122 CONG. REC. H10,272 (daily ed. Sept. 16, 1976) (remarks of Rep. Broomfield). See also *id.* at H10,273 (remarks of Rep. Sebelius); *id.* at S13,606 (daily ed. Aug. 5, 1976) (remarks of Sen. Dole); H.R. REP. NO. 1380, *supra* note 6, at 3359.

¹² I.R.C. § 2052 (repealed 1976).

¹³ Representative John McCollister noted that the average value of farmland in Nebraska rose from \$24 per acre in 1942 to \$289 per acre in 1975. 122 CONG. REC. H10,273 (daily ed. Sept. 16, 1976).

In Kentucky, the average per acre value of a farm (including land and buildings) in 1945 was \$52 per acre. By 1974, the per acre value had risen to \$427. Of the 102,053 Kentucky farms in 1974, 22,315 were valued at more than \$70,000. In 1969, only 11,489 farms had a value in excess of \$70,000. The number of farms potentially subject to the estate tax had virtually doubled in five years. 1974 CENSUS OF AGRICULTURE, *supra* note 9, at Table 1, I-1.

¹⁴ 122 CONG. REC. H10,272 (daily ed. Sept. 16, 1976) (remarks of Sen. Broomfield). See also *id.* at H10,273 (remarks of Rep. Sebelius); *id.* at S13,606 (daily ed. Aug. 5, 1976) (remarks of Sen. Dole); H. REP. NO. 1380, *supra* note 6, at 3359.

¹⁵ Senator Nelson said:

If I may paraphrase the chairman of the House Ways and Means Committee in introducing his original estate gift tax reform proposal, MR. ULLMAN said the estate tax laws which were aimed at the great fortunes of this country are now hitting the average farmer with an old Chevy. I think the Congress can do better than that in designing an equitable estate tax law.

122 CONG. REC. S13,593 (daily ed. Aug. 5, 1976) (remarks of Sen. Nelson) (footnote omitted). See also *id.* at S13,606 (remarks of Sen. Bentsen).

In Kentucky, the average value per farm (land and buildings) had risen from \$4,259 in 1945 to \$60,344 in 1974; thus by 1974 the average farm exceeded the exemption level. 1974 CENSUS OF AGRICULTURE, *supra* note 9, Table 1, at I-1.

¹⁶ See, e.g., 122 CONG. REC. S13,595-96 (daily ed. Aug. 5, 1976) (remarks of Sen. Ribicoff); Treas. Reg. § 20.2031-1(b), T.D. 6826, 1965-2 C.B. 367.

correlative of its actual use. Yet the fair market value of land is a correlative of the land's potential use.¹⁷ Whenever farmland can be put to a nonfarm use that will produce a higher yield, the fair market value of the land will exceed its actual value as farm land.

However, economic factors alone do not determine use. A farmer may well make his decision to use his land for farming based on other criteria such as his dedication to farming or his love of the land, criteria which may be eminently sensible. But a farmer's decision to continue farming does not negate the paper value, the fair market value, that attaches to his land; in the fair market scheme of things there is someone willing and able to pay more for the land if it has a potential use more profitable than farming.¹⁸

When a farmer dies and devises his land, the paper value becomes significant. If, prior to 1976, inflation alone had not already pushed the value of his land above the basic exemption level, the fair market value of the land might well have done so.¹⁹ This put the family farm in extreme circumstances. The nonliquid nature²⁰ of the capital investment in land often left the devisees in the unenviable position of either having to sell part of the farm or to borrow to pay the tax.²¹ The late Senator

¹⁷ 122 CONG. REC. S13,606 (daily ed. Aug. 5, 1976) (remarks of Sen. Dole).

¹⁸ This difference between actual use value and fair market value is most frequently characteristic of farmland near expanding urban areas. *Id.* For example, the average value per acre of farmland in Fayette County, in which the city of Lexington is located, is \$1,297; in neighboring Jessamine County the average value per acre is \$780. But in rural Carlisle and Graves Counties the average value per acre is \$375 and \$406, respectively. All figures include the value of land and buildings in the per acre value. 1974 CENSUS OF AGRICULTURE, *supra* note 9, Table 1, at II-1.

¹⁹ The staff of the Joint Committee on Taxation noted that "the percentage of decedents whose estates have been subjected to the Federal estate tax has increased from 1 percent to 8 percent." JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 at 12 (Comm. Print 1976).

²⁰ *See, e.g.*, 122 CONG. REC. S13,750 (daily ed. Aug. 6, 1976) (remarks of Sen. Mathias); *id.* at H10,265 (daily ed. Sept. 16, 1976) (remarks of Rep. Conable); *id.* at S13,595 (daily ed. Aug. 5, 1976) (remarks of Sen. Packwood).

²¹ Senator Robert Mathias stated the problem as follows:

The following entirely realistic example illustrates the impact of the estate tax on farmland, woodland, open space, and historical property: Farmer Jones, a widower, dies, leaving his estate to his two sons, who wish to continue living on and farming the land. Farmer Jones' estate consists of his farm—300 acres—and farm equipment and other personal property valued at \$50,000. Used as a farm, the land is worth \$500 an acre. If the Federal

Hubert Humphrey recounted the story of a constituent from Fisher, Minnesota:

Largely due to the increase in crop prices and inflation of land and machinery values, my net worth jumped to \$480,000 on January 1, 1974 and to \$709,000 on January 1, 1975.

.....

The estate tax at this point in time is estimated at \$115,000 if I die first and over \$280,000 if my wife dies before I do. The net cash outflow could not be met from operating cash and a sell off would be required. It is doubtful if any banker would advance my son, age 19, the necessary capital to pay my estate taxes.²²

Selling part of the farm could fractionalize the farm so that the remaining acreage would be too small to be operated profitably.²³ Borrowing to pay the estate tax would add to any debt load²⁴ already carried by the farm. Since a tax based on fair

estate tax were based on an assessment for that use, Jones' estate would be valued at \$200,000 and the tax payable would be \$32,700—a very large sum for the Joneses, but one which the family might be able to pay and still retain at least most of the farm. However, the farm is within 25 miles of a large city, and speculators and developers have driven up the current price of land in Farmer Jones' area to \$2,000 an acre. Such prices, of course, assume conversion of the land to nonfarm use—a conversion which the Jones boys have no desire to see happen. Nonetheless, the Internal Revenue Service under existing law assesses the farm at \$2,000 an acre. The result is a valuation of Jones' estate at \$650,000 and a Federal tax payable of \$117,200.

Obviously, the family is compelled to sell the farm, probably to a speculator or developer, in order to pay the tax. The result is a federally compelled destruction of farmland and open space in a critical environmental area on the border of a metropolitan region, and the acceleration of urban or suburban sprawl with no thought for proper land-use planning. If Farmer Jones' house is a historic one, the result is the federally compelled destruction of a historic house, or at least of its surroundings—the very thing the Federal Government is supposedly trying to prevent through its National Register and other programs. And the result for the individual family is the gross injustice of being forced off their farm and being compelled to pay an estate tax amounting to a confiscatory 89 percent of the value of what the estate is worth to them for the purpose to which they wish to put it.

122 CONG. REC. S13,750 (daily ed. Aug. 6, 1976) (remarks of Sen. Mathias). *See also* H.R. REP. NO. 1380, *supra* note 6, at 3359. Several legislators noted that corporate agriculture often acquires these farms that are sold for tax purposes. *See e.g.*, 122 CONG. REC. H10,273 (daily ed. Sept. 16, 1976) (remarks of Rep. McCollister); *id.* at S13,606 (daily ed. Aug. 5, 1976) (remarks of Sen. Bentsen).

²² 122 CONG. REC. S13,603 (daily ed. Aug. 5, 1976) (remarks of the late Sen. Humphrey)(quoting a letter from Gerhard Ross).

²³ *Id.* at S13,606 (remarks of Sen. Dole).

²⁴ *Id.* at H10,268 (daily ed. Sept. 16, 1976) (remarks of Rep. Keys).

market value is predicated on a yield in excess of what the land actually yields as a farm, the land may not have a sufficient yield as farm land to amortize the debt.²⁵ The estate tax, then, operates as economic pressure to take the land out of agricultural production and to develop it for nonfarm purposes.²⁶

B. *The Congressional View of the Family Farm*

Congress proved to be sympathetic to the plight of the farmer for several reasons, probably not the least of which was the influence of the farm lobby.²⁷ But to raise the spectre of the farm lobby and question the sincerity of the Congressmen speaking on behalf of farmers would be to underestimate the cogency of the lobby's arguments and to succumb to cynicism.

One is reminded, when reading the debates on this provision, that taxation is a means to economic, social, and political ends as well as a means to raise revenue.²⁸ Congress perceived a threat to an old and venerable American institution — the

In 1940 the ratio of debt to value for American farms was, on the average, 41.5%. By 1950 the ratio had dropped to 25.3%. In 1970 the ratio had climbed again to 42%. U.S. BUREAU OF CENSUS, DEPT. OF COMMERCE, 1969 CENSUS OF AGRICULTURE, vol. V, SPECIAL REPORTS, pt.2, FARM FINANCE, Table III, at 148 (1974); U.S. BUREAU OF CENSUS, DEPT. OF COMMERCE & U.S. BUREAU OF AGRICULTURAL ECONOMICS, DEPT. OF AGRICULTURE, vol. V. SPECIAL REPORTS, pt. 8, COOPERATIVE REPORT 1950 FARM-MORTGAGE DEBT, Table 2, at 12 (1952).

²⁵ Congressman William S. Broomfield notes that since "the market value [of their land] was far in excess of their ability to generate income . . . the heirs of these small operations have been forced to sell the enterprise just to pay the taxes." 122 CONG. REC. H10,272 (daily ed. Sept. 16, 1976) (remarks of Rep. Broomfield). See also H.R. REP. No. 1380, *supra* note 6, at 3376.

²⁶ The comments of Congressman Conte are illustrative: "Older dairymen complained to me that they saw little chance of passing along their farms to their sons or daughters because of the Federal inheritance tax laws, and because of this they predicted a continuing shrinkage of the dairy industry in New England." 122 CONG. REC. H10,230 (daily ed. Sept. 16, 1976) (remarks of Rep. Conte); see also H.R. REP. No. 1380, *supra* note 6, at 3359.

The pressure is so great that the United States Department of Agriculture estimates that one quarter of all farm property sold is sold in order to pay estate taxes. 122 CONG. REC. S13,606 (daily ed. Aug. 5, 1976) (remarks of Sen. Bentsen).

²⁷ Representative Keys alluded to the lobby when she noted: "I worked hard in committee to channel the expertise of the Kansas Livestock Association and other Kansas farm groups into the drafting of this section." 122 CONG. REC. H10,268 (daily ed. Sept. 16, 1976) (remarks of Rep. Keys).

²⁸ In view of the fact that the valuation provisions represent a new revenue loss of \$15 million for calendar year 1978 and further losses in subsequent years, the non-revenue objectives of the provisions are indisputable. H.R. REP. No. 1380, *supra* note 6, at 3362 (table 2).

family farm — and the land valuation provisions of the estate tax package are patently designed to protect that institution²⁹ from an often hostile economic environment created by speculators, land developers, corporate agriculture, and the circumstances of inflation, taxation, and the nonliquid nature of capital investment in land.

Congress saw the family farm as the Jeffersonian ideal.³⁰ The family farm bears, nurtures, tempers, and sustains the idyllic yeoman farmer, strong of body and creative of mind. The farmer is a self-sufficient individualist, working seven days per week to take his modest livelihood from the soil³¹ and living essentially in harmony with nature, uncrowded and uncorrupted. He is the keeper of the agrarian heritage, passing it down generation after generation.³² The farmer represents stability and homeliness; he “put[s] down roots”; he is the “cement of community life.”³³ A threat to the family farm is a threat to the quality of American life.³⁴

As an economic institution, the family farm was considered by Congress to be a bastion of the free enterprise system in its ideal form: small, but efficient and competitive, economic units.³⁵ Senator Gaylord Nelson told his senatorial colleagues: “on a strictly economic level, family farms . . . have

²⁹ *Id.* at 3359.

³⁰ See 122 CONG. REC. S13,594, S13,600 (daily ed. Aug. 5, 1976) (remarks of Sen. Nelson).

³¹ *Id.* at S13,593, S13,600.

³² *Id.* at S13,594. See also *id.* at S13,606 (remarks of Sen. Dole). Congressman Sebelius read a portion of a constituent's letter telling of the loss of a portion of his farm which had been in the family for four generations. *Id.* at H10,273 (daily ed. Sept. 16, 1976) (remarks of Rep. Sebelius).

Given the congressional penchant toward preserving the American heritage, it is not surprising that the original Senate amendment to H.R. 10612 (the Tax Reform Bill), which embodied the provision for special use valuation of farmland, also included special valuation for historic sites. SENATE FINANCE COMM., SUPPLEMENTAL REPORT TO S. REP. NO. 938 (pt. II), 94th Cong., 2d Sess. 14-16 (1976), reprinted in [1976] U.S. CODE CONG. & AD. NEWS 4040-42.

³³ 122 CONG. REC. S13,594 (daily ed. Aug. 5, 1976) (remarks of Sen. Nelson). Presumably, Senator Gaylord Nelson did not intend the first quote as a pun.

³⁴ *Id.* at H10,272 (daily ed. Sept. 16, 1976) (remarks of Rep. Bedell).

³⁵ *Id.* at S13,606 (daily ed. Aug. 5, 1976) (remarks of Sen. Bentsen).

In the category “farms with Sales of \$2,500 and Over,” the average size of an individual or family farm in Kentucky is 165.7 acres; the average size of the partnership farm is 260.2 acres; and the average corporate farm (including those that are close corporations) is 534.5 acres. 1974 CENSUS OF AGRICULTURE, *supra* note 9, Table 28, at I-29.

proven to be the most efficient producers of food . . . that can be found anywhere in the world."³⁶ Senator Lloyd Bentsen echoed Senator Nelson's words,

[T]he family farm and ranch is vital to American agriculture. Family farming and ranching is more productive than corporate agribusiness because the man who owns the land works longer and harder. The present trend against these family owned enterprises is dangerous, and we must reverse any policy that contributes to it.³⁷

Family farms are the building blocks of our economic system, and, unlike the structure of corporate agriculture, the system of family farms keeps power decentralized in the agricultural segment of the economy.³⁸ Unlike the speculator, the family farmer toils endlessly in the Puritan tradition.³⁹ From the strength of his back and the wiles of his intelligence, he earns his daily bread while producing that of his urban neighbor.⁴⁰ He is the protector of our open spaces, the bulwark against the suburbanization urged upon us by the speculator and developer.⁴¹

The idealized portrait of the family farm that graced the halls of Congress perhaps overlooked flaws, yet grasped essential truths. It was a portrait created by those Congressmen who perceived a difference between wealth passed on in the form of

³⁶ 122 CONG. REC. S13,594 (daily ed. Aug. 5, 1976) (remarks of Sen. Nelson).

³⁷ *Id.* at S13,606 (remarks of Sen. Bentsen).

³⁸ *Id.* at S13,600 (remarks of Sen. Nelson); *id.* at H10,269 (daily ed. Sept. 16, 1976) (remarks of Rep. Keys); *id.* at H10,272 (remarks of Rep. Broomfield).

³⁹ Congressman William S. Broomfield, discussing the old estate tax structure, alleged that "the Federal Government is engaged in nothing less than confiscation that penalizes the work and savings ethic, and threatens our free enterprise system." 122 CONG. REC. H10,272 (daily ed. Sept. 16, 1976) (remarks of Rep. Broomfield).

⁴⁰ *Id.* at H10,230 (remarks of Rep. Conte).

Of the 67,179 Kentucky farm operators with sales of \$2,500 and over (not including corporate operators) only about two-thirds, 44,689, list farming as their principal occupation. 1974 CENSUS OF AGRICULTURE, *supra* note 9, Table 28, at I-29.

⁴¹ 122 CONG. REC. H10,275 (daily ed. Sept. 16, 1976) (remarks of Reps. Baucus and Hammerschmidt).

As Senator Robert Dole pointed out, when farmland is valued at its fair market value and subsequently sold to pay estate taxes and "the selling price includes development potential [*i.e.*, having been sold at the fair market price], the new owner *must* develop the land to realize his investment." *Id.* at S13,606 (daily ed. Aug. 5, 1976) (remarks of Sen. Dole) (emphasis added). *See also* H.R. REP. NO. 1380, *supra* note 6, at 3376.

farm realty and wealth passed on in the form of readily marketable securities.⁴² The former offered the devisee security through hard work, the latter offered the legatee affluence through indolence. These Congressmen were ready to accord the family farm greater relief. But other Congressmen minimized or denied any distinctions that warranted exceptional treatment.⁴³ These Congressmen were willing to afford the family farm special valuation provisions, but they were not willing to enact a basic tax credit that discriminated in favor of farm realty.⁴⁴ But 1976 was an election year;⁴⁵ both groups in Congress wished to face their constituents in a posture of fairness and beneficence.

C. *Solution Offered by Congress*

The farmland valuation package had four basic purposes: to (1) preserve family farming operations, (2) keep land in agricultural production rather than subject it to the designs of speculators, (3) keep land from the hands of corporate agriculture, and (4) preserve basic social and economic values associated with the family farm. The means chosen to achieve these purposes were: to (1) increase the exemption level to allow for inflation, and (2) allow valuation of farmland based on its actual use rather than its potential use. By these means Congress hoped to reduce the number of family farms subject to the estate tax and to reduce the tax burden on those farms that were subject to the tax.

⁴² See, e.g., 122 CONG. REC. S13,592-94 (daily ed. Aug. 5, 1976) (remarks of Sen. Nelson).

⁴³ *Id.* at S13,595-97 (remarks of Sen. Ribicoff).

There has long been a tension in American politics between the interests of realty and personalty. That tension was particularly evident in the Senate debates concerning the Nelson-Packwood amendment. The amendment favored a split tax credit which would have accorded the family farm a tax exemption, in the form of a credit, greater than that accorded most other estates. *Id.* at S13,590-608. Senator Edward Kennedy offered an amendment which went even further than the Nelson-Packwood amendment in distinguishing between personalty and realty in according a basic tax exemption. *Id.* at S13,604-08. The Nelson-Packwood amendment failed. *Id.* at S13,608 (roll call vote). The Kennedy amendment, which was more anti-personalty than the Nelson-Packwood amendment, also failed. *Id.* at S13,607 (roll call vote).

⁴⁴ *Id.* at S13,595, S13,596 (remarks of Sen. Ribicoff).

⁴⁵ Senator Abraham Ribicoff made pointed note of this fact. *Id.* at S13,601 (remarks of Sen. Ribicoff).

II. THE ACT (I.R.C. SECTION 2032A)

A. *Requirements for Actual Use Valuation*

For farmland to qualify for actual use valuation several requirements must be met. First, the decedent must have been either a citizen or resident of the United States at the time of his death;⁴⁶ the realty in issue must be located in the United States and must have been used for farming purposes on the date of the decedent's death.⁴⁷ The realty must also have been owned by the decedent or a family member for at least five of the eight years immediately prior to the decedent's death, and, during the same period, the decedent or a family member must have materially participated in the farming operation.⁴⁸

Second, the fair market value of both the real and personal property used for farming, less the debts attributable to such property, must equal at least fifty percent of the fair market value of the decedent's gross estate, reduced by debts attributable to property included in the gross estate. Furthermore, the fair market value of the realty alone, reduced by debts attributable to it, must equal at least twenty-five percent of the fair market value of the decedent's gross estate, reduced by debts attributable to the property included in the gross estate. In other words, the value of the realty must be a substantial part of the estate.⁴⁹

Third, the land must have passed from the decedent to a qualified heir:⁵⁰ a member of decedent's family.⁵¹ Here, family is defined as the decedent's spouse, ancestors, and lineal des-

⁴⁶ I.R.C. § 2032A(a)(1)(A).

⁴⁷ I.R.C. § 2032A(b)(1)(2). "Farming purposes" is further defined as the growing of crops, including trees (not including the milling of trees), the storing of crops if at least one-half the crops were grown on the farm, and the raising of livestock. I.R.C. § 2032A(e)(5).

⁴⁸ I.R.C. § 2032A(b)(1)(C); 43 Fed. Reg. 31,041 (Proposed Treas. Reg. § 20.2032A-3(c)). The five years need not be consecutive. COLSON & KAHN *Supplement, supra* note 7, at 108.

Material participation is dealt with at length in text accompanying notes 72-149 *infra*.

⁴⁹ I.R.C. § 2032A(b)(A)(B)(C). For a discussion of problems farmers might face depending on how their debt load is secured, see COLSON & KAHN *Supplement, supra* note 7, at 104-06.

⁵⁰ I.R.C. § 2032A(b)(1)(A)(ii).

⁵¹ I.R.C. § 2032A(e)(1).

endants (and their spouses) of the decedent's grandparents.⁵² To remain qualified a family member must materially participate after the decedent's death.⁵³ It is quite clear that actual use valuation is available only to the family farm that stays in the family.

Fourth, the executor must elect actual use valuation.⁵⁴ Also, each person in being who has an interest in the realty must agree to personal liability in the event the recapture provisions of section 2032A are invoked.⁵⁵

B. *Recapture under Section 2032A*

If within fifteen years after the decedent's death the property ceases to be used for a qualified use or is conveyed out of the family, recapture provisions⁵⁶ are triggered. The estate tax savings that were accorded by virtue of actual use valuation are lost and the estate tax is reassessed. However, if recapture is triggered between the tenth and fifteenth years, the "tax is reduced on a ratable monthly basis."⁵⁷ Cessation of qualified use occurs if the property is put to nonfarm use⁵⁸ or if, during any eight-year period ending after decedent's death (within the fifteen-year limit), there were periods aggregating three years or more during which neither the decedent nor a member of his family materially participated in the farm operation.⁵⁹

⁵² I.R.C. § 2032A(e)(2). Adopted children are treated as blood relatives. *Id.*

⁵³ I.R.C. § 2032A(c)(7)(8).

⁵⁴ I.R.C. § 2032A(a)(1)(B), (d)(1).

⁵⁵ I.R.C. § 2032A(c)(6), (d)(2). COLSON & KAHN *Supplement, supra* note 7, at 112-13, discusses problems that may attend this agreement. "Given this cumbersome procedure, decedents should be watchful not to unnecessarily burden the estate by naming remote beneficiaries." *Id.* at 113.

⁵⁶ I.R.C. § 2032A(c).

⁵⁷ COLSON & KAHN *Supplement, supra* note 7, at 121; I.R.C. § 2032A(c)(3).

⁵⁸ I.R.C. § 2032A(c)(7)(A), referring to (b)(2)(A).

⁵⁹ For example, if the decedent failed to participate materially during the last two years of his life and his devisee did materially participate for four years but then did not for one or more years, recapture would be triggered. But if the devisee materially participated for six years and then did not for a year or more, recapture would not be triggered. Similarly, during any eight-year period in which the devisee holds the land, he must materially participate for an aggregate of more than five years to avoid recapture. I.R.C. § 2032A(c)(7)(B).

C. *Determination of Actual Use Value*

Section 2032A provides two methods for determining the actual use value of farmland which qualifies for special valuation. One is based on the rental value of comparable land in the area;⁶⁰ the other simply notes various factors that may be considered in assessing the value such as comparable sales, real estate tax assessment value if based on special use, and capitalization of the fair rental value.⁶¹ As a general rule, the executor may elect either method of valuation, but if there is no comparable land in the area⁶² from which the annual gross cash rental value may be determined, then the multiple factor test must be used.⁶³ It should be noted that the difference between actual use valuation and fair market value may not exceed \$500,000.⁶⁴

D. *Effect on Basis*

The executor should be aware that election of special farm use valuation may reduce or eliminate the various step-ups to

⁶⁰ I.R.C. § 2032A(e)(7)(A).

⁶¹ I.R.C. § 2032A(e)(8).

The proposed regulations offer a helpful explanation and one example of how to determine special use valuation. 43 Fed. Reg. 31,042-43 (1978) (Proposed Treas. Reg. § 20.2032A-4).

⁶² It is clear from I.R.C. § 2032A(e)(7)(i) that the comparable land must be "located in the locality." However, in view of the purpose of § 2032A to allow valuation for actual use and to exclude factors based on non-farm use that tend to inflate the value of farm land, *see* H.R. REP. No. 1380, *supra* note 6, at 3378, it would have been reasonable had Congress allowed the comparable land to be located in another area, provided it is in fact comparable farmland as to quality of soil, proximity to transportation and markets, and other factors that give land value as farmland. This would allow use of the more precise formula, 122 CONG. REC. H10,269 (daily ed. Sept. 16, 1976) (remarks of Rep. Keys), embodied in subsection (e)(7)(A) for valuing farmland near urban areas for which there may be no comparable land in the area not infected with nonfarm values. COLSON & KAHN *Supplement, supra* note 7, at 114, suggests the need for interpretive guidelines. The recently issued proposed regulations note the "same locality" requirements but add: "This requirement is not to be viewed in terms of mileage or political divisions alone . . . The determination of properties which are comparable is a factual one and must be based on numerous factors . . ." Such factors include similarity of soil, the degree to which the soil is depleted by the type of crop grown, and other topographical and economic factors. 43 Fed. Reg. 31,043 (1978) (proposed Treas. Reg. § 20.2032A-4(d)).

⁶³ I.R.C. § 2032A(e)(8).

⁶⁴ I.R.C. § 2032A(a)(2).

Thus a farm with a fair market value of \$1,000,000 and an actual use value of \$350,000 would be valued at \$500,000 for estate tax purposes.

the decedent's basis in the property which are available under the carryover basis provision of the Tax Reform Act.⁶⁵ Under the prior law,⁶⁶ the basis in property acquired from a decedent was the value of the property at the death of the decedent. Thus if property appreciated in the hands of the decedent, that increase in value was never subject to the income tax. The beneficiaries received the appreciated property with a stepped-up basis.⁶⁷

The carryover basis provision of the new law passes the property to the devisee with the decedent's basis. The basis is not stepped up to the value at death. Certain step-ups in basis are available, however. Congress included a fresh start provision⁶⁸ wherein the basis or property acquired before December 31, 1976, would be stepped up to the value on December 31, 1976. To that fresh start basis may be added (1) the value of federal and state estate taxes which are attributable to the appreciated value;⁶⁹ (2) the value by which \$60,000 (the minimum basis) exceeds the sum of the fresh start basis and the estate tax step-up;⁷⁰ and (3) the value of state death taxes paid by the distributee.⁷¹ The new basis afforded by these step-ups may not exceed the fair market value on the date of the decedent's death.

The fair market value is considered to be its [the property's] value for Federal estate tax purposes. Thus, if property is valued under the . . . special farm . . . valuation method . . . , that . . . special value is to be used to determine the amount of appreciation for purposes of making all adjustments to the carryover basis.⁷²

If the property is to remain an active family farm within

⁶⁵ I.R.C. § 1023.

⁶⁶ I.R.C. § 1014. The section is still in effect but does not apply for persons who died after December 31, 1976. I.R.C. § 1014(d).

⁶⁷ Congress felt that this prior provision unfairly discriminated against those who sold property before death and that it discouraged the sale of property by people in their later years. JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 552 (Comm. Print 1976).

⁶⁸ I.R.C. § 1023(b).

⁶⁹ I.R.C. § 1023(c).

⁷⁰ I.R.C. § 1023(d).

⁷¹ I.R.C. § 1023(e).

⁷² JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 554-55 (Comm. Print 1976).

the decedent's family, any resulting loss in basis step-ups is irrelevant. Yet the loss may be of importance if the devisee plans to hold the farm and materially participate only long enough to escape the recapture provisions of section 2032A, for then his basis would be limited to the special farm valuation of the property and would render the step-ups unavailable beyond that amount.

III. MATERIAL PARTICIPATION

Material participation is crucial.⁷³ It is necessary both to qualify for special use valuation and to avoid recapture of the taxes that might have been levied on the fair market valuation. As the following discussion will indicate, the family farmer who actively operates his farm, either by himself or with the aid of his family, has materially participated for the purposes of section 2032A. Material participation, however, must be a concern of the family farmer who decides to retire from full-time operation of the farm. If operation of the farm devolves on family members, most likely a daughter or son, the Act still permits special valuation.⁷⁴ However, if the farmer does not turn over operations to a family member but instead rents the land to someone else or leaves it idle, the material participation requirement might bar special valuation at the farmer's death and require the land to be valued at its fair market value. Similarly, if the devisee qualifies for special valuation but later declines active participation in farming and prefers to rent the land to another, the material participation requirement may activate the recapture provisions of the Act.⁷⁵

It is important, then, to define material participation. Section 2032A provides: "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)."⁷⁶ With the caveat that "in a manner

⁷³ The recently amended Kentucky provision does not require material participation by either the decedent or the qualified heir. KRS § 140.300-.360 (Supp. 1978). For a brief explanation of the Kentucky provision, see note 2 *supra*.

⁷⁴ I.R.C. § 2032A(b)(1)(c)(ii).

⁷⁵ See text accompanying notes 56-59 *supra* for a discussion of the recapture provisions.

⁷⁶ I.R.C. § 2032A(e)(6).

The proposed regulations issued under § 2032 provide that "[t]he regulations

similar to" may allow for a variation in the definition of material participation which a court might impose for section 2032A purposes, one must look to section 1402(a) and the regulations, revenue rulings, and court decisions based on it for a definition of material participation.

A. *Material Participation under Section 1402(a)*

Section 1402(a) defines earnings from self-employment for the purpose of taxing those earnings to finance the federal Old Age and Survivors Insurance Trust Fund (OASI).⁷⁷ The purpose of OASI is to provide security to those whose income is subject to the ravages of advancing age, disability, and death. To be eligible to receive OASI benefits one must have contributed to OASI. Most contribute through wage deductions (F.I.C.A.); however, self-employed individuals have no employer to withhold F.I.C.A. deductions and therefore must compute their own tax based on their self employed income. Income from rents is generally excluded from self-employment income and not taxed under OASI. The rationale is that rents are not subject to diminution due to advancing age, disability or death of the recipient because rents are not dependent on the physical labor of the recipient. However, rent received by those who materially participate in agricultural production on land they have rented to another is classified as self-employment income. This income is taxed under section 1402(a) and the material participant is later able to receive benefits from OASI.⁷⁸ The rationale for this exception to the general exclusion is that such rental income does depend on the activity of the land owner.⁷⁹

Regulations and revenue rulings have been issued which attempt to define material participation under section 1402(a).

under section 1402(a)(1) are applicable for purposes of this section to the extent they are not inconsistent with its express requirements." 43 Fed. Reg. 31,041 (1978) (Proposed Treas. Reg. § 20.2032A-3(d)).

⁷⁷ 42 U.S.C. §§ 401(a)(4), 411(a)(1) (1970). See I.R.C. ch. 2, and 42 U.S.C. ch. 7 (1970).

⁷⁸ Treas. Reg. § 1.1402(a)-4(a), T.D. 6691, 1963-2 C.B. 347.

⁷⁹ S. REP. NO. 2133, 84th Cong., 2d Sess. 8, reprinted in [1956] U.S. CODE CONG. & AD. NEWS 3884; *Celebrezze v. Miller*, 333 F.2d 30 (5th Cir. 1964); *Celebrezze v. Maxwell*, 315 F.2d 727 (5th Cir. 1963).

The regulations note that farm rental income qualifies as self-employment income if:

- (i) The income is derived under an arrangement between the owner . . . of land and another person which provides that such other person shall produce agricultural or horticultural commodities on such land, and that there shall be material participation by the owner . . . in the production or the management of the production . . . , and
- (ii) There is material participation by the owner⁸⁰

The agreement may be either oral or written and must contemplate material participation by the owner in either production or the management of production.⁸¹ The contemplated participation must be carried out by actual material participation. The actual participation need not be material with respect to only production or only management; the owner may materially participate by active involvement in both management and production so that his total involvement can be considered material. In this context, production refers to both the physical work of farming and the furnishing of tools and machinery. Management refers to the active and regular process of inspection, consultation, and decision.⁸²

Both contemplated and actual material participation must be proved.⁸³ Yet, actual participation is generally construed to indicate that the arrangement, whether oral or vaguely written, did in fact contemplate material participation by the owner.⁸⁴ However, participation gratuitously offered will

⁸⁰ Treas. Reg. § 1.1402(a)-4(b), T.D. 6691, 1963-2 C.B. 347 (emphasis added).

⁸¹ *Id.* § 1.1402(a)-4(b)(2); *McCormick v. Richardson*, 460 F.2d 783 (10th Cir. 1972); 43 Fed. Reg. 31,041 (1978) (Proposed Treas. Reg. § 20.2032A-3(d)(1)).

⁸² Treas. Reg. § 1.1402(a)-4(b)(3), T.D. 6691, 1963-2 C.B. 347.

⁸³ *Foster v. Celebrezze*, 313 F.2d 604 (10th Cir. 1963), *rev'd sub nom Foster v. Flemming*, 190 F. Supp. 908 (N.D. Iowa, 1960) (on other grounds).

⁸⁴ *Celebrezze v. Benson*, 314 F.2d 219 (8th Cir. 1963) (participation by owner proved agreement continued despite lapse of lease); *Whitlow v. Celebrezze*, UNEMPL. INS. REP. (CCH) ¶ 16140 (S.D. Ill. 1964) (material participation held not merely gratuitous). *But see Foster v. Celebrezze*, 313 F.2d 604, 607 (8th Cir. 1963) (in dicta the court noted: "volunteer services . . . on the part of the landlord in the absence of any arrangement . . . will not suffice.").

It is also appropriate to note here that the owner once was able to participate materially through an agent. Rev. Rul. 64-32, 1964-1 C.B. 319. Section 1402(a) has since been amended to preclude vicarious material participation. Pub. L. No. 93-368, § 10(b), 88 Stat. 422 (1974). Amendments to the regulations have also been proposed which reiterate the preclusion of material participation through an agent. 43 Fed. Reg.

not support a finding of material participation.⁸⁵

Just what quantum of participation constitutes material participation is difficult to define. "[N]o hard and fast rules can be laid down for determining in all cases the physical work and/or management decisions needed to establish the degree of participation contemplated by the statute."⁸⁶ However, as a practical accommodation to the taxpayer,⁸⁷ the Internal Revenue Service (IRS) has formulated four tests of material participation against which the taxpayer may measure his activities. One need meet only one of the following tests to qualify as materially participating:

Test No. 1. You do any three of the following:

- (1) advance, pay, or stand good for at least half the direct costs of producing the crop;
- (2) furnish at least half the tools, equipment and livestock used in producing the crop;
- (3) advise and consult with your tenant periodically; and
- (4) inspect production activities periodically.

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

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

Test No. 4. You do things which, considered in their total effect, show that you are materially and significantly involved in the production of the farm commodities.⁸⁸

31,040 (1978) (Proposed Treas. Reg. 31,040 (1978) (proposed Treas. Reg. § 1.1402(a)(4)(b)(5)).

⁸⁵ 43 Fed. Reg. 31,041 (1978) (Proposed Treas. Reg. § 20.2032A-3(d)(1)). For a case where the court considered whether labor was gratuitous, see *Whitlow v. Celebrezze*, UNEMPL. INS. REP. (CCH) ¶ 16,140 (S.D. Ill. 1964). This case is discussed in the text accompanying note 108 *infra*.

⁸⁶ Rev. Rul. 57-58, 1957-1 C.B. 270, at 271.

⁸⁷ The IRS defines material participation with a series of examples. Treas. Reg. § 1.1402(a)-4(b)(6), T.D. 6691, 1963-2 C.B. 347; Rev. Rul. 57-58, 1957-1 C.B. 270. For additional examples, see 43 Fed. Reg. 31,041-42 (1978) (Proposed Treas. Reg. § 20.2032A-3(F)).

⁸⁸ INTERNAL REVENUE SERVICE, DEPT. OF THE TREASURY, PUBLICATION NO. 225, FARMER'S TAX GUIDE 53 (1978).

The recently issued proposed regulations for § 2032A essentially reiterate the Tax Guide tests; they state:

No single factor is determinative of the presence of material participation,

1. *Test One*

Test One imposes a rigorous standard and seems to envision a joint enterprise arrangement in which management and the costs of production are shared. Such costs might include feed, seed, plants, fertilizers, fuel, machinery, repairs, pesticides, herbicides, transportation, livestock, and veterinarian expenses. *Bridie v. Ribicoff*⁸⁹ represents a classic example of a farmer who met the standards of Test One. Bridie owned a farm of 203 acres primarily devoted to raising livestock. On the farm were two houses with barns adjacent to each. Bridie lived in one; the tenant lived in the other. Bridie supplied one-half the livestock, made advances for major purchases (one-half subsequently repaid to him by his tenant), inspected, watered stock, drove the tractor for haying, and inoculated the soybeans. The tenant supplied his labor, all machinery and all feed (after consultation with Bridie as to type of feed), and the other one-half of the costs. They made joint decisions as to management and marketing. The profits were equally divided. The court found a joint venture existed in which Bridie materially participated.⁹⁰

It should be emphasized that fifty percent or greater financial participation without either consultation or inspection is insufficient under this test. *Bryant*, in *Bryant v. Celebrezze*,⁹¹

but physical work and participation in management decisions are the principal factors to be considered. As a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and family members must participate in making a substantial number of these decisions. Additionally, production activities on the land should be inspected regularly by the family participant, and funds must be advanced or financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, a substantial portion of the machinery, implements, and livestock used in the production activities should also be furnished by the owner and other family members.

43 Fed. Reg. 31,041 (1978) (Proposed Treas. Reg. § 20.2032A-3(d)(2)).

⁸⁹ 194 F. Supp. 809 (N.D. Iowa 1961).

⁹⁰ *Id. Accord*, *Celebrezze v. Wifstad*, 314 F.2d 208 (8th Cir. 1963) (owner paid ½ costs, selected and supplied seed, retained ultimate control but visited farm only occasionally); *Colegate v. Gardner*, 265 F. Supp. 987 (S.D. Ohio 1967) (owner paid ½ costs, made important managerial decisions, rarely inspected work of experienced tenant, supervised her share at harvest).

⁹¹ 229 F. Supp. 329 (E.D.S.C. 1964).

met one-half the costs but left the operations entirely to the tenant, her brother. The court noted:

She did reside on the farm and remained in actual possession of the land. . . . [I]f Beulah had possessed the skills required for farm management her brother would have paid heed. . . . It is noted, however, that Beulah apparently did not possess the requisite skills [She did not actually participate.] Not a single instance has been shown where the plaintiff made an important decision . . . or where her presence was of a significant value to a decision made by Herbert [her brother].⁹²

The court found that Bryant had not materially participated.

In *Vance v. Ribicoff*,⁹³ Vance rented out fifty-two acres, supplied all tobacco plants, all spray, all sticks, the drying barn, and a mule and plow. Her tenant supplied the labor. No agent was employed. Relying in part on *Harper v. Flemming*,⁹⁴ a case in which the court had found material participation through an agent, the court noted that the size of the operation was not important, stressed the substantial amount of Vance's financial contribution, and found material participation.⁹⁵ However, Vance, unlike Bryant, regularly walked past the tobacco crop and advised her tenant when it needed plowing or when she found worms in the tobacco. For the most part, she relied upon her skilled tenant but the court held that her advice and consultation, together with her financial investment, amounted to material participation.

In discussing inspection, advice, and consultation, the court has not imposed impossible standards. In *Celebrezze v. Wifstad*,⁹⁶ the court found that six to eight visits during the growing season and periodic phone calls, supplementing a one-half financial contribution, were sufficient to meet the material participation requirement. During consultation with his tenant, Wifstad made managerial decisions. In *Colegate v.*

⁹² *Id.* at 335.

⁹³ 202 F. Supp. 790 (E.D. Tenn. 1961). The *Vance* lease is discussed in the Appendix at note 161. The facts of *Vance* seem to be the basis for example 2 in the proposed regulations. 43 Fed. Reg. 31,041-42 (1978) (Proposed Treas. Reg. § 20.2032A-3(f)).

⁹⁴ 288 F.2d 61 (4th Cir. 1961).

⁹⁵ 202 F. Supp. 790, 795 (E.D. Tenn. 1961).

⁹⁶ 314 F.2d 208 (8th Cir. 1963).

Gardner,⁹⁷ Colegate made only two inspections and supervised the harvesting of her share of the crop. The court found these activities sufficient because her tenant was an experienced farmer and long time neighbor. On the other hand, in *Bryant v. Celebrezze*⁹⁸ Bryant made no inspections because her brother "knew best what to do about it more than I did"⁹⁹ and because she was not well; the court found no material participation even though Bryant met one-half the costs. It should also be noted that inspection and consultation must be directed toward production — the what, when, where, and how of farming — and not simply toward the preservation of one's realty.¹⁰⁰

2. Test Two

Test Two envisions management decisions that are made throughout the year. General policy planning at the outset of the season is insufficient. The owner must decide matters such as "when to plant, cultivate, spray or harvest, what items to buy, sell or rent, what records to keep, what reports to make, and what bills to pay and when"¹⁰¹ and in which government programs to participate.¹⁰² Retaining ultimate control over decision-making is important. In *Hoffman v. Gardner*, Hoffman lived 400 miles from his farms but the court found he "completely directed the farming operations" through direct consultation or the agency of his brother-in-law. The court noted that: "In order to 'materially participate,' the statute does not require the farm owner to settle all the problems, or even all the important problems . . . Claimant's participation need only be of substantial value or importance."¹⁰³ Hoffman

⁹⁷ 265 F. Supp. 987 (S.D. Ohio 1967).

⁹⁸ 229 F. Supp. 329 (E.D.S.C. 1964).

⁹⁹ *Id.* at 332.

¹⁰⁰ *Hoffman v. Ribicoff*, 305 F.2d 1 (8th Cir. 1962) (no material participation); *Hoffman v. Celebrezze*, 246 F. Supp. 380 (E.D. Mo. 1965), *rev'd sub nom.* *Hoffman v. Gardner*, 369 F.2d 837 (8th Cir. 1966) (different interpretation of facts). The plaintiff in these cases is the same Hoffman but the cases involve different farms. Although the results are different, the facts are not significantly different. Subsequent decisions distinguish the facts in the first Hoffman case. See *e.g.*, *McCormick v. Richardson*, UNEMPL. INS. REP. (CCH) ¶16,068 (W.D. Okla. 1972).

¹⁰¹ J. O'BYRNE, FARM INCOME TAX MANUAL (5th ed. 1977) [hereinafter cited as O'BYRNE].

¹⁰² *Hoffman v. Gardner*, 369 F.2d 837 (8th Cir. 1966).

¹⁰³ *Id.* at 841, 842 (citations omitted).

paid all the costs of grass seed and fertilizer and one-half the cost of corn seed and bailing; determined the time and fields for planting and the time of harvesting and spraying; and instructed on fencing, terracing, marketing and drainage. He also decided in which government farm programs he would participate.¹⁰⁴

How actively the owner must exercise his authority depends, in part, on the type of farming done and the age of the owner. In *Conley v. Ribicoff*,¹⁰⁵ Conley lived in California and rented his farm to former neighbors in South Dakota. He visited to inspect and consult twice each year for periods as long as two weeks. Prior to the season he issued directions on planting, seed quality, and what land to fallow in the summer. His decisions were based largely on his long experience in farming that same land and on the previous year's yield. The tenants did all the labor, paid all costs, furnished all equipment, and received two-thirds of the crop. The court found that Conley materially participated because there were no other significant contributions he could make to the management of farm production: "Conley could not have contributed anything by planting his feed in the furrows and watching his grain grow; to use his own words '[he] could of done no more if there daily all year.'"¹⁰⁶

3. Test Three

Test Three seems to be less demanding. If one works in production for 100 hours or more over a period of five or more

¹⁰⁴ *Id. Accord*, *McCormick v. Richardson*, 460 F.2d 783 (10th Cir. 1972); *Foster v. Celebrezze*, 313 F.2d 604 (8th Cir. 1963), *reversing sub nom.* *Foster v. Flemming*, 190 F. Supp. 908 (N.D. Iowa 1960); *Lee v. Richardson*, UNEMPL. INS. REP. (CCH) ¶ 16,402 (E.D.N.C. 1971).

¹⁰⁵ 294 F.2d 190 (9th Cir. 1961).

¹⁰⁶ *Id.* at 195. *Cf. Stueckle v. Celebrezze*, UNEMPL. INS. REP. (CCH) ¶ 14,033 (E.D. Wash. 1965), where the court seemed to expect less activity because of Stueckle's age. "That she had authority to control the operation, which she did not always use, would seem to me to be sufficient to qualify her . . ." *But see Millemon v. Secretary of Health, Education and Welfare*, 256 F. Supp. 928 (W.D. Okla. 1966) wherein the court stressed the exercise of a "substantial degree of managerial prerogative." *Id.* at 940. Millemon lived 11 miles from the farm and her son, an experienced farmer, operated her farm and his own. "It is not shown herein where her presence was of significant value to any decision by her son." *Id.* She was not found to have materially participated.

weeks during a year, one has materially participated. In other words, by working forty minutes each day during the year, one qualifies, but not by working twenty hours each day for four weeks and never thereafter.¹⁰⁷ Only one case involves this test. In *Whitlow v. Celebrezze*,¹⁰⁸ Whitlow and his tenant made joint decisions and jointly worked the farm. The court noted that Whitlow worked 200 hours spread over five weeks doing such things as harvesting, weeding, mowing, maintaining fences, purchasing, and applying phosphate. The court held that these activities were not gratuitous because they had a direct bearing on production and therefore a direct bearing on Whitlow's share of the profit.¹⁰⁹

O'Byrne¹¹⁰ notes that for purposes of meeting this test emphasis should be placed on work — physical labor — and not on managerial-type work because the tax administrators have “a peasant approach to farming, a stereotype of a man and his horse tilling the soil in the fading sunset.” He stresses that physical activity “is still the best proof of participation.”¹¹¹

4. Test Four

Test Four is a catch-all. The claimant may, under this test, allege material participation based on the totality of factors even though he fails to satisfy the relatively specific standards of the other three tests. *Celebrezze v. Miller*¹¹² is a good example. Miller, eighty-two years old, had an oral agreement with his tenant. Miller paid one-third of the cost of fertilizer, pesticides, herbicides, and labor. He consulted, advised, and inspected three or four times each month. In return he received one-third of the crop or suffered one-third of the loss. His tenant supplied all of the seed, covered the remainder of other

¹⁰⁷ O'BYRNE, *supra* note 101, at 900-91.

¹⁰⁸ UNEMPL. INS. REP. (CCH) ¶ 16,140 (S.D. Ill. 1964).

¹⁰⁹ Mere gratuitous labor is not contemplated by the parties under such an arrangement. See text accompanying notes 81-85 *supra* for a discussion of the required arrangement.

¹¹⁰ John O'Byrne is a noted authority on taxation as it affects farmers. See note 101 *supra* for a citation to his FARM INCOME TAX MANUAL.

¹¹¹ O'BRYNE, *supra* note 101, at 911.

The proposed regulations note that “physical work *and* participation in management decisions are the principal factors to be considered.” 43 Fed. Reg. 31,041 (1978) (Proposed Treas. Reg. § 420.2032A-3(d) (2)) (emphasis added).

¹¹² 333 F.2d 29 (5th Cir. 1964).

costs, and provided the labor. The court found a mutual undertaking in which Miller materially participated.¹¹³

5. *The Risk Element*

It is extremely important to note that in *all* the cases cited here under section 1402(a), the owner shared in a percentage of the crop and was not entitled to a flat, money rent unrelated to actual production. In many of the cases the courts have explicitly noted that this crop-share arrangement, while not alone sufficient, is important in finding material participation and in distinguishing the crop-share farmer or joint venturer from a mere landlord.

The policy behind the law is, of course, the reason for the distinction.¹¹⁴ The income of the crop-share farmer or the joint venturer is dependent on his participation. Attendant to his participation, he shares an element of risk. The greater the landowner's contribution in time and money, the greater his risk. The courts, therefore, often focus on risk as a measure of contribution, particularly under Test Four. In *Henderson v. Flemming*,¹¹⁵ Henderson, ninety years old and confined to a wheelchair, had a crop-sharing arrangement with her son. Four hundred acres were charged to his account, 200 to hers. Her son did all the physical work. She made important decisions and furnished much of the money (\$1,100 each year). The court held that her son was her agent and that the relationship gave her vicarious personal participation. But the risk she took was important:

One is hardly a mere landlord in the traditional sense if he must risk considerable funds in addition to the land in the success of the venture. And what he gets—or hopes to get—is more than rent. It is profit from the operation of a business, a business fraught with financial risks. . . .¹¹⁶

¹¹³ *Id.* See also *Celebrezze v. Benson*, 314 F.2d 219 (8th Cir. 1963).

¹¹⁴ See text accompanying notes 77-79 *supra* for this policy.

¹¹⁵ 283 F.2d 882 (5th Cir. 1960).

¹¹⁶ *Id.* at 888. *Bridie v. Ribicoff*, 194 F. Supp. 809 (N.D. Iowa 1961), distinguishes profit from rent on the basis of the risk attendant to profit. See also *Colegate v. Gardner*, 265 F. Supp. 987 (S.D. Ohio 1967), and *Celebrezze v. Miller*, 333 F.2d 29 (5th Cir. 1964) (both quoting the language from *Henderson* quoted above). See note 84 *supra* for a discussion of the use of agency under the material participation test.

Of the reported cases, *Celebrezze v. Maxwell*¹¹⁷ represents the claimant with the least contribution. Maxwell supplied the land and paid one-quarter of the expenses for fertilizer, pesticides, and herbicides used in conjunction with cotton production. Maxwell had five tenants: three grew only corn, one grew only cotton, and one grew both corn and cotton. Maxwell received one-third of the corn crop and one-quarter of the cotton crop as rent. A total of seventy-five acres were in production. The arrangement was oral. The court held Maxwell was no more than a landlord because there was: (1) no arrangement to manage, (2) no actual management, (3) no substantial financial contribution in relation to the tenants' contribution, (4) no dependence of the tenants on his advice, (5) no agency established,¹¹⁸ and (6) no inspection. In sum, Maxwell took minimal risk and therefore did not materially participate.¹¹⁹ Since Maxwell's income depended on production and yet he failed to qualify, it would be difficult to prove that a landlord who received a flat, money rent, in no way dependent on production, was materially involved in production.¹²⁰

6. Summary

The material participation test seems well-suited for the purposes underlying section 1402(a) — to finance the OASI. OASI functions as an income insurance program to provide security for those whose ability to labor has become impaired in their later years. Those who do not depend upon labor for their income, those who do not “materially participate,” do not

¹¹⁷ 315 F.2d 727 (5th Cir. 1963).

¹¹⁸ See note 84 *supra* for a discussion of the use of agency under the material participation test.

¹¹⁹ 315 F.2d 727 (5th Cir. 1963).

¹²⁰ The proposed regulations stress active participation and financial risk as elements of material participation. They explicitly state:

Passively collecting rents, salaries, draws, dividends, or other business is not sufficient for material participation, nor is merely advancing capital and reviewing a crop plan or other business proposal and financial reports each season or business year.

43 Fed. Reg. 31,040 (1978) (Proposed Treas. Reg. § 20.2032A-3(a)). *But see* COLSON & KAHN *Supplement*, note 7 *supra*, at 108: “Presumably, a farmer can materially participate under a cash rental arrangement as well as under a crop share arrangement.” See also O'BRYNE, note 101 *supra*, at 907. O'Bryne notes, without citation, the opinion of an administrative law judge finding material participation by a cash-rent landlord.

need the benefits of the government income insurance. The major anomaly first presented by the courts' interpretation of section 1402(a) and, later by the Treasury Department's interpretation of the section—vicarious material participation solely through an agent—has been removed by Congress.¹²¹ The foregoing cases which turned on vicarious participation must be read with this legislative change in mind. Material participation may no longer be imputed to the landlord from the agent's activities, but the courts' construction of the essential elements of material participation in cases with agents should be the same as in those cases without agents. It is the participation that is important, whether performed by or through an agent. However, participating vicariously is really no different than being a passive landlord; the elimination of the possibility of participation through an agent makes section 1402(a) more harmonious with its underlying purpose.

For present purposes the question is: Does the material participation requirement adequately serve the underlying purposes of section 2032A?

B. *Material Participation and Section 2032A*

As discussed above, section 2032A has four primary purposes: (1) to preserve the family farming operation, (2) to keep land in agricultural production, (3) to preclude dominance by corporate agriculture, and (4) to preserve the economic and social values associated with the family farm. Congress hoped, with section 2032A, to further these purposes and to ameliorate the economic pressures of inflation and speculation that tend to force devisees to sell part or all of the land in order to pay estate taxes.¹²² In according this benefit Congress made the legislation narrow in its application, particularly the requirement that the owner or a family member must have materially participated in farming the land prior to the owner's death and that a qualified heir must continue to participate materially after the owner's death.¹²³ It is arguable that this requirement narrows the applicability of section 2032A so as to thwart maximum realization of its broad purposes.

¹²¹ Pub. L. No. 93-368, § 10(b), 88 Stat. 422 (1974) (amending I.R.C. § 1402(a)).

¹²² See section I *supra* for a discussion of the legislative history of § 2032A.

¹²³ See section II *supra* for a discussion of the requirements of § 2032A.

Several hypothetical examples will serve to illustrate:

(1) Farmer A married late in life and now, after working the family farm for thirty-five years, he wishes to retire from active farming. His daughter, age seventeen, has plans to attend an agricultural college and will not take her degree for five more years; then she would like to farm the family land. If he retires and rents the land to a neighbor and subsequently dies four years later, before his daughter actively participates, the material participation test will not be met and the land will be valued at its fair market value for estate tax purposes.

(2) Farmer B dies without qualified heirs who might materially participate after his death. He devised the farm to the second son of his best friend. The material participation requirement cannot be met and the land will not be accorded special use valuation for estate tax purposes even though the neighbor's son intends to use the land as a family farm.

(3) Farmer C dies. His son is a doctor; his daughter is an attorney. Neither wishes to farm actively but having been devised the family farm they wish to keep it in the family for possible use by future generations and, in the meantime, rent the farm to X who will live on it and farm the land. For want of material participation the land cannot be accorded special use valuation.

(4) Farmer D dies and devises the land to his children, none of whom wish to farm or even to keep the farm. Y wishes to buy the farm and use it as his family's farm. For purposes of valuing D's estate, the farm must be valued at its fair market value because the devisees did not materially participate.

In each of the examples the farm must be valued at its fair market value because the material participation requirement is not met. This valuation may force the sale of all or part of the farm, attach a value to the land which cannot be realized in agricultural production, or so add to the debt load that the land cannot sustain the burden. Fair market valuation, then, may either force the sale of the land to corporate agriculture or to developers or force a change in use that would offer a yield commensurate with fair market valuation. In either event, the land would be lost as a family farm.¹²⁴

¹²⁴ See section I A *supra* for a discussion of the economic problems faced by the family farm.

The hypothetical examples suggest situations in which the material participation requirement, as narrowly drafted, might frustrate maximum realization of the broad purpose of the Act. To see if this requirement can be broadened, it is necessary to divide it into its two parts: "material participation"¹²⁵ and "qualified heir" or "member of the . . . family."¹²⁶

1. *Material Participation*

"Material participation," as it has been defined by the courts, Congress, and the IRS, is detailed above. Active personal participation is required. Might "material participation" be broadened in scope for purposes of section 2032A? It was previously noted that the section provides that "material participation shall be determined in a manner similar to the manner used for purposes of . . . section 1402(a)."¹²⁷ This "similar to" language suggests that the courts could give a more expansive reading to "material participation" for section 2032A purposes. The different legislative purposes underlying sections 1402(a) and 2032A suggest the test need not be applied identically for each section.¹²⁸

When the courts first considered the material participation test under section 1402(a) they held that one could materially participate through an agent.¹²⁹ The IRS relented to the interpretation¹³⁰ until Congress acted and explicitly excluded vicarious participation.¹³¹ Precluding participation through an agent was perfectly consistent with the purpose of section 1402(a).¹³²

Initially, it might seem that allowing participation through an agent would be consistent with section 2032A and

The free market purist might suggest that the land ought to pass to the highest bidder but such considerations are beyond the scope of this Note.

¹²⁵ I.R.C. §§ 2032A(b)(1)(C)(ii), (e)(6).

¹²⁶ I.R.C. § 2032A(e)(1)-(2). *See also* I.R.C. §§ 2032A (b)(1)(A)(ii), (b)(1)(C)(ii), (c)(1), (7).

¹²⁷ I.R.C. § 2032A(e)(6).

¹²⁸ *See text following note 45 supra* for the purposes of § 2032A and the text following note 77 *supra* for the purposes of § 1402(a).

¹²⁹ *See, e.g., Harper v. Flemming*, 288 F.2d 61 (4th Cir. 1961).

¹³⁰ Treas. Reg. § 1.1402(a)-4(b)(5), T.D. 6691, 1963-2 C.B. 347; Rev. Rul 64-32, 1964-1 C.B. 314.

¹³¹ Pub. L. No. 93-368, § 10(b), 88 Stat. 422 (1974) (amending I.R.C. § 1402(a)).

¹³² *See text following note 77 supra* for the purpose of OASI.

that the "similar to" language should be utilized to permit vicarious participation. In the first example above, the estate of Farmer A would be afforded special use valuation if he were allowed to participate through an agent. The estate of Farmer C would also benefit by special use valuation if the arrangement with X were drawn to make X an agent of Farmer C's children. The rent would probably have to be proportionate to production—a crop-share arrangement exposing the lessors to entrepreneurial risks.¹³³ Vicarious participation could thus bridge gaps between periods of direct participation.

But it may be seen that the material participation test does not unjustifiably narrow the applicability of section 2032A, and it would be unfortunate if the courts were to use the "similar to" opening to permit vicarious participation. Actual participation is an important part of the social and economic institutions and values Congress sought to preserve through the broad purposes of the Act. Vicarious participation divorces ownership from production. In preserving the family farm, Congress wished to preclude the separation of ownership and production.¹³⁴

In addition to the agency limitation, the other requirements for material participation under section 1402(a) are well suited for the purposes of section 2032A.

2. *Who Must Participate*

Congress has unduly narrowed the applicability of section 2032A in defining who must participate in the farming operations, the second component of the material participation requirement. Prior to the transfer at death, there must have been "material participation by the decedent or a member of the decedent's family."¹³⁵ After the transfer, there must be "material participation by [a] qualified heir or any member of [the qualified heir's] family."¹³⁶ A "member of family" is, with respect to a decedent or a qualified heir, an ancestor of such person, a lineal descendant of the grandparent of such

¹³³ See notes 114-20 *supra* and accompanying text for a discussion of the necessity that the lessor be exposed to financial risk.

¹³⁴ 122 CONG. REC. S13,595 (daily ed. Aug. 5, 1976) (remarks of Sen. Packwood).

¹³⁵ I.R.C. § 2032A(b)(1)(C)(ii).

¹³⁶ I.R.C. § 2032A(c)(7)(B)(ii), (c)(I).

person, the spouse of such person, or the spouse of such person's descendant.¹³⁷ A "qualified heir" is a member of the decedent's family who acquired the property, directly or indirectly, from the decedent.¹³⁸ Thus the literal language of the Act does not afford the benefits of special use valuation to family farms that no longer remain within the family and does not attach significance to the fact that the farm might be used as a family farm by a different family. Because the accepted rule of statutory construction is that explicit statutory language controls over legislative history neither the courts nor the treasury department can read the restriction out of the Act.¹³⁹ In view of the legislative history and the problem Congress sought to ameliorate, this express denial of special use valuation upon inter-family transfers is difficult to explain.

The limitation of the benefit to intra-family transfer may represent a compromise between revenue needs and tax relief. On the other hand, it may represent an undue and short-sighted deference to the family farm when the farm is passed within the family from one generation to another. The congressional debates are replete with adulation and reverence for those farm lands that have been worked by the same family generation after generation.¹⁴⁰ While such dedication to the family land may well give pause and evoke admiration, the fact that certain land has remained in one family for an extended period of time is not the heart and soul of the family farm as an economic and social institution. The fact that one's grandparents are buried on the knoll in the west forty may add sentiment to the land. But the dedication of the generation presently working the land, whether it be the first generation of that family or the tenth, provides the economic competitiveness, the social stability, and the bulwark against corporate agriculture; that dedication is what keeps the land agriculturally productive.

¹³⁷ I.R.C. § 2032A(e)(z).

¹³⁸ I.R.C. § 2032A(e)(1).

¹³⁹ The Technical Corrections Bill of 1977 (H.R. 6715) reaffirms that special valuation is to be afforded only to that farm property which remains in the decedent's family. STAFF OF THE JOINT COMM. ON TAXATION, 95TH CONG., 1ST SESS., DESCRIPTION OF H.R. 6715: TECHNICAL, CLERICAL AND CONFORMING AMENDMENTS OF THE TAX REFORM ACT OF 1976, at 15 (Comm. Print 1977).

¹⁴⁰ See, e.g., 122 CONG. REC. H10,273 (daily ed. Sept. 16, 1976) (remarks of Rep. Sebelius).

Congress has adopted a rather restrictive definition of the family farm by focusing on the destination of the transfer: has the land remained in the family? A broader definition, more in harmony with the broad purposes of section 2032A, would focus on the use of the land after the transfer: is it being used as a family farm? The economic and social objectives Congress sought to achieve flow from the use of land as a small, agricultural, economic unit: owned, occupied, and worked by a small, cohesive, social unit whose rewards are based directly on production. The family farm in this broad, institutional sense¹⁴¹ is no less a family farm if transferred to a different family.

The hypothetical examples offered above¹⁴² may serve to illustrate this point. Under the present congressional scheme, Farmer B's estate would be denied special use valuation because Farmer B, being without progeny, devised the farm to another family.¹⁴³ The broader view would see that the land was a family farm at all times before and after the transfer. The fact that a different family has the land is of little social, and of no economic consequence. The example of Farmer D's land poses no difficulty within the broad view. Farmer D's children do not wish to farm.¹⁴⁴ However, if the farm is valued at its highest and best use, it may be beyond the financial reach of a subsequent family farmer like Y. Farm use valuation would be an incentive

¹⁴¹ See H.R. REP. No. 1380, *supra* note 6, at 3359.

¹⁴² See text following note 123 *supra* for those hypotheticals.

¹⁴³ Actually, there is one possible solution to this problem. I.R.C. § 2032A(c)(2) states that a "legally adopted child" of an individual shall be treated as a child of such individual by blood for purposes of determining if that child is a family member of the decedent. Therefore, Farmer B might arrange to adopt his best friend's second son.

KRS§405.390 provides that an adult person may be adopted "as provided by law for the adoption of a child and with the same legal effect." According to KRS§199.520(2), an adopted child is considered for purposes of inheritance and succession and all other legal considerations as "the natural legitimate child of the parents adopting it the same as if born of their bodies." It should be noted, however, that the status of the adopted child under a will or trust is an unsettled area of the law in Kentucky, particularly where class gifts are involved. See *Note* 59 Ky. L.J. 921 (1971). After such adoption, an existing will should be republished and reviewed, or a new will executed, to ensure that the testator's intent to include the adopted person is clear.

¹⁴⁴ The question may fairly be asked: At what price did Farmer D's children sell the land? If it was sold at its highest and best fair market value, there would be no justification to accord the estate special use value. If, however, the land was sold solely for farming (i.e. with a restrictive covenant) at below the fair market value, then the estate should perhaps be accorded special use valuation.

for D's children to sell to a farmer.¹⁴⁵

The circumstances that befell Farmer C's land clearly take the land outside the scope of section 2032A. The land is no longer used as a family farm. Congress might well wish to deny tax benefits in this instance so as to discourage, or at least not to reward, the development of a rentier class. While the land remains a small, agricultural unit, it is not owned, occupied and worked by a small, cohesive social unit. Fixed money rents, not proportionate to or dependent upon production, may supplant a crop-share arrangement.¹⁴⁶ Ownership is separated, for an indefinite period of time, from occupancy and work.

Farmer A's situation poses some difficulty.¹⁴⁷ The gap between periods of direct participation is anticipated to be brief and for a definite period of time. Both before and after the gap the use of the land will meet the criteria of the broad view; indeed it will meet the criteria of the current narrower view. But during the gap the use of the land may not meet the criteria of a family farm; ownership would be separated from occupancy and production. Just where to draw the line is always a difficult question in close cases. Congress has chosen to limit gaps in material participation to periods of no more than three years during any consecutive eight-year period.¹⁴⁸ It cannot be said that the three-year figure is unwarranted or irrational. Yet if Farmer A only semi-retires, rents the land on a crop-share basis, assumes entrepreneurial risk, regularly in-

¹⁴⁵ Of course, the purchaser would have to be subjected to the recapture provisions provided in the Act.

¹⁴⁶ Under such fixed-money arrangements, the owner probably will not materially participate even vicariously under the test formulated in *Henderson v. Flemming*, 283 F.2d 882 (5th Cir. 1960). See text accompanying notes 115-16 *supra*, for discussion of *Henderson*. See also, H.R. REP. NO. 1380, *supra* note 6, at 3377. ("The mere passive rental of property will not qualify."), and 43 Fed. Reg. 31,040 (1978) (Proposed Treas. Reg. § 20.2032A-3 (a)).

The proposed regulations offer an example similar to the hypothetical involving Farmer C. The proposed regulations note that Farmer C's children could qualify by taking an active role in the management of farming by making important decisions and regularly inspecting the farming operation. 43 Fed. Reg. 31,041-42 (1978) (Proposed Treas. Reg. § 20.2032A-3(f)).

¹⁴⁷ Similar situations may be envisioned, such as the farmer who, having become an invalid, conveys his farm to T in trust, while retaining equitable life estates for his wife and himself, with a remainder in legal and equitable fee to his children.

¹⁴⁸ This includes any consecutive eight-year period commencing eight years prior to the decedent's death and ending fifteen years after decedent's death. I.R.C. § 2032A(c)(7).

spects, and consults with his lessee, there may in fact be no gap in material participation.¹⁴⁹ In this close case, wise estate planning could assure special use valuation for the land.

C. *Summary and Recommendation*

It may be said, then, that the material participation requirement, as developed under section 1402(a), is fully consonant with the objectives of section 2032A. Above all, the family farm concept which Congress sought to preserve requires active participation, and the material participation test represents the minimum standard of participation necessary for designation as a family farm. That standard should not be weakened. But in the interest of the broad objectives of section 2032A, the applicability of the section should be broadened by redefining the class of transferees who might materially participate. The definition should allow transfer, either directly or indirectly, to persons outside the decedent's family. The change could be accomplished by substituting the following for the definition of "qualified heir":¹⁵⁰

(1) Qualified Transferee. The term "qualified transferee" means, with respect to any property, one who acquired the property from the decedent or the decedent's devisee or heir and who puts the property to qualified use. If a qualified transferee disposes of any interest in qualified real property, the subsequent transferee may be thereafter treated as a qualified transferee.

It would also be necessary to substitute "qualified transferee" for "qualified heir" where that latter term is used in section 2032A and to substitute the following for section 2032A(c)(1):

(1) Imposition of additional estate tax. If within 15 years after the decedent's death and before the death of the qualified transferee, any qualified transferee ceases to use the qualified real property which was acquired (or passed) from the decedent for a qualified use, then, there is hereby imposed an additional tax.

The net effect of these changes would be to accord special use valuation to a property transferred out of the decedent's

¹⁴⁹ 122 CONG. REC. S13,596 (daily ed. Aug. 5, 1976) (remarks of Sen. Packwood).

¹⁵⁰ I.R.C. § 2032A(e)(1).

family provided that it is still used as a family farm. The recapture provisions would be invoked if the farm were put to a non-qualified use and not operated as a family farm.¹⁵¹ These changes would also obviate some of the questions raised concerning property in which not all the interests of ownership are passed to the same person. For example, under the present narrow view it is unclear whether special use valuation is available for a farm that is devised to a life tenant who is not a qualified heir and to a remainder person who is a qualified heir.¹⁵² Under the broader view, if both the life tenant and the remainder person put the farm to a qualified use, then special use valuation may clearly be afforded.

IV. ESTATE PLANNING FOR MATERIAL PARTICIPATION

It is not for the courts or the treasury department to broaden the applicability of section 2032A; that matter rests in the hands of Congress. Whether or not Congress finds it expedient or wise to encourage transfer of the family farm from one family to another, the material participation component must be a concern to estate planners.¹⁵³

The surest method of meeting the material participation requirement, and yet totally withdrawing from active farming,¹⁵⁴ is to turn the operation over to a member of the family. It should be remembered that the decedent himself need not materially participate.¹⁵⁵ The member of the family who assumes control must then materially participate.¹⁵⁶ Probably the best course is to put the farm under the control of that person who is to be the qualified heir.

¹⁵¹ See I.R.C. § 2032A(b)(2). See also I.R.C. § 2034A(e)(5).

¹⁵² See, e.g. COLSON & KAHN *Supplement, supra* note 7, at 106-07 and 121-24.

¹⁵³ The executor should consider the effect of special use valuation on basis. See text accompanying notes 65-72 *supra*. For a suggestion regarding the use of buy-sell agreements to control the valuation of farm property for estate tax purposes, see Castleton, *The Use of Restrictive Agreements in Estate Tax Valuation of Farmlands and Other Properties*, 64 Ky. L.J. 785 (1976).

¹⁵⁴ Of those farm operators in Kentucky with annual sales of \$2500 and over, 20 percent are 65 years old and older. 1974 CENSUS OF AGRICULTURE, *supra* note 9, Table 28, at I-9.

¹⁵⁵ 122 CONG. REC. S13,603 (daily ed. Aug. 5, 1976) (remarks of Sen. Packwood); I.R.C. § 2032A(b)(1). See also example 3 in 43 Fed. Reg. 31,041 (1978) (Proposed Treas. Reg. § 20.2032A-3(f)).

¹⁵⁶ I.R.C. § 2032A(b)(C).

If the qualified heir or other member of the family is not in a position to assume control of the family farming operation at the time the farmer wishes to reduce active participation, the farmer may, by leasing the farm, at least minimize his involvement to the point of semi-retirement and still meet the material participation test. The lease agreement¹⁵⁷ should be written and should clearly contemplate that the lessor is to materially participate.¹⁵⁸ The lease should require that the lessee seek the advice of the lessor; indeed it should be clear that decision-making power resides in the lessor. Rent should be in the form of a crop-share and not a flat money rent; the lessor must assume a risk akin to that assumed when he operated the farm himself. It must not appear that the lessee is the agent of the lessor; therefore, the lease should require at least enough physical labor from the lessor so as to meet the requirements of Test Three.¹⁵⁹ In addition, the lessor should finance some of the costs of production as evidence that he bears a share of the risk. Given the purpose of section 2032A, it may be that the courts will use the "similar to" language to preclude participation of the *Vance* type:¹⁶⁰ financial underwriting with very minimal active participation, which is close to an agency arrangement. The lease might provide that the lessor be active on a full-time basis for two months during the spring. During this period the lessor should take an active role in decision-making

¹⁵⁷ See the Appendix *infra* for sample lease agreements.

¹⁵⁸ This is both to comply strictly with the Treasury Regulations and to avoid the risk that actual services rendered will be characterized as volunteered. *Foster v. Celebrezze*, 313 F.2d 604 (8th Cir. 1963); Treas. Reg. § 1.1402(a)-4(b), T.D. 6691, 1963-2 C.B. 347.

¹⁵⁹ See text accompanying note 88 *supra* for the provisions of Test Three.

Example 3 in the proposed regulations speaks directly to this situation—the farmer who wishes to semi-retire. The example does not hypothesize actual physical labor on the part of the retired farmer but it does envision regular consultation and decision-making during both planting and harvesting. Furthermore, it does hypothesize that the semi-retired farmer will live in his old farm house when attending to farming operations. 43 Fed. Reg. 31,041-42 (1978) (Proposed Treas. Reg. § 20.2032A-3(f)). While cases decided under I.R.C. § 1402(a) have not directly focused upon residence on the farm as a factor in material participation, the proposed regulations do. 43 Fed. Reg. 31,041 (1978) (Proposed Treas. Reg. § 20.2032A-3(d)(2)). However, it should be noted that residence is only one factor and is not solely determinative.

¹⁶⁰ *Vance v. Ribicoff*, 202 F. Supp. 790 (E.D. Tenn. 1961). However, the proposed regulations seem to borrow the *Vance* facts for use in their second example, an example exemplifying material participation. 43 Fed. Reg. 31,041-42 (1978) (Proposed Treas. Reg. § 20.2032A-3(f)).

and the initial work of crop production. Thereafter, the lessor might relax into semi-retirement offering only periodic advice and consultation.

If the option afforded by section 2032A is to be left open to his executor, the family farmer must preserve carefully a record of material participation. This is especially true for the family farmer who wishes to reduce his active role in his later years. Copies of correspondence, records of phone calls, and notes of inspection tours and consultations should be filed for future reference. The farmer should keep a log of the hours worked and the tasks done. The work must focus on production and not maintenance of capital. Accurate ledger entries should be made of expenditures related to production. Records of materials and machinery furnished for use by the lessee and the use to which they are put should be kept. The planner must remember that the material participation test represents a minimum standard of activity and it is best to plan and record participation which exceeds the minimum.

David A. Bratt

APPENDIX

Two farm lease agreements, taken from reported cases, are presented here for illustrative purposes.

A. *The Vance Lease*¹⁶¹

CONTRACT—RENTAL OF FARM

This contracted [*sic*] entered into for the year 1958 between Mrs. Lizzie Vance of the first part and Lester Akins of Second Part:

Akins is to cultivate this farm by raising the following crops Namely: Hay Oats corn and Tobacco. For the year 1959 14 acres of wheat, 10 acres of Oats, 14 Hay and .06 Tobacco.

Party of the second part finishes tools for preparing and cultivating the crop except the tobacco. Party of the First Part finishes stock to tend the tobacco. Akins gets 2/3 of Wheat, 1/2 Hay and 2/3 Corn.

Party of the First part furnishes 1/2 all¹⁶² Fertilizer for the Tobacco all of Spray and plants, sticks and barn room, participates in raising tobacco as much as possible and the agreement is that she advises where to Plant certain crops and where to Market the grain and Tobacco.

Sign: /s/Mrs. Lizzie Vance
Mrs. Lizzie Vance, First Part

Sign: /s/Lester Akins
Lester Akins, Second Part

The court held that the agreement between Vance and Akins contemplated Vance's material participation. The contract represents the bare minimum. Still, the essentials are there: She was to play a financial role and thereby undertake a risk; she was to advise and consult and thereby manage production; and she was to take an active physical part in the production of the crop. The court further held that she actually materially participated by carrying out the terms of the agreement, and thus she was entitled to OASI benefits. Her physical role, as suggested by the "as much as possible" language, was in fact rather limited. Vance was eighty-two years old. Two or

¹⁶¹ *Id.*

¹⁶² The court noted that the word "all" had been interlined by hand. Vance testified that it should have been "all," not "1/2." *Id.* at 792.

three times each week she passed through the tobacco crop which was on the farm where she lived and she advised Akins if the crop needed attention.¹⁶³

B. *The Foster Lease*¹⁶⁴

In consideration of the leasing of the premises the Tenants agree, without expense to the Landlord, to furnish all necessary tools, machinery, equipment, livestock, crop seeds (including hybrid seed corn), and labor to operate and maintain the farm in a husbandlike manner and to put in such crops in such manner as the Landlord may direct and to pay a cash rent and crop share rent as follows:

Two-fifths share of all small grain grown on said premises during term hereof;

One-half share of all corn grown on said premises during term hereof;

Two-fifths share of all beans grown on said premises during term hereof;

Cash rent of \$6.50 per acre for all land not included in foregoing crop, which cash rent shall be due and payable at Cedar Rapids, Iowa, at threshing time but in no event later than December 1 of the year of said term. In computing the cash rental the farm shall be taken as 112.65 acres and from this shall be deducted the acreage in corn, small grain, and beans, and the cash rental above specified shall be paid on the remainder.

If any installment of rent is not paid when due, the full amount of the rental specified becomes due and payable at once at the option of the Landlord.

The Tenants further agree:

1. To clean and treat all small grain seed and inoculate all clover, alfalfa and soybean seed sown.
2. To plant only seeds, including hybrid seed corn, approved by the Landlord.
3. To clip all fields newly sown to clover and mow weeds in pasture when and if requested by the Landlord.
4. To permit no hogs on grassland without ring in snout and to reseed any ground rooted up.
5. To mow or spray the weeds along all fence rows each

¹⁶³ *Id.* The lease was executed two years after the 1958 crop year.

¹⁶⁴ *Foster v. Flemming*, 190 F. Supp. 908 (M.D. Iowa 1960), *rev'd sub nom.* *Foster v. Celebrezze*, 313 F.2d 604 (8th Cir. 1963).

year and to cut or control weeds in cultivated crops.

6. To keep the buildings and lots free and clean of trash and litter, to keep the house lawn mowed and the lots free of weeds, so as to present a neat appearance at all times.

7. To cut no alfalfa after September first nor cut a second crop of clover at any time.

8. To furnish the Landlord immediately after harvesting of all small grain and soybeans, a signed statement by the thresher showing the number of bushels or kind of grain or seed threshed or combined.

9. To not burn, sell or remove any straw either baled or loose from the premises for it is agreed all unused straw is the property of the Landlord.

10. To haul out and spread on the arable lands or wherever Landlord may direct, all manure now on or hereafter accumulated on the premises.

11. To plow no new seeding, meadow or permanent pasture without the Landlord's written consent.

12. To pasture no meadows, cultivated fields or fields sown to legumes without the Landlord's written consent.

13. To comply fully with the regulations of the Department of Agriculture if so directed by the Landlord and to operate the farm in compliance therewith.

14. To commit no waste or damage on the premises and to permit none to be done.

15. To cut no live trees without written consent of the Landlord.

16. To preserve and protect the fruit and ornamental trees, vines and shrubbery, that are now or may be hereafter planted upon the premises, from injury by plowing, or from cattle or other stock or rabbits.

17. To protect and care for all buildings and improvements and to keep the same in such state of repair as they now are or may be placed during the term hereof, reasonable wear or damage by accidental fire or windstorm only excepted.

18. To use the premises for agricultural purposes only and to occupy the dwelling house and retain possession of said premises during the entire term of this lease and not to sublet any part thereof without the written consent of the Landlord.

19. To furnish the labor for keeping the fences in condition without charge to the Landlord.

20. To husk and crib the Landlord's share of corn.

21. To shovel corn into sheller and deliver the Landlord's share of crops to the nearest railroad market point or any other equal distance when so directed by the Landlord. (Landlord to pay for shelling).

22. To reserve for the Landlord a proportionate share of cribs, bins or storage space available for the Landlord's share of all crops.

23. To allow the Landlord, his agents or managers, or whomever the managers may engage, the right to enter the premises at any reasonable time to view the same or show them to prospective purchasers or to make repairs or improvements or to plow land on which a crop has been removed.

24. To surrender the premises at the termination of their tenancy (including termination by cancellation) without further demand or notice in such condition as shall be in compliance with the provisions hereof.

In addition, Foster was to provide "all grass, clover and alfalfa seed to be sown on the premises."¹⁶⁵

Foster had an agency relationship with a farm management company which actually oversaw her interest in the lease arrangement. The Secretary of Health, Education and Welfare had maintained that she could not materially participate through an agent,¹⁶⁶ but while the appeal was pending the Secretary acquiesced to vicarious participation. Thus, the only real issue before the court of appeals was whether the arrangement contemplated material participation.¹⁶⁷

The district court had found that the provisions of the lease which gave Foster a role in farm affairs, particularly the consideration clause, were directed toward preserving her capital investment in the farm and not toward production of crops.¹⁶⁸ Almost one-half of the lease provisions were directed toward preserving the farm, especially paragraphs numbered four, six, fourteen through nineteen, and twenty-four. The district court viewed the consideration clause with its broad grant to control the farm in a "husbandlike manner" together with the above mentioned paragraphs as a reflection of a basic pur-

¹⁶⁵ *Id.* at 928-30.

¹⁶⁶ *Foster v. Celebrezze*, 313 F.2d 604, 605 (8th Cir. 1963).

¹⁶⁷ *Id.* at 605, 609.

¹⁶⁸ *Foster v. Flemming*, 190 F. Supp. at 908.

pose to preserve the farm and held that such preservation did not qualify as material participation.¹⁶⁹ The court of appeals seemed to disagree with this interpretation of those provisions but rather than have its decision turn on "this rather close question of interpretation,"¹⁷⁰ the court found that the additional numerical paragraphs clearly gave Foster a direct hand in crop production. It should be noted that the lease did not contemplate actual physical labor on the part of the lessor. Her active role, actually her agent's role,¹⁷¹ was limited to inspection, consultation, and decision-making. Her financial role was limited to providing the land and buildings. The court of appeals held that the lease contemplated material participation. And, because the Secretary had relented so as to allow actual material participation through an agent, Foster's income qualified for OASI purposes.¹⁷²

The lesson for estate planners is clear. It is possible and wise to include lease provisions directed toward preservation of one's capital investment in the farm, but control over production and managerial activities should be unmistakable, if not actually predominant.

¹⁶⁹ *Id.* at 930.

¹⁷⁰ *Foster v. Celebrezze*, 313 F.2d at 608.

¹⁷¹ *See* note 84 *supra* for a discussion of participation through an agent.

¹⁷² *Foster v. Celebrezze*, 313 F.2d at 608.