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I am submitting herewith a thesis written by Timothy S. Moore entitled "Impact of Section 2032A on Land Alienation and Values." I recommend that it be accepted in partial fulfillment of the requirements for the degree of Master of Science, with a major in Agricultural Economics.

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IMPACT OF SECTION 2032A ON LAND ALIENATION AND VALUES

A Thesis
Presented for the
Master of Science
Degree
The University of Tennessee, Knoxville

Timothy S. Moore

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DEDICATION

The author would like to dedicate this thesis to the memory of his father, J. L. (Tooke) Moore, who was the author's primary source of strength and advice until his untimely death July 7, 1975.

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The author is grateful for the assistance and guidance of Dr. B. R. McManus, professor in the Agricultural Economics and Rural Sociology Department, and chairman of the author's graduate committee. A special thanks is also due Mr. Ronald W. Todd for his assistance and technical advice. Appreciation is also expressed to Dr. Clark D. Garland for his material participation.

Most of all, the author wishes to express his gratitude to his mother, Maxine Moore, for her love and guidance throughout his education and his life.

ABSTRACT

The §2032A use valuation provision of the 1976 Tax Reform Act will have an impact on the agricultural sector. The objectives of this research were to set forth the requirements for compliance with §2032A, estimate potential tax liabilities for selected estate situations using various rates of asset appreciation, and determine the potential impact of §2032A upon farm real estate alienation and prices.

Data were obtained from U.S.D.A. publications, the Internal Revenue Code, Treasury regulations, and various other publications relating to interpretation of §2032A and its application.

From projected 1980 estate tax liabilities, estate tax savings from election of §2032A were calculated. For Sales Classification IA, $100,000 of gross sales and over, estate tax savings were $63,188 for those estates being able to utilize a marital deduction, and $143,098 for those estates having no marital deduction. Smaller tax savings resulted from election of §2032A for those farms in lower sales classifications. The $500,000 adjusted gross estate reduction limitation takes effect when the gross estate is $1,930,501, real assets are $1,428,571, and debt is $308,880, assuming the land use value is 65 percent. Tax savings from election of §2032A in such a case would be $93,716 for those estates where a marital deduction can be utilized, and $214,864 where a marital deduction cannot be utilized.

The election of §2032A has the potential to reduce the short-term supply of land in the real estate market by 1 percent per year. Price

increases of farmland around urban areas may be complicated by §2032A because of its attractiveness in terms of investment potential and low use values due to a combination of low cash rental rates, ease of material participation, and high rates of taxation.

TABLE OF CONTENTS

LIST OF TABLES

CHAPTER I

INTRODUCTION

The Tax Reform Act of 1976 contains a provision which allows those farm operations which meet certain requirements to be valued for estate tax purposes at agricultural value rather than the prevailing market price. This provision, Section 2032A of the Internal Revenue Code, is likely to have an important impact on the frequency of transfer and price of farmland. There are two main factors that may bring about this impact. The first is the requirement that estates electing the §2032A provision must hold the land in a qualified use for a 15-year period or be subject to estate tax recapture. It would be expected that the resulting decrease in the amount of farmland placed on the market each year would cause an increase in the price of farm real estate. The second factor relates to possible increased demand for farmland from those individuals with qualifying capabilities and estates large enough to benefit through reduced estate tax payments from farmland included at use value rather than market value.

I. CONGRESSIONAL INTENT

> Those who labor in the earth are the chosen people of God, if ever He had a chosen people, whose breasts He has made His peculiar deposit for substantial and genuine virtue . . . generally speaking, the proportion which the aggregate of the other classes of citizens bears in any state to that of its husbandmen, is the proportion of its unsound to its healthy

> parts, and is a good enough barometer whereby to measure its degree of corruption.[1]

The above statement from Thomas Jefferson presents a moral judgment that an agrarian society develops stronger moral character than its more urban counterpart. Congress evidently was reflecting this philosophy in the House Committee Report on P. L. 95-600, which contained the use value provision, when it stated:

> Your committee believes that when land is actually used for farming purposes or in other closely held businesses (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential "highest and best use" especially since it is desirable to encourage the continued use of property for farming and other small business purposes.[2]

The Committee Reports and testimony from farm owners and agricultural policy experts during committee hearings indicated that excessive estate tax burdens result in the liquidation of many family farms. Due to inflation and the increase in size of individual farm operations, the exemption level of $60,000 adjusted gross estate established in 1942 was too low.

II. OBJECTIVES

The objectives of the research were:

1. Delineate the requirements for complying with §2032A of the Internal Revenue Code.

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[1] Thomas Jefferson, <u>Complete Jefferson</u>, Assembled and arranged by Saul K. Padover (New York: Darrel, Sloan, and Pearce, Inc., 1943), p. 367.

[2] House Committee Report on P. L. 95-600, 94th Congress (Washington: U.S. Government Printing Office), p. 362.

2. Estimate the projected estate tax liability for selected estate situations at current values and at specified future values using selected rates of appreciation.

3. Analyze and evaluate the impact of use valuation on the alienation and price of farmland.

III. DATA

Specific requirements concerning §2032A were taken from the Internal Revenue Code.[3] Specific requirements concerning material participation were drawn from Treasury Regulations.[4] Other information pertaining to the interpretation of the law and application to individual estates was obtained from Commerce Clearing House publications,[5] various state agricultural extension departments, and law journals containing articles relating directly to the §2032A use valuation provision.

The characteristics of farm units, in terms of asset and liability composition, were obtained from the 1978 Balance Sheet of the Farming Sector.[6] These data were used as bases for projections made concerning estate tax liability using selected rates of appreciation. Census

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[3] IRC §2032A.

[4] Federal Tax Regulations §1.1402(a)-4(b)(4) (1980).

[5] Commerce Clearing House, Topical Law Reports, Federal Estate and Gift Tax Reporter, Vol. 2, Chicago, 1977.

[6] USDA, 1978 Balance Sheet of the Farming Sector (Washington: Economics, Statistics, and Cooperatives Service), October, 1978.

data,[7] which included age, tenure, and enterprise characteristics of older farmers in the United States, were obtained to determine implications for both the entire agricultural sector and also individual enterprises.

The data used to determine the impact of use valuation on alienation and price of farmland were obtained from United States Department of Agriculture publications. Information relating to transfers of farm real estate was taken from Farm Real Estate Market Developments.[8] This information included the number and size of farm transferred for various purposes such as estate settlement and foreclosure. Other information taken from Farm Real Estate Market Developments included farmland prices and cash rental rates. Cash rental rates[9] and average property taxes for agricultural land[9] were used in the §2032A capitalization formula to determine the use value of farmland in selected states.

IV. HISTORICAL ESTATE TAXATION PERSPECTIVE

As early as 700 B.C., property transfers were taxes in Egypt at a 10 percent rate; the transfer of property by inheritance was included

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[7] United States Department of Commerce, 1974 Census of Agriculture, Vol. 1, Part 51 (Washington: Bureau of the Census, 1977).

[8] USDA, Farm Real Estate Market Developments (Washington: National Economic Analysis Division Economics, Statistics, and Cooperatives Service), July, 1978.

[9] USDA, Farm Real Estate Taxes (Washington: Economic Research Service), March, 1977.

in this tax.[10] In Rome, the first inheritance tax was instituted in 6 A.D. by Emperor Augustus to raise a fund to provide pensions and landed settlement for the army.[11] In early Western European countries, feudal principles had great influence on the way property was transferred from one generation to the next. A decedent's heirs could live on the property he had; however, the ruler was assumed to have a life estate in the property. If a man died leaving no direct heirs, the property would escheat to the state or ruling power.

It was not until the Middle Ages that governments in Western Europe began to take a portion of estates for tax purposes. During this period of time, the principle of relief or rochat developed, by which a sum was paid to the ruler for the right of intergenerational transfer of property. A second principle, prevalent in England, was based on the manorial system. The heriat principle consisted of the ruler of the manor taking the best of an heir's chattels, usually his cattle. These customs and ideas have had an influence on modern estate taxation.

The English Influence

Historically, estate taxation principles in the United Kingdom have had an important influence on estate taxation in the United States. The basis for modern estate taxation in the United Kingdom was established in 1694 with the passage of the original Stamp Act, which was a tax on probates and letters of administration. By 1900, Britain had established

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[10] William J. Schultz, The Taxation of Inheritance (Cambridge: The Riverside Press, 1926), p. 3.

[11] Schultz, p. 5.

a complicated system of five distinct but allied taxes, known collectively as the "death duties." The five taxes were probate, account, legacy, succession, and estate duties.[12] The first three applied to personal property alone; the succession duty applied to real estate and certain types of personal property; and the estate duty applied to both real and personal property.

Early Estate Taxation in the United States

In the United States, prior to 1916, individual states made more use of inheritance taxation than did the Federal government. In 1826, Pennsylvania enacted the first inheritance tax. The law provided for a 2 1/2 percent on collateral transfers.[13] In Tennessee, a 5 percent collateral inheritance tax was introduced in 1891, and was continued by the Revenue Act of 1893. Taxation of direct heirs began in 1909.[14]

Early inheritance taxation by the Federal government was apparently designed to raise revenue, while more recent motives appear to be based on redistribution of income and other egalitarian principles. Various attempts were made before the Civil War to impose inheritance taxes. However, most such efforts either died in Congress or were short lived after becoming law. The first effective inheritance tax was suggested by Secretary of the Treasury, Chase, and passed by Congress in 1861.[15]

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[12] Max West, The Inheritance Tax (New York: Columbia University Press, 1893), p. 38.

[13] West, p. 62.

[14] West, p. 90.

[15] Schultz, p. 151.

The tax applied to all heirs with those of more distant kinship being taxed at a higher rate. In 1870, after the Civil War revenue needs were met and the inheritance tax was repealed. The first Federal estate tax was introduced by the War Revenue Act of 1893 to supply revenue for the Spanish-American War. This law included only personal property, and made use of progressive rates in the taxation of estate property. After the revenue needs of the Spanish-American War had been satisfied, the tax was repealed.

The predecessor of our present estate tax system was enacted in 1916, again for the purpose of raising revenue. This law was expanded to include all types of property, and applied a graduated tax scale to a net taxable estate. The tax ranged from 1 percent for net estates under $50,000 to 10 percent for net estates in excess of $5,000,000. In 1942, the range of estate tax rates was changed, varying from 3 percent to 77 percent, and an estate exemption set at $60,000.[16] This basic framework was in effect until modified by the Tax Reform Act of 1976.

V. HISTORICAL CONFLICT BETWEEN LANDHOLDERS AND CAPITALISTS

Throughout history, there has been a struggle between agrarian interests and a combination of factions opposed to landed gentry. Individuals whose estates are made up largely of land have also had to contend with holders of capital in governing bodies. Income taxes have

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[16] House Ways and Means Committee, Hearings on Federal Estate and Gift Taxes (Washington: U.S. Government Printing Office, 1976), p. 989.

been advocated by landholders and land taxes by capital holders to minimize their own taxes while shifting tax load to the other economic sector. Estate taxation has also received greater support from capital holders because of the relative ease of collecting estate taxes on land. Capital owners have contended that real estate taxes fail to take land appreciation into adequate consideration, and that a progressive and relatively large estate tax can recapture some of the income that otherwise has escaped an ordinary income tax. In the late Seventeenth Century, Tory landholders repeatedly defeated inheritance tax projects introduced in British Parliament.[17] The Russian writer, Paul Koensel, believed that death duties in England and the inheritance taxes of France and the other continental countries developed largely as incidental to the political struggle between the old landed aristocracy and the new business oligarchy that the Industrial Revolution brought to the fore.[18]

VI. PREMISES UNDERLYING ESTATE TAXATION

Early political economists were divided into two groups in regard to the merits and degree of inheritance taxation. One group, which included Adam Smith and David Ricardo, believed that both economic efficiency and equity were advanced by minor or no inheritance taxation. Smith stated that all taxation should meet the following four canons, or requirements:

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[17] Schultz, p. 18.

[18] Schultz, p. 191.

1. Subjects should contribute to the state according to the ability of the citizen to pay. Expressed in other terms, the principle of equality should be enforced when a government taxes its citizenry.

2. Taxes should be certain, not arbitrary.

3. Every tax should be levied at the time, or in the manner, most convenient for the contributor to pay.

4. Collection of taxes should be efficient; i.e., a minimum of enforcing bureaucracy should be imposed between the taxpayer and his government.[19]

In order to meet the above requirements, Smith said laws governing inheritance taxation should take the frequency of transfer in any particular family into account, and not be so oppressive as to result in a reduction in the productive capital of a nation. David Ricardo stated: "There are no taxes which have not a tendency to lessen the power to accumulate. All taxes must either fall on capital or revenue."[20] Ricardo reasoned that since every man tried to maintain his station in life, attempts would be made to pay all taxes, whether on capital or income, out of income. Excessive taxation could cause inadequate savings, thus leading to capital shortages.

On the other hand, some political economists favored relatively heavy inheritance taxation. John Stuart Mill was opposed to burdensome

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[19] Adam Smith, The Wealth of Nations (Oxford: Charendon Press, 1976), p. 825.

[20] David Ricardo, The Principles of Political Economy (London: G. Bell and Sons, Ltd., 1926), p. 96.

income taxation, however he held a different view concerning the taxation of inheritances, stating:

> Were I framing a code of laws according to what seems to me best in itself, without regard to existing opinions and sentiments, I should prefer to restrict not what anyone might bequeath, but what anyone should be permitted to acquire, by bequest or inheritance.[21]

Mill thought that parents did not owe children a large amount of wealth, but that all individuals should have as equal opportunity as possible at the beginning of the race.

An Italian, Eugenio Rignaro, was typical of the Socialistic economists in the early 1900's. He went further than Mill and envisioned a . . .

> complete system of interlocking national, state, and municipal property commissions controlling and administering the property and enterprises which have come into the Government's possession through the operation of a semi-confiscating inheritance tax.[22]

In his work, The Social Significance of the Inheritance Tax, Rignaro set out the format for a project that would tax a decedent's property according to how it was received. Property which the decedent had received by an inheritance would be taxed at rates up to 99.9 percent. No taxes would be levied on property acquired by labor and saving.[23]

The prime reason writers such as Mill and Rignaro looked favorably upon high rates of inheritance taxation was that these rates would

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[21]John Stuart Mill, The Principles of Political Economy (London: Longmans, Green, Reader, and Dyer, 1878), p. 138.

[22]Schultz, p. 194.

[23]Eugenio Rignaro, The Social Significance of the Inheritance Tax (New York: Alfred A. Knopf, 1924), p. 101.

prevent the amassing of large family fortunes, which might enable such families to possess undue political and economic power.

VII. JUSTIFICATION OF TAXATION

Probably the most prevalent approach is taxation according to ability of the taxpayer, in terms of financial well-being. Musgrave couches the approach in terms of welfare economics, when he states that taxes are distributed so as to minimize the total sacrifice involved.[24] Adam Smith expressed this view in his first canon, when he stated that subjects should contribute to the government in proportion to their respective ability. Mill also expressed the notion that income taxation should be applied according to the maxim of equal sacrifice.[25] Equity considerations are involved, and the promotion of these, along with egalitarian motives, are largely the reasons for progressive taxation of income, estate, and gift transfers in the United States today.

Problems involved in the ability to pay approach include property or wealth to be considered when taxation occurs, and the extent of such tax. Both of these considerations must be recognized in order to avoid losing too much production efficiency in the pursuit of distribution equity.

A second approach to taxation can be expressed in terms of benefit. The citizens of a country should pay taxes according to the value of the services received from the government such as defense, education, and

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[24] Richard A. Musgrave, The Theory of Public Finance (New York: McGraw-Hill, 1959), p. 90.

[25] Mill, p. 485.

others. Following one line of reasoning, this idea would lead to progressive taxation, since the rich have more to defend. Another type of logic, followed by Mill and others, says taxation according to benefits received would lead to regressive taxation, since the poor are more in need of governmental services they are unable to purchase. From an agrarian viewpoint, the issue arises as to whether the farm sector receives or gains the utility in proportion to entitlement. Another related problem is whether benefits can be measured in a pragmatic and reliable manner.

CHAPTER II

SECTION 2032A AND THE INDIVIDUAL ESTATE

The use valuation option provided in §2032A of the Internal Revenue Code allows the administrator of an estate, upon proper election,[1] to value real property according to its current use value rather than at market value. The maximum amount that a gross estate may be reduced under this special valuation provision is $500,000. The provision applies only to estates of decedents who were residents or citizens of the United States at death.[2] To optimize use valuation in an individual estate, the statutory provisions must be met and certain estate planning implications should be considered.

I. STATUTORY PROVISIONS

The primary intent of Congress in including the use valuation provisions in the Tax Reform Act of 1976 was apparently to reduce the frequency of forced sales of farms to pay estate taxes.[3] To delimit this intent, Congress restricted qualifying real property, imposed a recapture tax for premature disposition of an interest in such property and provided two methods for appraising real property.

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[1] IRC, §2032A (d).

[2] IRC, §2032 (a)(1).

[3] H.R. Report No. 94-1380, 94th Congress, 2nd Session 24-25 (Washington: U.S. Government Printing Office, 1976).

Qualifying Requirements

To qualify for use valuation, real property must be located in the United States, be transferred to a qualified heir, be devoted to farming or other closely held business, and meet certain ownership and material participation requirements. Additionally, 25 percent of the adjusted gross estate must consist of qualified realty and at least 50 percent of such estate must consist of realty or personal property used in the farm or closely held business.[4]

Qualified heir. The term "qualified heir" means for purposes of use valuation a member of decedent's family who acquired the subject property or to whom such property passed from the decedent. The term also includes any member of the qualified heir's family receiving a transfer of qualified property from the qualified heir.[5] A "member of decedent's family" is a phrase which for purposes of the statute means "with respect to any individual, only such individuals ancestor or lineal descendant, a lineal descendant of a grandparent of such individual, the spouse of such individual or spouse of any such descendant. For purposes of the preceding sentence, a legally adopted child of an individual shall be treated as a child of such individual by blood."[6]

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[4] IRC, §2032A (b).

[5] IRC, §2032A (e)(1).

[6] IRC, §2032A (e)(2).

Farm or farming purposes. In the agricultural context "qualified use" means real property used as a farm for farming purposes. More specifically, the term "farm" includes stock, dairy, poultry, fruit, furbearing animals, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands. "Farming purposes" includes the activities normally associated with agricultural production such as soil cultivation and management, also the growing and preparation, other than milling, of trees for market. The handling, drying, packing, grading, or storing on a farm of any agricultural or horticultural commodity in its unmanufactured state is treated as having been done for farming purposes only if the owner, tenant, or operator of the farm regularly produces more than half of the commodity so treated.[7]

Ownership requirement. Use valuation requires that the decedent or a member of his family own and materially participate in the operation of the farm or other closely held business for at least five years of the eight-year period ending with the decedent's death. The statute does not mandate calendar years but permits periods aggregating five or more years to suffice.[8]

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[7] IRC, §2032A (e)(5).

[8] IRC, §2032A (b)(1)(C).

Material participation. One of the requirements of the use valuation provisions is material participation. The statute requires material participation by the decedent or a member of his family for periods aggregating five or more years during the eight years immediately preceding the decedent's death.[9] Such participation must be continued by at least one qualified heir for a period of 15 years after decedent's death, or until all qualified heirs have died, if the full advantage of the use valuation provisions is to be obtained.[10]

Section 2032A states that "material participation shall be determined in a manner similar to the manner outlined in section 1402 (a) (relating to the net earnings from self-employment)." When the Social Security Act was originally enacted, self-employed farmers were excluded from coverage. However, a 1956 amendment to §1402 included those owners of farmland who made substantial and important contributions to the production process. While §1402 excludes farm rental income from self-employment tax, it includes farm income to the landowner if (1) there is an arrangement for material participation between the owner and the producer or tenant, and (2) there is material participation with respect to the production of agricultural or horticultural commodities.[11] Treasury regulations go further by insisting that the landowner must have contemplated, planned, and have an agreement as to material participation

[9] IRC, §2032A (b)(1)(C).

[10] IRC, §2032A (c)(1).

[11] IRC, §1402 (a)(1).

with the tenant before the actual production process begins.[12] Such agreement may be either oral or written and must involve either the production process or the management of production. Production refers to the physical work performed such as planting, cultivating and harvesting of crops, as well as the payment of expenses incurred in the furnishing of machinery, implements, seed and livestock.[13] Management of production refers to the entrepreneural function, requiring the owner to participate in key decisions regarding timing and selection of enterprises. Cropping decisions include seed selection, establishing cropping plans, determining types and amounts of fertilizers and pesticides to use, as well as when to harvest and market the crops. For livestock enterprises, decisions relating to breeding, feeding and marketing programs are important.

The degree of similarity between material participation for social security and use valuation purposes may be unknown until after further court decisions, Treasury regulations, and IRS rulings have been promulgated. However, case law and associated rules and regulations interpreting material participation for social security purposes should be helpful in charting a safe course.

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[12] Treas. Reg. §1.1402 (a)-4.

[13] Treas. Reg. §1.1402 (a)-4 (b)(3)(ii).

The amount of capital at risk,[14, 15, 16] whether or not a prior agreement was entered,[15, 16, 17] and whether or not the landlord had a significant input in management decisions,[15, 16, 17] have been important in court decisions construing material participation. The farmer planning for the use valuation election should take the necessary precautions to satisfy the material participation requirement. A written agreement requiring the landlord to participate in management decisions and to bear a substantial part of the cost of production would be supporting evidence in fulfilling the material participation requirement. The landlord or a member of his family could add documentation by maintaining management participation records concerning regular visits to inspect crops and livestock, consulting with the tenants and advising them as to the application of fertilizers and chemicals, time to plant and harvest, storage arrangements, marketing, and other similar decisions affecting the farming operation. Appendix A contains case information.

Recapture Provisions

As an attempt to prevent an easy loophole in the use valuation provision, Congress included a tax recapture provision. This recapture provision was designed to prevent the benefits of use valuation (in cases where the use valuation provisions were not met). The recapture

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[14]Celebrezze v. Maxwell 315 F. 2d 727 (5th cir. 1963).

[15]Celebrezze v. Miller 333 F. 2d 29 (1964).

[16]Conely v. Ribicoff 294 F. 2d (9th cir. 1961).

[17]Colgate v. Gardner 265 F. Supp. 987 (S.D. Ohio, 1967).

provision is stringent, requiring a total repayment of the tax saved through use valuation if a recapture event occurs within 10 years after decedent's death and a partial repayment if the recapture event occurs between the tenth and fifteenth year after decedent's death.[18]. A recapture event occurs when the qualified heir transfers qualified property to an unqualified person or ceases to use the property in a qualified manner. When the recapture event occurs between the tenth and fifteenth year after decedent's death, the amount of recapture will be prorated. The prorated amount is determined by multiplying the total recapture amount by a fraction: (1) the numerator of which is the number of full months after the decedent's death in excess of 120, and (2) the denominator of which is 60.[19] No recapture is required on the death of a qualified heir even with the 15-year period, and use valuation may also be elected by the qualified heir's executor.

Special rules apply for involuntary conversions of use valuation property. Where the proceeds of such involuntarily converted property is reinvested in real property which would have qualified for use valuation, recapture roles do not apply.[20] It follows that where the entire amount of qualifying real property is condemned it will not be possible to reinvest in the real property which originally qualified for use valuation and thus will not be possible to avoid recapture.

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[18]IRC, 2032A (c)(2).

[19]IRC, 2032A (c)(3).

[20]H.R. Report No. 94-1380, 94th Congress, 2nd Session 812 (Washington: U.S. Government Printing Office, 1976).

Recapture does not represent an added tax above that which would have been due in the absence of use valuation. Any recapture tax paid will represent only the tax originally saved and no interest will be due for the period the tax was shifted forward. Thus, the estate electing use valuation obtains, in effect, an interest-free loan from the government when a recapture event occurs.

Valuation Methods

The use value of land must be determined by one of two methods, as specified in IRC §2032A (e), paragraph 7. The first, or formula method, is commonly used in determining the value of land for farming purposes. The second or alternate method of land valuation may be used if the executor chooses and must be chosen if gross cash rent data for comparable land are not available.

Formula Method

First, one must obtain the average annual cash rent on comparable land used for farming purposes in the same general locality. Next, the average annual state and local real estate taxes are subtracted from cash rent. Third, use value is determined by dividing the number obtained from the first two steps by the weighted average annual effective interest rate for all new Federal Land Bank loans. The effective rate reflects changes made during the year and Federal Land Bank stock. The official rates can be obtained from the Internal Revenue Service. The computations in the above formula are based on average data for the five years preceding the decedent's death.

Alternate Method

The statute outlines factors which are to be substituted for formula valuation in determining the value of qualified farmland. The following five factors are considered in the alternative method:[21]

1. The capitalization of income which the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain, and related factors.

2. The capitalization of the fair rental value of the land for farmland or closely held business purposes.

3. Assessed land values in a state which provides a differential or use value assessment law for farmland or closely held business.

4. Comparable sales of other farms or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sale price.

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

The value using the alternative method will be based on the judgmental assimilation of these factors for each respective property. These factors, though helpful, are not entirely self-explanatory and until regulations are promulgated as a guide to their use, formula valuation may have more appeal.

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[21] IRS, §2032 (e).

II. IMPLICATIONS FOR ESTATE PLANNING

The use valuation provisions of the Tax Reform Act of 1976 can significantly reduce the estate tax burden to qualifying farm estates. To assure that a particular estate will qualify and that use valuation benefits outweigh its burdens, adequate planning will be required.

III. GENERAL CONSIDERATIONS

Size of Estate and Type of Property Ownership

The size of estate and type of property ownership will influence the desirability of use valuation in a given estate. Estates large enough to have property taxed at the highest incremental rates of the unified estate and gift tax scale can receive a maximum reduction in estate taxes of up to $350,000 based upon the $500,000 maximum estate reduction. Where the farm was acquired as community property or where the spouse is considered to own an undivided 50 percent interest because of her contribution to the farm,[22] the $500,000 estate reduction limit could effectively be increased to $1,000,000. Smaller reductions in estate tax will be available from use valuation for smaller estates, reaching zero in 1981 and thereafter[23] for unmarried individuals having estates valued at no more than $175,625 and for married persons utilizing

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[22] Contribution may consist of: (1) providing capital for purchase, (2) receipt of an interest by gift under IRC 2040(b) with proper election and payment of gift taxes, and (3) by IRC 2040(c) recognition of services of a spouse who materially participates in the management and operation of jointly owned, debt-financed farm business.

[23] For estates settled in 1979 and 1980, some savings can be obtained from use valuation in smaller estates due to lower values of unified

the maximum marital deduction having estates of no more than $425,625. If married persons do not qualify for or elect not to use the marital deduction, their estate will be taxed the same as those of unmarried persons.

Effect on Section 6166 Deferral

Section 6166 of the Internal Revenue Code permits estates to defer estate taxes attributed to an interest in a farm or other closely held business for up to 15 years with a 4 percent interest rate on such deferred tax attributable to the first million dollars in value of such property. To be eligible for this deferral, 65 percent of the adjusted gross estate is required to consist of the value of the farm or other closely held business interest. If use valuation is chosen, that value must be used in determining whether the estate qualifies for §6166 deferral and low interest provisions. Therefore, some estates that would otherwise qualify for §6166 deferral will not qualify, requiring estate taxes to be paid with resultant liquidity pressures.

IV. PREMORTEM CONSIDERATIONS

Farm estate owners having relatively large amounts of real property and heirs apparent who desire to continue the farm business should do considerable premortem planning. Such planning should be designed to assure meeting the statutory qualifications for use valuation as well as

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credit available to offset estate taxes. Unmarried individual estates may receive a reduction in estate taxes via use valuation when they surpass $147,333 in 1979 and $161,563 in 1980. Corresponding values for estates of married individuals taking advantage of the maximum marital deduction will be $397,333 in 1979 and $411,563 in 1980.

maximizing its potential in the estate plan and, in addition, to assure adequate retirement income and fairness between beneficiaries.

Maximizing Use Valuation Potential

To gain maximum benefits from use valuation, it is important to assure that qualified property be available up to the $500,000 estate reduction maximum in those estates large enough to utilize such a reduction. Priority for making lifetime gifts, funding of the marital deduction, and pecuniary bequests should first be made from nonqualifying rather than property qualifying for use valuation.

Where a gift of qualifying property is made, there are at least two potentially unsatisfactory results. First, use value is not applicable in determining gift taxes and thus where the difference between gift tax value and use value are large the incentive to make gifts and shift potential appreciation from the estate will be lost. Secondly, a gift of qualifying property may have the effect of changing the makeup of remaining estate property to the extent that the 50 percent and 25 percent requirements cannot be met and use valuation will not be possible.

Marital deductions and pecuniary bequests, where possible, should be funded from nonqualifying property. Property going to a spouse will not need use valuation to the extent that it does not exceed half of the adjusted gross estate. Thus qualifying property should be reserved for use valuation except where there is ample qualifying real property to utilize the $500,000 maximum estate reduction in addition to property qualifying for the marital deduction. The outcome of funding a pecuniary bequest with property that otherwise qualified for use valuation is not clear. There is a question as to whether the property would qualify for use valuation in that arguably it neither is acquired from or passes from the decedent.

Effect on Retirement Income

Retirement income can be reduced under Social Security rules and regulations where the farmer materially participates in the operation so that his property will later qualify for use valuation. First, where the farmer is between the ages of 62 and 70, income received while materially participating in the farm business may reduce Social Security payments while rental income in the absence of material participation does not affect Social Security benefits. Secondly, self-employment income from material participation in the farm business will be subject to continued Social Security tax payments even after the farmer is, for practical purposes, retired.

Fairness Among Beneficiaries

Where use valuation is chosen and the decedent has only one heir, problems of fairness are not encountered. However, where there are several heirs and one receives the use valued property, potential unfair situations can arise. The major source of unfair treatment is from the recapture provisions which require the qualified heir receiving the property to pay the recapture tax upon disposition to a nonqualified person or on cessation of the qualified use. If the qualified heir receives the same value of estate property as other heirs, his share is in effect reduced in value by a contingent liability, while other heirs share equally in the estate tax reduction resulting from use valuation. A second type of potential unfairness also arises from the recapture provisions. Where the qualified heir finds it necessary to dispose of the use valued property, potential buyers will be limited to members of the qualified heir's family if the recapture tax is to be avoided. Under this situation, members of the qualified heir's family will acquire leverage in holding down the price of such property. To avoid these results, provisions can be placed in the estate plan that will offset the unfair results that may naturally occur under use valuation provisions.

Other Considerations

There are other factors which should be taken into consideration before election of §2032A. One is the fact that lenders may refuse to lend money on security that has a potential tax lien because of the election of §2032A. Such lenders may require a first mortgate on real estate taken as security, and the election of §2032A may present a problem where such policy is concerned.

Care must be taken to avoid tax recapture after a decedent's death. If there are several heirs, and only one has been given farm management responsibility for §2032A purposes, a replacement must be elected to continue qualifying activities if that particular heir becomes sick or dies. Otherwise, the estate may fail to meet one of the qualifications for §2032A use.

Where very large estates are involved, it may be advantageous to omit buildings and building sites from use valuation.[24] A higher value for the buildings would provide more depreciation for lowering income taxes in the following years. Higher value for the building sites would reduce the capital gains tax potential on later sales. The decision would depend upon plans for the estate components.

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[24] Neil E. Harl, "Tax Reform Act Complicates Life After Death," Agri-Finance, October, 1978, p. 18.

CHAPTER III

IMPACT OF SECTION 2032A ON INDIVIDUAL ESTATES AND THE LAND MARKET

I. TAX SAVINGS FOR VARIOUS SIZED ESTATES

Projected values of farm assets and debt for the four sales classifications were calculated to determine potential tax liability with and without the §2032A provision. Farmland was assumed to be 74 percent and debt 16 percent of gross assets. The 1977 percentages were obtained from Balance Sheet of the Farming Sector and used throughout for computations. The marital deduction was $250,000 or half the adjusted gross estate, whichever was larger. In absolute dollar amounts, the larger farms and those having no marital deduction benefited most by the election of §2032A. This relationship may indicate that those large estates left by widows and widowers, with children operating the farm, may choose the use valuation provision more often than those estates having a marital deduction.

A use value of 65 percent was used for estimating land values under §2032A. The 65 percent was the rounded average of 14 states and was similar to the use value obtained for Tennessee.[1] Maryland was excluded from the average due to the use value of that state being atypical.

[1]The states included were Georgia, Indiana, Illinois, Iowa, Kentucky, Minnesota, Mississippi, Missouri, North Carolina, North Dakota, Ohio, Oklahoma, Tennessee, and Wisconsin.

The asset and liability data for 1977 were taken from the Balance Sheet of the Farming Sector, 1978, published by the United States Department of Agriculture. Projected tax liabilities were obtained by the utilization of the "Unified Rate Table for Estate and Gift Taxes for U.S. Residents and Citizens," which is published in the United States Code Annotated.

In Sales Classification IA, estate tax savings from §2032A amounted to $63,188 for those estates with a marital deduction, and $143,093 for the estates without a marital deduction, using data appreciated at 8 percent (Tables I and II). In Sales Class II, no tax liability was projected with a marital deduction, so §2032A should not be a viable alternative in such a case. However, there was a tax savings of $29,219 with §2032A when no marital deduction could be utilized in Sales Class II. Estimated estate tax liabilities were computed under 6 percent and 10 percent appreciation assumptions (Appendix Tables I through IV).

II. $500,000 LIMITATION

The point at which the $500,000 limit becomes fully effective appears to be $1,428,571 or real estate in market value; $928,571 in use value, assuming a use valuation of 65 percent of market value (Table III).[2] If land prices increase at an 8 percent annual rate, the estate would be approximately 2,015 acres in Tennessee and 2,502 acres taking an average per acre value in Tennessee and the United States,

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[2]Market value and use value may have a different relationship for any given property.

TABLE I

ESTIMATED[a] 1980 ESTATE TAX LIABILITY WITH AND WITHOUT A MARITAL DEDUCTION FOR AN AVERAGE SIZE FARM WITHIN RESPECTIVE SALES CLASSIFICATION CATEGORIES

Item	Sales Classification III 10,000 to 19,999	II 20,000 to 39,999	IB 40,000 to 99,000	IA 100,000 or more
	---Dollars---			
Balance Sheet:				
Land Value	174,463	254,492	427,451	1,042,417
Gross Estate	235,761	343,908	577,636	1,408,672
Debt	20,747	58,120	110,906	331,038
Adjusted Gross Estate	215,014	285,788	466,730	1,077,634
Tax Liability:				
With Marital Deduction:				
Marital Deduction	250,000	250,000	250,000	538,817
Taxable Estate	---	35,788	216,730	538,817
Tentative Taxes[a]	---	7,273	60,154	170,162
Tax Credit[b]	42,500	42,500	42,500	42,500
Tax Liability	---	---	17,654	127,662
Without Marital Deduction:				
Taxable Estate	215,014	285,788	466,730	1,077,634
Tentative Taxes[a]	59,604	82,968	144,488	377,630
Tax Credit[b]	42,500	42,500	42,500	42,500
Tax Liability	17,104	40,468	101,988	335,130

[a]Computed from Internal Revenue Code of 1954, as amended, Section 2001.

[b]The tax credit is $38,000, $42,500, $47,000 for 1979, 1980, 1981, respectively, and $47,000 each year thereafter.

Sources of data: Land values were taken from Balance Sheet of the Farming Sector 1977, Economic Research Service, U.S. Department of Agriculture, p. 47.

TABLE II

ESTIMATED[a] 1980 ESTATE TAX LIABILITY WITH AND WITHOUT A MARTIAL DEDUCTION FOR AN AVERAGE SIZE FARM WITHIN RESPECTIVE SALES CLASSIFICATION CATEGORIES FOR USE VALUATION ELECTION UNDER SECTION 2032A

	Sales Classification			
	III	II	IB	IA
Item	10,000 to 19,999	20,000 to 39,999	40,000 to 99,999	100,000 or more
	Dollars			
Balance Sheet:[a]				
Land Value	113,401	165,420	277,843	677,571
Gross Estate	174,699	254,836	428,028	1,043,826
Debt	20,747	58,120	110,906	331,038
Adjusted Gross Income	153,952	196,716	317,122	712,788
Tax Liability:				
With Marital Deduction:				
Marital Deduction	250,000	250,000	250,000	356,394
Taxable Estate	---	---	67,122	356,394
Tentative Taxes[b]	---	---	14,852	106,974
Tax Credit[c]	42,500	42,500	42,500	42,500
Tax Liability	---	---	---	64,474
Without Marital Deduction:				
Taxable Estate	153,952	196,716	317,122	712,788
Tentative Taxes[b]	40,065	53,749	93,622	234,532
Tax Credit[c]	42,500	42,500	42,500	42,500
Tax Liability	---	11,249	51,122	192,032

[a]Use valuation with §2032A was assumed to be 65 percent of market value.

[b]Computed from Internal Revenue Code of 1954, as amended, Section 2001.

[c]The tax credit is $38,000, $42,500, $47,000 for 1979, 1980, 1981, respectively, and $47,000 each year thereafter.

Sources of data: Land values were taken from Balance Sheet of the Farming Sector 1977, Economic Research Service, U.S. Department of Agriculture, p. 47.

TABLE III

AN EXAMPLE OF LAND VALUE FOR THE MAXIMUM $500,000 GROSS ESTATE REDUCTION WITH ASSOCIATED ESTATE TAX LIABILITY, 1980

Item	Without §2032A	With §2032A
	-----------Dollars-----------	
Estate Size:		
Land Value[a]	1,428,571	928,571
Gross Estate	1,930,501	1,430,501
Debt	308,880	308,880
Adjusted Gross	1,621,621	1,121,621
Tax Liability with Marital Deduction:		
Marital Deduction	810,810	560,810
Taxable Estate	810,810	560,810
Tentative Taxes[b]	272,016	178,300
Tax Credit[c]	42,500	42,500
Tax Liability	229,516	135,800
Tax Liability without Marital Deduction:		
Taxable Estate	1,621,621	1,121,621
Tentative Taxes[b]	610,529	395,665
Tax Credit[c]	42,500	42,500
Tax Liability	568,029	353,165

[a]Use valuation with §2032A was assumed to be 65 percent of market value.

[b]Computed from Internal Revenue Code of 1954, as amended, Section 2001.

[c]The tax credit is $38,000, $42,500, $47,000 for 1979, 1980, 1981, respectively, and $47,000 each year thereafter.

Sources of data: Land values were taken from Balance Sheet of the Farming Sector 1977, Economic Research Service, U.S. Department of Agriculture, p. 47.

respectively. As shown in Table III, for that set of relationships the difference between land market value and land use value would exceed $500,000 when the land market value exceeded $1,428,571.

Election of the marital deduction in conjunction with the above examples results in an estate tax liability of $229,516 without §2032A and $135,800 with the use value election. If a marital deduction could not be utilized, Federal estate tax liability would be $568,029 without §2032A and $353,165 with election of §2032A. A use value percentage above 65 percent would raise the above estate tax liabilities while a use value below 65 percent would lower the estate tax liability.

III. MACROECONOMIC EFFECT OF SECTION 2032A

Section 2032A alternative valuation provisions of the 1976 Tax Reform Act probably will result in some land being held off the real estate market that otherwise would be sold. Studies in Illinois and Iowa indicated that out of all farmland sales for estate settlement purposes, about 6 percent were required to obtain funds for payment of estate taxes.[3] Continued appreciation of farm assets will cause more estates to be in higher tax brackets in coming years, giving added incentive to utilization of §2032A provisions.

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[3] Harold D. Guither, "Death, Taxes, and Farmland Transfers," Farm Economics Facts and Opinions, University of Illinois, August, 1978, p. 2.

IV. FARM TRANSFERS IN THE UNITED STATES

Farm sales made for estate settlement purposes has remained relatively constant at approximately 15 percent of all farm sales since the early 1970's. This is a lower rate than experienced during the late 1950's and 1960's, when a peak of 21.1 percent was reached in 1964. The number of farms sold per year has decreased from 281,600 in 1950 to 104,500 in 1977. In most cases, the number of farms sold for estate settlement purposes changed from year to year in the same direction as the number sold for voluntary purposes.

There appears to be no pattern between number of estate sales and level of farm income. This lack of a pattern suggests that not only is land held off the market during times of low farm income and weak land markets, but also that most estate sales are voluntary and not forced. Alternatively, foreclosure sales increased in periods of low farm income. For example, in 1973, a relatively high income year for farmers, there were 2,200 foreclosure sales amounting to 1.5 percent of all farm transfers. In 1977, with farm income at a lower level, there were 5,000 foreclosure sales, or 4.9 percent of all farms sold.

In the 10 states with the highest average real estate value per farm, six had increased farm sales for estate settlement purposes after the use value provisions became effective in January 1977. These states were Arizona, Colorado, New Jersey, Delaware, Illinois, and Nebraska. In two of the 10 states, Montana and Wyoming, sales for estate settlement purposes decreased in 1977. There appeared to be limited relationship between overall farm income and the number of farms sold for estate settlement purposes in most states. However, the two states with large average value of real estate per farm and relatively low income due to low cattle prices prior to enactment of §2032A showed decreased sales for estate settlement purposes after enactment.

In states with relatively low values of real estate per farm, sales per 1,000 farms for estate settlement purposes also increased in the majority of cases from 1976 to 1977. Tennessee, which was among the states having relatively low real estate value per farm, had a small change of from 9.0 to 9.2 farms per 1,000 from 1976 to 1977.

There also appeared to be no large change from one region of the U.S. to another. In the mountain states, with an average of $414,300 of real estate per unit, the number of farm transfers for estate settlement purposes averaged 2.81 per 1,000 farms in 1977. At the same time, voluntary sales per 1,000 farms averaged 32.67. In the Appalachian region, with average real estate values per farm of $87,760, there were 8.48 farms per 1,000 sold for estate settlement purposes in 1977. Voluntary sales, other than those for estate settlement purposes, were 24.33 per 1,000.

V. LIQUIDITY OF THE FARM SECTOR

The question of farm sector liquidity and the ramifications for payment of estate taxes has been addressed in several articles. An Illinois study for the 1974 period indicated the average estate had liquid assets of $74,491, or 20 percent of the gross estate.[4] While

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[4]Guither, p. 2.

43 percent of the estates surveyed had liquid assets valued at less than the estate tax bill, 44 percent had liquid assets equal to 125 percent or more of the estate tax bill. This research indicated that few farms were sold due to the burden of estate taxation. Only 6 percent of the estates surveyed sold land to pay estate and inheritance taxes.[5]

Research in Iowa also addressed the liquidity question in farm estates. In that study, published in 1974, only gross estates with values over $200,000 were included. Liquid assets consisted of the net value of stocks, bonds, checking accounts, promissory notes, savings accounts certificates of deposits and cash. Farm personal property was excluded in the definition of liquid assets, as was the case in the Illinois study. The results showed that there were differences between the liquidity conditions of living farmers and those of probated estates. Probate expenses averaged 22 percent of the average appraised gross estate (AAGE) and liquid assets averaged 25 percent of AAGE in probated estates.[6] Living farmers, on the other hand, had an average of $61,900 in liquid assets or 9.5 percent of their average expected gross estate.[7] The conclusion of the Iowa author follows:

> Something occurs between the average ages of 51 and 71 years to ease the kind of liquidity squeeze which is perhaps merely symptomatic of that middle stage of the family farm cycle in which most of the subject-farmers found themselves at the time of this study. In any event, the conclusion seems inescapable that whatever liquidity problems were observed among living farmers, they constitute only a

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[5]Guither, p. 2.

[6]"Large Farm Estates," Iowa Law Review, Vol. 59, 1974, p. 989.

[7]"Large Farm Estates," Iowa Law Review, Vol. 59, 1974, p. 981.

> temporary condition which either tends to cure itself with the passage of time or is solved by the affirmative actions of the client or his attorney at some point prior to death.[8]

From balance sheet analysis of sales classes, similar conclusions can be made. Although the lower sales classes have a higher percentage of real estate, and relatively lower percentage of liquid assets, they also have relatively lower debt. Therefore, it would appear that even though most farms in the lower sales classes are not large enough to encounter estate taxation, potential liquidity problems are less likely due to lower debt.

VI. IMPACT ON LAND PRICES

The impact of use valuation on the alienation and price of farmland is of concern to farmers generally, and especially to those planning to buy more land. Well established farmers are in a better position to buy land at higher prices because of the equity base in the present farming operations and the potential for added returns to size that may result from expanding the farm operation. Section 2032A may add further incentive for older farmers and others to invest in farmland to take advantage of reductions in total estate values provided by the use value election.

For the purposes of this study, the term "gross estate" included the physical assets of real estate, livestock and poultry, machinery and motor vehicles, crops stored, household equipment, deposits and currency, savings bonds, and investments in cooperatives. The assumption

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[8] "Large Farm Estates," Iowa Law Review, Vol. 59, 1974, p. 929.

applied here is that the average estate reflects averages compiled from balance sheet data. The adjusted gross estate was determined by subtracting the adjusted gross debt from the gross estate. Projections of potential tax liabilities were calculated through 1990, with and without a marital deduction. The value of assets and liabilities was adjusted at an annual rate of 8 percent to account for expected appreciation impacts on the farm sector (Table IV).

The balance sheet values per farm in the United States in 1977 were \$178,805 in real estate assets, \$242,028 in gross assets and \$37,939 debt. These values corresponded with research in Illinois and Iowa in that farm real estate value tends to account for 74 percent of gross assets and debt tends to have a value about 16 percent of gross assets. When the values were increased at a rate of 8 percent, real estate value per farm in the United States would be \$225,243 in 1980, with a gross estate value of \$304,877, debt of \$48,780 (16 percent of gross assets), and an adjusted gross estate of \$256,097 (Table IV). With a marital deduction of \$250,000 and a unified estate and gift tax credit of \$42,500, the average farm should have no estate tax liability in 1980. However, the Federal estate tax liability would be \$32,838 in cases where the marital deduction does not apply.

For Tennessee, the average farm was projected to have \$95,683 in real estate assets and \$129,301 in gross assets by 1980 (Table V). The debt to asset ratio in the last several reporting periods has been higher for Tennessee than for the United States as a whole. When debt is assumed to be 17.6 percent of gross assets in Tennessee, the debt per farm in Tennessee would be \$22,757, leaving an adjusted gross estate of

TABLE IV

ESTIMATED ESTATE SIZE AND TAX LIABILITY WITH AND WITHOUT A MARITAL DEDUCTION FOR AN AVERAGE FARM, UNITED STATES, SELECTED YEARS

Item	1979	1980	1981	1985	1987	1990
	Dollars					
Estate Size:						
Real Estate	208,558	225,243	243,262	330,955	387,026	486,280
Gross Estate	282,293	304,877	329,266	497,963	522,504	657,138
Debt	45,167	48,780	52,683	71,674	83,601	105,142
Adjusted Gross Estate	237,126	256,097	276,583	376,289	438,903	551,996
Without Marital Deduction:						
Tentative Taxes[a]	66,680	72,873	79,838	113,738	135,027	175,038
Tax Credit[b]	38,000	42,500	47,000	47,000	47,000	47,000
Tax Liability	28,680	30,373	32,838	66,738	88,027	128,038
With Marital Deduction:						
Marital Deduction	250,000	250,000	250,000	250,000	250,000	275,998
Adjusted Gross Estate	---	6,097	26,583	126,289	188,903	275,998
Tentative Taxes[a]	---	1,098	5,248	31,687	51,219	79,639
Tax Credit[b]	38,000	42,500	47,000	47,000	47,000	47,000
Tax Liability	---	---	---	---	4,249	32,639

[a]Computed from Internal Revenue Code of 1954, as amended, Section 2001.

[b]The tax credit is $38,000, $42,500, $47,000 for 1979, 1980, 1981, respectively, and $47,000 each year thereafter.

Sources of data: Land values were taken from Balance Sheet of the Farming Sector 1977, Economic Research Service, U.S. Department of Agriculture, p. 47. (These data were adjusted positively at 8 percent per annum.)

TABLE V

ESTIMATED ESTATE SIZE AND TAX LIABILITY WITH AND WITHOUT A MARITAL DEDUCTION FOR AN AVERAGE FARM, TENNESSEE, SELECTED YEARS

Item	1979	1980	1981	1985	1987	1990
	--------	--------	--------	Dollars	--------	--------
Estate Size:						
Real Estate	88,595	95,683	103,338	140,590	163,984	206,573
Gross Estate	119,723	129,301	139,646	189,987	221,600	279,153
Debt	21,071	22,757	24,578	33,438	39,002	49,131
Adjusted Gross Estate	98,652	106,544	115,068	156,549	182,598	230,022
Without Marital Deduction:						
Tentative Taxes[a]	23,423	25,763	28,320	40,896	49,231	64,407
Tax Credit[b]	38,000	42,500	47,000	47,000	47,000	47,000
Tax Liability	---	---	---	---	2,231	17,407
With Marital Deduction:						
Marital Deduction	250,000	250,000	250,000	250,000	250,000	250,000
Adjusted Gross Estate	---	---	---	---	---	---
Tentative Taxes[a]	---	---	---	---	---	---
Tax Credit[b]	38,000	42,500	47,000	47,000	47,000	47,000
Tax Liability	---	---	---	---	---	---

[a]Computed from Internal Revenue Code of 1954, as amended, Section 2001.

[b]The tax credit is \$38,000, \$52,500, \$47,000 for 1979, 1980, 1981, respectively, and \$47,000 each year thereafter.

Sources of data: Land values were taken from Balance Sheet of the Farming Sector 1977, Economic Research Service, U.S. Department of Agriculture, p. 47. (These data were adjusted positively at 8 percent per annum.)

$106,544. Tentative estate tax without a marital deduction would be $25,763. When the $42,500 unified credit is applied against this amount, no estate tax liability would be incurred.

The average farm in the United States will have $330,955 of real estate assets, $447,963 of gross assets and $71,674 of debt by 1985, if the assumed appreciation rate is correct. At that time, the average farm estate will have the potential of an estate tax liability of zero where the marital deduction applies, and $66,738 without a marital deduction. In 1987 and later, the asset value per farm will have increased such that the marital deduction of $250,000 or half of the adjusted gross estate, whichever is larger, will fail to protect the unit from estate taxation, assuming 8 percent appreciation and no change in the Federal estate tax laws. In 1987, the potential tax liability will be $88,027 without a marital deduction, and $4,249 with the deduction. By 1990, if assets increase at an 8 percent annual rate, real estate value per farm will be $486,282, gross assets $657,138, and debt of $105,142. These changes would mean a potential estate tax liability of $108,038 without a marital deduction and $32,639 with the deduction.

Farm estate values in Tennessee are somewhat lower than for the United States as a whole. The 1985 projected values for Tennessee show real estate assets of $140,590, gross assets $189,987, and indebtedness of $33,438. The average adjusted gross estate would then be $156,549, with a tentative tax of $40,896 in the absence of a marital deduction, leaving no Federal tax liability when the $47,000 credit is applied.

By 1987, the value per farm in Tennessee will be such that a tax liability will be incurred, but then only where the marital deduction does not apply. In such a case the tax liability would be $2,231. By 1990 the real estate value per farm in Tennessee will be $206,573, gross assets will be worth $279,753 and a debt load will be $49,131. The adjusted gross estate will be $230,022 and the tentative tax in such a case would be $64,407. When the $47,000 credit is applied against this tentative tax, a $17,407 tax liability would be incurred. The marital deduction will prevent any potential tax liability in cases where the maximum marital deduction is available for the average size farm in Tennessee as late as 1990.

Among the factors that could change the above projections would be the continuing trend toward larger farm units, which would tend to increase the average tax liability. Another factor is differing rates of appreciation of farm real estate assets. The actual rate may be higher or lower than the assumed 8 percent.

There are several scenarios from which one can choose in determining the impact of §2032A on alienation of farmland. One would involve the combination of farm real estate market statistics published by the United States Department of Agriculture and findings resulting from research at Illinois and Iowa. There were 15,800 farm units sold for estate settlement purposes in 1977. If 17 percent of estate-containing farmland is sold, this percentage would mean there would be approximately 92,941 estates with farmland as one of the assets probated or settled in 1977.

The average size of farms sold for voluntary and estate settlement purposes was 308 acres in 1977. Average price per acre in these sales was $591, giving an average of $182,028 of real estate per sale. With real estate comprising 74 percent of gross assets, then the average gross estate was equal to $245,984 in 1977, a value comparable to census data, balance sheet tabulations and thesis projections for average farm size of the older farmer.

If 6 percent of the farms sold for estate settlement purposes in 1977 were to pay estate taxes, and if all of these farms had elected the §2032A alternative valuation, the results would have been a decrease of 948 farms on the market, or 291,984 acres. There were 104,500 farms sold for all purposes in 1977. If each farm had an average of 308 acres, then there were 32,186,000 acres sold in 1977. Alternatively, the above would then lead to a decrease of about 1 percent (.907 percent) in the amount of farmland placed on the real estate market. The result would be 1.18 percent of the total acreage sold for voluntary and estate settlement purposes.

The supply of agricultural land is relatively inelastic, especially in the long run, due to the limited world surface area. A decrease in the amount of land offered for sale in a given time period will likely result in a greater proportionate increase in price. In addition, land price relationships may be complicated by changes in demand factors. Although the demand for land is considered to be relatively inelastic due to the "limited and routine demands and need for most land resources,"[9] that rendition has not considered farmland for its investment potential. Thus, estimation of demand is more complex due to important variables involving investor expectations both from the pure investment and estate planning vantage points.

An alternative scenario could assume that estates electing §2032A would most likely be larger than the average, since an estate should have been larger than $120,666 without a marital deduction in 1977 in order to accrue benefits from §2032A that more than offset the restrictions on the land in the following 15-year period. The upper 6 percent of American farms, those with sales over $100,000 annually, have an average of 1,838 acres per farm unit. Only 4 percent of the land sales to pay estate taxes came from Sales Class IA and 2 percent came from Sales Class IB (average of 754 acres/unit) and if these farms elected §2032A, the result would have been 1,399,880 acres held off the market, or approximately 4.35 percent of the total amount of land sold for all purposes in 1972.

VII. LONG-RUN IMPACT OF SECTION 2032A

The impact of §2032A on land prices is most likely to increase until lands that were withheld under the provision are released at the same rate as new elections occur. Perhaps the most important factor affecting the time lag is that the liens and restrictions placed on agricultural land by the election of §2032 do not justify its use by

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[9] Raleigh Barlowe, Land Resource Economics (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1972), p. 20.

those estates of average size and below. One estimate has placed the value of estates below which §2032 should not be chosen at $350,000,[10] assuming a marital deduction can be utilized.

However, if assets appreciate at an equal rate of 8 percent, the average adjusted gross estate will be $376,287 by 1985. If present exemption rates and credits remain fixed, the number of estates choosing §2032A valuation is likely to increase over time, due to more estates being in higher estate tax brackets.

How quickly the impact of §2032A will be effectuated into the farm real estate market will be influenced somewhat by the demographic characteristics of landowners. The time interval between generations is estimated at 30 to 35 years.[11] Composition of land ownership among the generations would influence how long it would take the initial impact of §2032A to be reflected in the market. Considering the time interval between generations, land ownership among the generations and the 15-year holding period, most of the impact should be reflected within 50 years after enactment of §2032A. It is hypothesized that approximately three-fourths of the impact will occur in the first 25 years. However, as land values rise, expectations are that the process of withholding farmland from the real estate market by use of §2032A will be used more frequently and be more likely repeated by successive generations.

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[10] Roland L. Hjorth, "Special Estate Tax Valuation of Farmland and the Emergence of a Landholding Elite Class," Washington Law Review, Vol. 53, 1978, p. 621.

[11] Henry S. Shryock and Jacob S. Siegel et al., The Methods and Materials of Demography (New York: Academic Press, 1976), p. 252.

VIII. IMPACT OF SECTION 2032A IN SELECTED REGIONS OF THE UNITED STATES

The impact and utilization of §2032A can be expected to differ among the various states. Table VI shows the reduction in valuation in selected states when the capitalization formula outlined in §2032A is used. The greatest reduction of the states listed is Maryland, where the use value is calculated to be 4.25 percent of market value. In the Corn Belt states, Ohio has an average use valuation of 43.57 percent of market value while farmland in Indiana and Missouri both have use values of over 74 percent of market values. Tennessee also has a relatively large use valuation in comparison with market value at 68.48 percent.

The utilization of §2032A and its impact appear to have the greatest potential in the high land value areas such as the northeast and urban fringes. These areas will have the greatest differences between the market values and use values due to real estate taxes and rental income relationships. In rural nonurbanized areas, the market values and §2032A use values should be nearly the same in most cases.

TABLE VI

RENTAL RATES, PROPERTY TAXES, ESTIMATED USE VALUE, MARKET VALUE, AND USE VALUE AS A PERCENT OF MARKET VALUE FOR SELECTED STATES, 1977

State	Average Rent	Property Taxes	Estimated[a] Use Value	Market Value	Use Value as a Percent of Market Value
	----------------Dollars----------------				---Percent--
Georgia	28.20	3.09	304.00	564	53.90
Illinois	90.00	10.11	967.19	1,581	61.18
Indiana	85.00	5.09	967.43	1,303	74.25
Iowa	82.00	6.76	910.90	1,268	71.84
Kentucky	36.45	2.72	408.35	671	60.86
Maryland	26.80	21.26	67.07	1,578	4.24
Mississippi	26.30	1.21	303.75	464	65.46
Missouri	40.00	2.82	450.12	602	74.77
Minnesota	53.90	4.53	597.70	730	81.88
North Carolina	28.50	3.45	303.27	694	43.70
North Dakota	17.40	1.80	188.86	273	69.18
Ohio	52.50	7.05	550.24	1,263	43.57
Oklahoma	16.50	1.24	184.75	402	45.96
Tennessee	37.20	2.81	416.34	608	68.48
Wisconsin	48.00	12.11	434.50	690	62.97

[a]Estimated use value = (average farmland rental rate - property taxes) ÷ Federal Land Bank interest rate.

Sources of data: Land values were taken from Balance Sheet of the Farming Sector 1977, Economic Research Service, U.S. Department of Agriculture, p. 47; real estate taxes were taken from Farm Real Estate Taxes 1978, p. 14; and rental data and Federal Land Bank interest rates were taken from Farm Real Estate Market Developments, Economics, Statistics, and Cooperatives, Service, U.S. Department of Agriculture, pp. 51 and 42, respectively.

CHAPTER IV

SUMMARY AND IMPLICATIONS

I. SUMMARY

The §2032A use valuation provision of the 1976 Tax Reform Act will have an impact on the agricultural sector. While the intent of Congress was apparently to facilitate intergenerational transfers of family farms, there also appears the likelihood that the law will have an impact on farm real estate prices.

The objectives of this research were to set forth the requirements for compliance with §2032A, estimate potential tax liabilities for selected estate situations using various rates of asset appreciation both with and without utilization of §2032A, and determine the potential impact of §2032A upon farm real estate alienation and prices.

The maximum amount a gross estate can be reduced under §2032A is $500,000. Twenty-five percent of the adjusted gross estate must consist of qualified (agricultural) real property and at least 50 percent of the estate must consist of real and personal property used in an agricultural or other qualified use before §2032A can be used. Either the decedent-to-be or a qualified heir must be a material participator in at least five of the eight years preceding the decedent's death. Such participation must be continued by at least one qualified heir for a period of 15 years after the decedent's death. If the qualified heir transfers the property to an unqualified person, or ceases to use the property in a qualified way, there is a recapture of the tax avoided by the election of §2032A. The qualified heirs will be liable for the full amount if the recapture event occurs in the first 10 years after the decedent's death. During the time period from the tenth to the fifteenth year, the tax is prorated.

The law provides two methods of valuing land at use value. The first involves a formula in which the annual cash rent, minus annual state and local real estate taxes, is divided by the average weighted annual effective interest rate for all new Federal Land Bank loans. The numbers in the formula are based on average data for the five years preceding the decedent's death. The second method of valuation is based upon five factors relating to capitalization of income and factors unique to the particular area where a farm is located.

Factors to be given consideration before the election of §2032A include the effects of the election on Social Security payments and income, basis for capital gains taxation, §6166 tax deferral election, and fairness among beneficiaries.

From projected 1980 estate tax liabilities, estate tax savings from election of §2032A were calculated. For Sales Classification IA, $100,000 of gross sales and over, estate tax savings were $63,188 for those estates being able to utilize a marital deduction, and $143,098 for those estates having no marital deduction. Smaller tax savings resulted from election of §2032A for those farms in lower sales classifications. The $500,000 adjusted gross estate reduction limitation takes effect at $1,428,571 in real estate assets, or $1,930,501 in terms of gross estate. Tax savings from election of §2032A in such a case would be $93,716 for those estates where a marital deduction can be utilized, and $214,864 where a marital deduction cannot be utilized.

Sales for estate settlement purposes have remained relatively constant in the past 15 years in the United States. The percentage of total farm sales made for estate settlement purposes is approximately 15 percent. There appeared to be no pattern between the number of estate sales and level of farm income.

The average farm estate in the United States is expected to have $225,243 of real estate, $304,877 in total assets, debt of $48,780, and an adjusted gross estate of $256,097 in 1980. With a marital deduction, such an estate would encounter no Federal estate taxation. Comparable results for Tennessee are expected to be $95,683 of real estate assets, $129,301 of gross assets, debt of $22,757, and an adjusted gross estate of $106,544.

The election of §2032A for larger estates has the potential to reduce the short-term supply of land in the real estate market by 1 percent per year. This reduction of supply and the resultant increase in farm real estate prices may increase the number of estates electing §2032A over time. Heirs may become more inclined to hold farm real estate assets and materially participate in some type of production process in order to reduce the amount of estate taxation and for investment reasons.

II. IMPLICATIONS

Increasing land prices will make farm ownership by younger farmers and tenant farmers more difficult to attain. A trend toward sharecropping agreements rather than cash rental may become evident as more landholders plan their estates to qualify under the use valuation provision. Material participation appears easier to be effected and proven when the decedent-to-be shares in both the production decisions and risk in an individual enterprise.

Price increases of farmland around urban areas may be complicated by §2032A. Since real estate taxes are usually higher on such land, the formula method of use valuation will yield a lower value than land with a smaller amount of taxes, assuming the same cash rent on both properties. Furthermore, the proximity of land to an urban growth area offers the added attraction of price increase potential due to increased demand for the land for alternative purposes. One of the best investments in terms of long-term growth and estate tax savings may be upland farm real estate close to urban areas where relatively low cash rents, ease of material participation, and high taxes may yield a low use value for estate purposes. The type of enterprise which the decedent-to-be and his heirs operate will also have a bearing on ease of material participation and amount of estate tax savings. Land-based operations such as cattle and cropping enterprises may be more attractive than more capital-intensive enterprises such as swine confinement operations or drylot dairying. Timber tracts may be attractive from a §2032A standpoint; however, there may be some difficulty in determining cash rental values. Furthermore, such use values may approach present market values in many areas of the country.

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APPENDICES

APPENDIX A

Courts, in deciding cases pertaining to material participation, have offered different interpretations of Treasury regulations. These cases, though not dealing directly with material participation for §2032A purposes, will probably be relevant since §2032A(3), paragraph (6), states that "material participation for §2032A purposes 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."

Celebrezze v. Maxwell[1]

The Fifth Federal Court of Appeals ruled in Celebrezze v. Maxwell that the payment of one-fourth of the fertilizer, seed, and other expenses for a cotton crop by an elderly woman did not in itself constitute material participation, even though proceeds from crops raised were divided on a share basis. The expenditures borne by the owner were small, not only in percentage terms, but the court also decided the gross amount for two years ($71) was also unimpressive. Therefore, an important element in this and other cases appears to be the amount of capital the owner has "at risk."

Two other factors that influenced the court to rule against material participation in the Maxwell case were that there existed no prior arrangement for the owner to materially participate and also the

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[1]Celebrezze v. Maxwell 315 F. 2d 727 (5th cir. 1963).

tenants did not depend on the owner for advice and direction when making important decisions concerning the cotton crop. In the words of the court:

> The 1956 amendment which creates the exception to the exclusion (written in the 1954 Social Security law prohibiting farmers from coverage) shows a benevolent intent to protect citizens whose income diminishes or is wiped away because of old age or disability, and on the other hand to exclude income which continues in spite of old age or disability such as the fruits of someone else's labor.[2]

Celebrezze v. Miller[3]

In Celebrezze v. Miller, a landowner was ruled to have materially participated under the following arrangement. Miller (the landowner) had oral agreements with his tenants that Miller was to inspect the crops three or four times a month, pay one-third the costs of fertilizer, poisons, and all the labor hired, during the periodic visits to inspect the crops and premises, to consult and advise with the tenants as to the application of fertilizers and poisons, and the time and place to plant. The tenants furnished the seed and labor. The agreements were carried out as planned and Miller received one-third of the crop proceeds.

Conley v. Ribicoff[4]

Material participation appears somewhat easier to prove in those agricultural enterprises that have a few critical periods during the year than those where the work and important decisions are spread out

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[2]Celebrezze v. Maxwell 315 F. 2d 727 (5th cir. 1963).

[3]Celebrezze v. Miller 333 F. 2d 29 (1964).

[4]Conley v. Ribicoff 294 F. 2d 190 (1961).

over the entire year. In Conley v. Ribicoff, the 9th Federal Circuit Court of Appeals ruled that the landowner had materially participated even though he visited the farm only twice per year. The key point seemed to be that the enterprise engaged in was dry-farming where the land was neither irrigated nor cultivated. All the farming activities depended on weather conditions and no consideration or attention was given the grain crop during the growing period. The owner made important decisions such as crops to be grown and where the crops were to be raised. The owner and tenant had made prior arrangements to engage in a joint venture and the owner had drawn up a complete farm plan. The owner also paid all the expenses and received proceeds from crop revenue on a share basis. The above factors combined with a type of farming that required few visits did in fact constitute material participation. The court did state, however, that if the owner had been merely an absentee landholder, interested only in land as an investment, he would not have qualified.[5]

Colegate v. Gardner[6]

A final case, Colegate v. Gardner, illustrates that the number of years the owner and tenant have engaged in a joint agricultural venture may influence whether material participation can be proven. In this case, the landowner made only two inspections in the spring, once at plowing and again at planting; and the owner only went around the

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[5]Conley v. Ribicoff 294 F. 2d 190 (1961).

[6]Colegate v. Gardner 265 F. Supp. 987 (S. D. Ohio 1967).

perimeter of the crops during the growing season. However, there was an oral agreement between the owner and the tenant, and the owner also made the decisions concerning crops to plant. She also paid 50 percent of expenses incurred in the cropping operation. The court ruled that the long-term relationship between the owner and tenant helped prove material participation. The court stated:

> Between two old-time neighboring farmers, thoroughly familiar with the detail of the day-to-day operation of farms in a particular locality, the management decisions are, in the most part, made at the beginning and the end of the grain-farm year.*** Between a new land owner and a new tenant farmer, one could expect frequent occasions for joint decisions.

APPENDIX B

TABLE B-I

ESTIMATED ESTATE SIZE AND TAX LIABILITY WITH AND WITHOUT A MARITAL DEDUCTION FOR AN AVERAGE FARM, USING A 6 PERCENT ASSET APPRECIATION RATE, UNITED STATES, SELECTED YEARS

Item	1979	1980	1981	1985	1990
	Dollars				
Estate Size:					
Real Estate	200,905	212,957	225,741	284,979	381,373
Gross Estate	271,493	287,779	305,056	385,107	515,369
Debt	43,439	46,045	48,809	61,617	82,459
Adjusted Gross Estate	228,054	241,734	256,247	323,490	432,910
Without Marital Deduction:					
Tentative Taxes[a]	63,777	68,155	72,924	95,787	132,989
Tax Credit[b]	38,000	42,500	47,000	47,000	47,000
Tax Liability	25,777	25,655	25,924	48,787	85,989
With Marital Deduction:					
Marital Deduction	250,000	250,000	250,000	250,000	250,000
Adjusted Gross Estate	---	---	---	---	---
Tentative Taxes[a]	---	---	---	---	---
Tax Credit[b]	38,000	42,500	47,000	47,000	47,000
Tax Liability	---	---	---	---	2,331

[a]Computed from Internal Revenue Code of 1954, as amended, Section 2001.

[b]The tax credit is $38,000, $42,500, $47,000 for 1979, 1980, 1981, respectively, and $47,000 each year thereafter.

Sources of data: Land values were taken from Balance Sheet of the Farming Sector 1977, Economic Research Service, U.S. Department of Agriculture, p. 47.

TABLE B-II

ESTIMATED ESTATE SIZE AND TAX LIABILITY WITH AND WITHOUT A MARITAL DEDUCTION FOR AN AVERAGE FARM, USING A 10 PERCENT ASSET APPRECIATION RATE, UNITED STATES, SELECTED YEARS

Item	1979	1980	1981	1985	1990
	----------	----------	Dollars	----------	----------
Estate Size:					
Real Estate	216,354	237,990	261,788	383,286	617,288
Gross Estate	292,370	321,607	353,768	517,955	834,174
Debt	46,779	51,457	56,603	82,873	133,468
Adjusted Gross Estate	245,591	270,150	297,165	435,082	700,706
Without Marital Deduction:					
Tentative Taxes[a]	69,389	77,651	86,836	133,728	230,061
Tax Credit[b]	38,000	42,500	47,000	47,000	47,000
Tax Liability	31,389	35,151	39,826	86,728	183,061
With Marital Deduction:					
Marital Deduction	250,000	250,000	250,000	250,000	350,353
Adjusted Gross Estate	---	20,150	47,165	185,082	350,353
Tentative Taxes[a]	---	3,833	9,920	50,026	104,920
Tax Credit[b]	38,000	42,500	47,000	47,000	47,000
Tax Liability	---	---	---	3,026	57,920

[a]Computed from Internal Revenue Code of 1954, as amended, Section 2001.

[b]The tax credit is $38,000, $42,500, $47,000 for 1979, 1980, 1981, respectively, and $47,000 each year thereafter.

Sources of data: Land values were taken from Balance Sheet of the Farming Sector 1977, Economic Research Service, U.S. Department of Agriculture, p. 47.

TABLE B-III

ESTIMATED ESTATE SIZE AND TAX LIABILITY WITH AND WITHOUT A MARITAL DEDUCTION FOR AN AVERAGE FARM, USING A 6 PERCENT ASSET APPRECIATION RATE, TENNESSEE, SELECTED YEARS

Item	1979	1980	1981	1985	1990
	Dollars				
Estate Size:					
Real Estate	85,344	90,464	95,894	121,058	171,728
Gross Estate	115,330	122,248	129,587	163,592	232,066
Debt	20,298	21,516	22,807	28,792	40,844
Adjusted Gross Estate	95,032	100,732	106,780	134,800	191,222
Without Marital Deduction:					
Tentative Taxes[a]	22,409	24,020	25,834	34,240	51,991
Tax Credit[b]	38,000	42,500	47,000	47,000	47,000
Tax Liability	---	---	---	---	4,991
With Marital Deduction:					
Marital Deduction	250,000	250,000	250,000	250,000	250,000
Adjusted Gross Estate	---	---	---	---	---
Tentative Taxes[a]	---	---	---	---	---
Tax Credit[b]	38,000	42,500	47,000	47,000	47,000
Tax Liability	---	---	---	---	---

[a]Computed from Internal Revenue Code of 1954, as amended, Section 2001.

[b]The tax credit is $38,000, $42,500, $47,000 for 1979, 1980, 1981, respectively, and $47,000 each year thereafter.

Sources of data: Land values were taken from Balance Sheet of the Farming Sector 1977, Economic Research Service, U.S. Department of Agriculture, p. 47.

TABLE B-IV

ESTIMATED ESTATE SIZE AND TAX LIABILITY WITH AND WITHOUT A MARITAL DEDUCTION FOR AN AVERAGE FARM, USING A 10 PERCENT ASSET APPRECIATION RATE, TENNESSEE, SELECTED YEARS

Item	1979	1980	1981	1985	1990
	-----------------Dollars-----------------				
Estate Size:					
Real Estate	91,907	101,097	111,207	162,819	262,223
Gross Estate	124,198	136,618	150,280	220,026	354,355
Debt	21,859	24,045	26,449	38,725	62,366
Adjusted Gross Estate	102,339	112,573	123,831	181,301	291,989
Without Marital Deduction:					
Tentative Taxes[a]	24,502	27,572	30,949	48,816	85,076
Tax Credit[b]	38,000	42,500	47,000	47,000	47,000
Tax Liability	---	---	---	1,816	38,076
With Marital Deduction:					
Marital Deduction	250,000	250,000	250,000	250,000	250,000
Adjusted Gross Estate	---	---	---	---	41,989
Tentative Taxes[a]	---	---	---	---	8,677
Tax Credit[b]	38,000	42,500	47,000	47,000	47,000
Tax Liability	---	---	---	---	---

[a]Computed from Internal Revenue Code of 1954, as amended, Section 2001.

[b]The tax credit is $38,000, $42,500, $47,000 for 1979, 1980, 1981, respectively, and $47,000 each year thereafter.

Sources of data: Land values were taken from Balance Sheet of the Farming Sector 1977, Economic Research Service, U.S. Department of Agriculture, p. 47.

VITA

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