[JOINT COMMITTEE PRINT]

BACKGROUND ON REGULATIONS UNDER SECTIONS 482, 483, AND 2032A OF THE INTERNAL REVENUE CODE

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE

ON APRIL 27, 1981

PREPARED FOR THE USE OF THE

COMMITTEE ON FINANCE

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Finance Committee's Subcommittee on Oversight of the Internal Revenue Service has scheduled a hearing on April 27, 1981, regarding regulations recently proposed or promulgated under sections 482, 483, and 2032A of the Internal Revenue Code and their impact on family farms and businesses. Section 482 relates to the tax characterization of transactions between related organizations, trades or businesses. Section 483 relates to the treatment of a portion of certain installment payments as the payment of interest. Section 2032A relates to the valuation, for estate tax purposes, of qualified real property used in farming or another family business.

This pamphlet, prepared in connection with the hearings, contains three parts. The first part discusses sections 482 and 483. The second part discusses section 2032A. Each of these parts describes the relevant legislative history, present law, and the issues raised by recent regulatory changes (or proposed changes) that affect taxpayers subject to these sections. Part three describes the Federal Land Bank program to assist in the financing of farm real estate and presents other data on farm real estate financing.

I. IMPUTED INTEREST RATES (SECTIONS 482 AND 483)

A. Legislative History

Section 482

The internal revenue laws have contained a provision substantially similar to section 482 since the Revenue Act of 1921. Section 240(d) of that Act permitted the Commissioner to consolidate the returns of "two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests . . . for the purpose of making an accurate distribution of gains, profits, income, deductions or capital between or among such related trades or businesses." The report of the Committee on Finance stated that the provision was "necessary to prevent the arbitrary shifting of profits among related businesses. . . ." (Senate Rep. No. 275, 67th Cong., 1st Sess. (1921)).

In the Revenue Act of 1934, the current provision was amended by adding the word "organizations" to "trades or businesses" to "remove any doubt as to the application of this section to all kinds of business activities." (H. R. Rep. No. 704, 73d Cong., 2d Sess. 1934)). In the Revenue Act of 1943, the words "credits or allowances" were added to "income or deductions."

Section 483

Section 483 was added to the Code in 1964 and has not been amended substantively since its enactment. The report of the Committee on Finance with respect to this provision sets forth the following reasons for the provision:

> [T]here is no reason for not reporting amounts as interest income merely because the seller and purchaser did not specifically provide for interest payments. This treats taxpayers differently in what are essentially the same circumstances merely on the grounds of the names assigned to the payments. In the case of depreciable property this may convert what is in reality ordinary interest income into capital gain to the seller. At the same time the purchaser can still recoup the amount as a deduction against ordinary income through depreciation deductions. Even where the property involved is a nondepreciable capital asset, the difference in tax bracket of the seller and buyer may make a distortion of the treatment of the payments advantageous from a tax standpoint. The House and [the Finance Committee] believe that manipulation of the tax laws in such a manner is undesirable and that corrective action is needed. (S. Rep. No. 830, 88th Cong., 2d. Sess. 102)

The Finance Committee report provided the following guidance for determining the interest rate to be used to carry out the purposes of section 483:

> The interest rate to be used for purposes of this provision is to be a rate provided by regulations prescribed by the Secretary of the Treasury or his delegate. It is anticipated that any rate specified by the Secretary of the Treasury or his delegate will reflect the going rate of interest and will not be higher than the rate at which a person, in reasonably sound financial circumstances and with adequate security could be expected to borrow money from a bank. (S. Rep. No. 830, 88th Cong., 2d. Sess. 102)

B. Present Law

Section 482

Section 482 provides that—

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

This provision has been interpreted as granting broad authority to the Secretary to make adjustments in the income, deductions, credits, or allowances of related business activities to achieve a clear reflection of their respective incomes.

Section 482 has been used to adjust sales prices, charges for services, interest charges, rentals and royalties between related businesses. Use of the provision by the Secretary is discretionary and taxpayers may not rely on section 482 to alter the tax treatment of transactions between related businesses.

The Code establishes three prerequisites to application of section 482. First, there must be two or more organizations, trades or businesses. Second, the entities must be owned or controlled, directly or indirectly, by the same interests. Third, the Secretary must determine that a proposed change is necessary to prevent evasion of taxes or to reflect clearly the income of the entities.

The requirement that there be two or more organizations, trades or businesses generally limits the application of section 482 to transactions in a commercial, as opposed to personal, setting. In defining the term "organization," the Treasury regulations under section 482 refer to an organization as conducting a trade or business. Thus, the concept of "organization" in section 482 is, in part, synonymous with the concept of trade or business. The term "trade or business, as used in the Internal Revenue Code, is not susceptible to a single or simple definition. In *Deputy v. DuPont*, 308 U.S. 488 (1940), Justice Frankfurter stated that "carrying on any trade or business . . . involves holding one's self out to others as engaged in the selling of goods or services." In a later opinion, the court relied upon the "extent, continuity, variety and regularity" of the taxpayer's activities in finding the existence of a trade or business. Similarly, the mere act of investing is not considered a trade or business, nor is the act of an occasional sale.

Under the definition of trade or business described above, if a parent sold the family farm to a child upon retirement, the transaction would not be subject to section 482 because the parent would not be engaged in a trade or business.

The second requirement for application of section 482 is that the requisite trades or businesses be owned or controlled by the same interests. Under existing Treasury regulations, control includes "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted." The ability to arbitrarily shift items of income and deduction has become the hallmark of control for purposes of section 482. If the reality of a relationship between two entities includes distinct interests in the organizations and their profits, and an inability of any party to arbitrarily shift the income and deductions of the organizations, then section 482 will not apply. The mere fact that an organization is controlled by a person who is a child, spouse, or sibling of another individual in control of the second organization, does not mean that the organizations are commonly controlled. (*Brittingham v. Commissioner*, 598 F.2d 1375 (5th Cir. 1979)).

The third requirement for application of section 482 is a determination by the Secretary that application of the section is necessary to prevent tax evasion or to reflect clearly the income of the commonly controlled entities. The regulations define the purpose of section 482 to be the placing of controlled taxpayers on a parity with uncontrolled taxpayers by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The standard applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. Thus, although the concept of clear reflection of income is not always susceptible to precise definition, for purposes of section 482, tranactions at arm's length will clearly reflect income. For example, if a loan is made by one controlled business to another at a rate above or below the safe harbor rates set forth in the regulations, but at a rate of interest that reflects the prevailing rates charged in similar transactions by unrelated businesses, section 482 will not apply.

Section 483

Section 483 generally provides that if the total deferred payments of the sales price under a contract for the sale or exchange of property includes any unstated interest, a portion of each deferred payment will be treated as interest instead of sales price (sec. 483(a)). In determining whether the total deferred sales price payments include any unstated interest, the total deferred payments of sales price are compared to the sum of the present values of such payments plus the present values of any stated interest payments due under the contract (sec. 483(b)). If the total deferred sales price payments exceed the total present values of sales price and stated interest payments, there is unstated interest.

The present value of a deferred payment is the amount that the parties would agree to pay and receive today instead of waiting for the deferred payment. The determination of this value depends on two factors. The first is the length of time until the deferred payment is to be made. The second factor is the interest rate that represents the value of money over that period. Present values are determined by discounting payments at an interest rate prescribed in regulations by the Secretary (sec. 483(b)). Under existing regulations, the interest rate used to determine whether there is unstated interest is 6 percent simple interest. This rate is referred to as the "test rate."

An example illustrates how the test rate is used to determine whether there is unstated interest. Assume real property is sold under a contract that requires a down payment plus a deferred payment of $100,000 together with $10,000 of stated interest, 2 years after the sale. In determining whether there is unstated interest, the total of deferred sales price payments required under the contract ($100,000) is compared to the present value of such deferred payments plus the present value of stated interest payments (*i.e.*, the present value of $110,000 which is $98,215). Because the portion of sales price deferred under the contract ($100,000) exceeds the present value of the deferred payments and stated interest payments under the contract ($98,215), there is unstated interest under the contract.

For purposes of determining how much of a deferred sales price payment is to be treated as interest, a calculation is made similar to the one used to determine whether there is unstated interest. The only difference is that the interest rate used is one percentage point higher than the test rate. This rate is referred to as the "imputed rate" and is 7 percent under existing regulations. As applied to the previous example, the portion of the $100,000 deferred sales price payment that will be treated as interest is the difference between the $100,000 and the sum of present values of the $100,000 payment and the $10,000 interest payment, discounted at 7 percent. The sum of the present values, discounted at 7 percent, is $95,858. Thus, $4,142 of the $100,000 deferred sales price payment will be treated as interest and $95,858 will be treated as sales price. The $10,000 stated interest is not affected by section 483. Thus, the total interest is $14,142 ($10,000+$4,142).

Section 483 generally applies only to those payments made under a contract for the sale or exchange of property that are made more than 6 months after the date of the sale or exchange, if at least one payment is due more than one year after the date of the sale or exchange. Section 483 does not apply to certain deferred payments under contracts for the sale or exchange of property, such as contracts with a sales price that cannot exceed $3,000, certain sales or exchanges of patents, and sales or exchanges that result only in ordinary income to the seller (sec. 483(f)).

The interest rates used to determine whether there is unstated interest and how much sales price is to be treated as interest must be prescribed in regulations by the Secretary. These interest rates have been adjusted periodically by the Treasury to reflect the prevailing rate of interest in the country.

When the Treasury establishes the test rate and imputed rate to be used under section 483, a single test rate and a single imputed rate are prescribed. Although prevailing interest rates depend on the location of the lender, the kind of property sold, or the credit worthiness of the borrower, the Code contemplates establishment of a single test rate and a single imputed rate. The legislative history indicates that the imputed rate provided under the regulations must reflect the going rate of interest that is not higher than the rate at which a person in reasonably sound financial circumstances and with adequate security could be expected to borrow from a bank. Under the statute, the test rate must be at least one percentage point lower than the imputed rate.

Consequences of applying sections 482 and 483

In general

There are several consequences to the buyer and the seller from treating part of the deferred payments of sales price as interest.

Buyer.—There are three main consequences for the buyer. First, the buyer has additional interest expenses which will be deductible. Second, the buyer's basis in the property is reduced to reflect the sales price as redetermined under section 482 or 483. Therefore, if the property is depreciable property, the buyer will have smaller allowable depreciation deductions, and if the buyer sells the property the basis for determining gain or loss will not include the imputed interest element. Finally, if the buyer is eligible for an investment tax credit, the qualified investment in the property (the amount used in determining the amount of the credit) is reduced to exclude the interest element. Under present law, the buyer will usually experience a net tax savings from an increase in the amount of a payment treated as interest.

Seller.—The effect on the seller is to reduce the gain (or increase the loss) on the sale or exchange and increase the amount of interest income. The net effect is to reduce the amount of capital gain recognized and recharacterize it as ordinary income. Since long-term capital gains are normally taxed at a lower rate than ordinary income, the seller would usually experience an increase in its tax liability.

Section 483 does not increase the total amount of sales price and interest payments made under a contract. Instead, part of the sales price is recharacterized as interest under the imputed rate, with the tax effects mentioned above.

Related party and intra-family transactions

In the case of a transaction between related taxpayers, sales prices below fair market value may raise other tax issues. For example, in a transaction between a corporation and one of its shareholders, the difference between the selling price and the property's fair market value could be considered a dividend or a capital contribution.

In a transaction between family members, a sale at less than fair market value or an interest-free purchase money mortage raises the issue of whether a gift has been made. In this regard, a taxpayer could argue that application of section 483 to the gift portion of a transfer is precluded by the statutory reference limiting section 483 to sales or exchanges of property.[1]

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[1] In *Fox* v. *United States*, 33 AFTR 2d 74–1118 (E.D. Pa. 1974), *aff'd*, 510 F.2d 1330 (3d Cir. 1975), the court held that section 483 was intended to apply in commercial settings and not to marital property settlements. On appeal, the Third Circuit affirmed the lower court decision by reasoning that section 483 which is general in its application did not override specific provisions of sections 71 and 215. The Internal Revenue Service has agreed with the Third Circuit's holding (Rev. Rul. 76–146, 1976–1 C.B. 144).

Such an argument would raise additional issues such as how to identify and value the gift portion of the transaction and how to apply section 483 to the remainder of the transaction. In addition, since section 483 may be relied on by taxpayers to recharacterize transactions, the Treasury may find taxpayers on different sides of the same transaction taking inconsistent positions. For example, in a sale of property by a parent to a child at its fair market value with no provision for interest, the parent might argue that a gift had been made of the interest (*i.e.*, no ordinary income to the parent), the child might rely on section 483 to impute interest (*i.e.*, a deduction from income for the child) and the Treasury might value the gift by relying on section 483 to recompute the purchase price and then treat the difference between the fair market value and the recomputed price as the gift.

Structuring transaction to avoid section 483

If taxpayers wish to avoid the imputation of interest at the imputed rate, they can structure the sale so that the stated interest rate is at least as much as the test rate under section 483, which is 1 percent lower than the imputed rate. The effect of increasing the stated interest rate depends on whether there is a corresponding reduction in sales price or simply an additional amount of interest charged. If there is a corresponding reduction in sales price, so that the total payments are not increased, the result is similar to that resulting from application of section 483 except that less of the sales price is converted to interest.

On the other hand, the total payments would be increased if the sales price were left unchanged and additional interest were charged. In this case, the seller would have additional interest income and no reduction in capital gain. The buyer would have additional interest expenses, but no reduction in basis for determining depreciation allowances, tax credits, or gain on later disposition. This type of structuring results in more income and more tax liability for the seller. The buyer incurs extra interest expenses and has extra interest deductions that provide some offset. This type of structuring might be preferred by related taxpayers who wish to avoid any possible gift issues raised by a reduction in sales price.

C. Issues Concerning Treasury Implementation

On August 29, 1980, the Treasury published proposed regulations to adjust the interest rates imputed under sections 482 and 483 to more accurately reflect market interest rates. Under the proposed regulations, the safe haven rule for loans and advances under section 482 would consist of a range from 11 percent to 13 percent per annum simple interest. If the interest charge is within this range, that the rate actually charged is presumed to be at arm's length. If the rate actually charged does not fall within this range and the taxpayer does not establish a more appropriate rate (i.e., an arm's-length rate), the interest rate imputed under section 482 would be 12 percent per annum simple interest.[2]

The interest rate imputed under section 483 on the sale of property subject to deferred payments would be 10 percent compounded-semiannually. The test rate used to determine whether the imputed rate will be applied would be changed to 9 percent per annum simple interest. The notice of proposed rule making states that the difference between the interest rates under sections 482 and 483 is explained by the fact that the 10-percent rate in section 483 is absolutely binding whereas the range of interest rates in section 482 is only a safe harbor. Therefore, the Treasury decided that the proposed regulations should take a more lenient approach under section 483 than under section 482.

In response to concerns raised by members of the Congress with respect to the proposed regulations, former Assistant Secretary of the Treasury Lubick agreed in a letter to Senator Melcher that no final action would be taken on the proposed regulations before July 1, 1981.

The Treasury also announced, as part of the notice of proposed rulemaking, its intention to consider whether the interest rates under sections 482 and 483 should be adjusted automatically in the future.

In addition to increasing concern over existing issues such as whether section 482 applies to intra-family transactions or whether section 483 should provide for an array of interest rates depending upon the kind of property sold or the seller's location, the notice raises several other issues.

The first issue is whether the same interest rate should apply for purposes of both section 482 and section 483. The Treasury proposed differing rates and justified these on the grounds that section 482 may be avoided by proof that the rate actually used is more appropriate whereas section 483 may not be avoided in that manner. On the other hand, it is not clear that lending transactions subject to section 482 differ enough from those subject to section 483 to predict that in arm's-

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[2] Under another proposed rule, section 482 would not apply to loans or advances, when the interest or principal amount is expressed in a foreign currency. This proposed change was not addressed by the Subcommittee's hearing announcement and is not described in this pamphlet.

length transactions higher rates would be charged in section 482 transactions.

If different rates are set, a second issue arises which is whether section 482, section 483, or both will apply in a transaction subject to both provisions. Existing regulations under section 482 provide that the treatment of unreleated taxpayers should govern related taxpayers. This implies that section 483 should apply. However, the section 483 regulations contemplate the application of other provisions in addition to section 483.

An added difficulty arises from the fact that under section 482 a taxpayer may prove that a rate below the safe haven rate is appropriate but is not permitted to prove the appropriateness of a lower rate for section 483 purposes. How these various provisions might be applied probably would depend on the particular case in which the issue arose. For example, a transaction using a rate lower than the section 482 rate but higher than the section 483 rate would be more likely to survive scrutiny under section 482 than one in which no interest is charged.

A third issue raised by the Treasury in the notice of proposed rulemaking is whether some system for automatically adjusting interest rates under sections 482 and 483 should be adopted. The Treasury has the authority to adopt such a system without additional legislation. Related to this issue are the questions of how closely interest rates under sections 482 and 483 should reflect market rates of interest charged with respect to such instruments as mortgages, Treasury bills, and corporate bonds.

In 1965, when the first regulations under section 483 were issued, the test rate was set at 4 percent and the imputed rate at 5 percent. At that time, the prime rate was approximately 4½ percent, mortgage rates were approximately 5½ percent, and government and corporate bond rates were approximately 4½ percent. In 1975, when the rates were last adjusted, the test rate was set at 6 percent and the imputed rate was set at 7 percent. At that time, the prime rate was at 7⅞ percent and corporate bonds were yielding 8½ to 9 percent.

II. CURRENT USE VALUATION (SECTION 2032A)

A. Legislative History and Background

In the case of decedents dying before January 1, 1977, the value of all property included in the gross estate, for purposes of determining the Federal estate tax, was the fair market value of the property interest at the date of the decedent's death (or at the alternate valuation date, if elected). The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of property will depend upon the use to which it is, or may be, put.

If the fair market value of real property is subject to dispute, there are several valuation techniques which the courts tend to accept. These methods include the income-capitalization technique, the reproduction-cost-minus-depreciation technique, and the comparative sales technique. Courts generally will use one of these methods, or a combination of these methods, in determining fair market value.

However, in the case of land, it is presumed that the price between a willing buyer and a willing seller will be based on the "highest and best use" to which that land could be put, rather than the current use of the land at the time it is transferred.

As part of the Tax Reform Act of 1976, Congress enacted a new section (sec. 2032A) that permits an executor to elect to value real property on the basis of the property's value as a farm or in a closely-held business [1] rather than on the basis of its highest and best use. This election is available to estates of decedents dying after December 31, 1976.

The legislative history of the Tax Reform Act of 1976 stated that the Congress believed 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 full fair market value since it is desirable to encourage the continued use of property for farming and other small business purposes. In some cases, the greater estate tax burden from valuing property at its highest and best use could make continuation of farming, or the closely-held business activities, infeasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell

[1] While the special valuation method provided by section 2032A is generally referred to in this pamphlet as "current use valuation method", it should be noted that, where the formula method (discussed below) is available, the value of real property under section 2032A may be (and often is) less than the current use value of the real estate.

the land for development purposes. Also, when the valuation of land reflects speculation to such a degree that the price of the land does not bear a reasonable relationship to its current earning capacity, the Congress believed it unreasonable to require that this "speculative value" be included in an estate with respect to land devoted to farming or closely-held businesses.

To date, the current use valuation provision has been used almost exclusively for the valuation of real estate used in the trade or business of farming. When estates are eligible for current use valuation, the benefits have been substantial. Table 1, below, sets forth the results of a survey by the Internal Revenue Service indicating the average reduction in value (*i.e.*, average discount) for farms eligible for current use valuation.

TABLE 1.—PERCENTAGE REDUCTION IN VALUATION OF FARM LAND UNDER CURRENT USE VALUATION IN DIFFERENT IRS REGIONS

	Percent
Midwest Region	
Springfield, Illinois	62
Chicago, Illinois	61
Des Moines, Iowa	50
Fargo, North Dakota	47
Milwaukee, Wisconsin	62
Omaha, Nebraska	45
St. Louis, Missouri	49
Aberdeen, South Dakota	47
St. Paul, Minnesota	47
Southwest Region	
Albuquerque, New Mexico	65
Oklahoma City, Oklahoma	64
Austin, Texas	67
Dallas, Texas	64
Wichita, Kansas	39
Cheyenne, Wyoming	71
Denver, Colorado	63
Little Rock, Arkansas	44
New Orleans, Louisiana	44
Southeast Region	
Greensboro, North Carolina	44
Jacksonville, Florida	65
Nashville, Tennessee	66
Atlanta, Georgia	43
Birmingham, Alabama	67
Columbia, South Carolina	57
Central Region	
Cincinnati, Ohio	57
Cleveland, Ohio	49
Detroit, Michigan	62
Indianapolis, Indiana	51
Louisville, Kentucky	51
Parkersburg, West Virginia	46
Mid-Atlantic Region	
Philadelphia, Pennsylvania	76
Newark, New Jersey	63
Baltimore, Maryland	60
Richmond, Virginia	55
Wilmington, Delaware	59
North Atlantic Region	
Albany, New York	23
Boston, Massachusetts	67
Brooklyn, New York	42
Buffalo, New York	46
Burlington, Vermont	68
Hartford, Connecticut	70
Manhattan, New York	39
Portsmouth, New Hampshire	32
Providence, Rhode Island	26
Western Region	
Boise, Idaho	52
Helena, Montana	47
Seattle, Washington	40
Portland, Oregon	57
Fresno, California (IRS Service Center)	55
Salt Lake City, Utah	46
Los Angeles, California	29
Phoenix, Arizona	59
San Francisco, California	40

Source: Treasury Department testimony of March 4, 1980, before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, based on IRS survey of November 1979 showing reduction in fair market value of property (as reported by executors) resulting from election of current use valuation.

B. Present Law

In general

If certain requirements are met, present law allows family farms and real property used in a closely-held business to be included in a decedent's gross estate at current use value, rather than full fair market value, provided that the gross estate may not be reduced more than $500,000 (sec. 2032A).

An estate may qualify for current use valuation if: (1) the decedent was a citizen or resident of the United States at his death; (2) the value of the farm or closely-held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable to the real and personal property), is at least 50 percent of the decedent's gross estate (reduced by debts and expenses); (3) at least 25 percent of the adjusted value of the gross estate is qualified farm or closely-held business real property;[2] (4) the real property qualifying for current use valuation must pass to a qualified heir;[3] (5) such real property must have been owned by the decedent or a member of his family and used or held for use as a farm or closely-held business ("a qualified use") for 5 of the last 8 years prior to the decedent's death; and (6) there must have been material participation in the operation of the farm or closely-held business by the decedent or a member of his family in 5 years out of the 8 years immediately preceding the decedent's death (secs. 2032A (a) and (b)).[4]

If, within 15 years after the death of the decedent (but before the death of the qualified heir), the property is disposed of to nonfamily members or ceases to be used for farming or other closely-held business purposes, all or a portion of the Federal estate tax benefits obtained by virtue of the reduced valuation will be recaptured by means of a special "additional estate tax" imposed on the qualified heir.

Requirement that farm must "pass" to qualified heir

Under the fourth requirement, above, the real property must have been acquired from or passed from the decedent to a qualified heir. Section 2032A(e)(9) provides that the real estate is considered to pass

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[2] For purposes of the 50 percent and 25 percent tests, the value of property is determined without regard to its current use value.

[3] The term "qualified heir" means a member of the decedent's family, including his spouse, lineal descendants, parents, and aunts or uncles of the decedent and their descendants.

[4] In the case of qualifying real property where the material participation requirement is satisfied, the real property which qualifies for current use valuation includes the farmhouse, or other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use.

to a qualified heir when the property receives a stepped-up basis under present law (sec. 1014(b)). Under these rules, property which is purchased from a decedent's estate is not considered to have passed from the decedent to a qualified heir and is not eligible for current use valuation.

The legislative history of the 1976 Act stated that property passing in trust is considered to pass to a qualified heir to the extent that the heir receives a present interest in the trust.[5] The Treasury Department has interpreted this requirement to provide that, unless a qualified heir receives a present interest and that interest is specially valued, no other interests in the same property are eligible for current use valuation (Treas. Reg. § 20.2032A-3(b)). In addition, the Treasury regulations define the term "present interest" by reference to the gift tax definition of that term under section 2503 (Treas. Reg. § 20.2032A-3 (b)(1)). That definition is used to determine whether a $3,000 per donee annual exclusion from gift tax is available. Under this definition, trust interests which are subject to the trustee's discretion are not present interests. This is true even if all such interests belong to qualified heirs.

Requirement that property must be used for a qualified use

Under the fifth requirement, above, current use valuation is available only for real property that is used in a qualified use. A qualified use is a use as a farm for farming purposes or in a trade or business other than the trade or business of farming (secs. 2032A(b)(2), (3) and (4) and 2032A(e)(5). Although the Code requires that the property be used in a trade or business, it does not indicate who must be engaged in that trade or business. The Treasury regulations interpret the trade or business requirement to mean that the decedent-owner (rather than the family member that materially participates in the operation of the trade or business) must be engaged in the trade or business. (Treas. Reg. § 20.2032A-3(b)). This interpretation is supported by statements in the legislative history that current use valuation was not intended to be available for a use that was a "mere passive rental." [6]

General tax principles require that a person have an equity interest in a trade or business for that person to be considered engaged in that trade or business, and the Treasury regulations so require. Subsequent IRS rulings define an equity interest as an arrangement under which the owner's return on the land is contingent on farm production. Under this interpretation, current use valuation would not be available when the decedent leased the farmland on a net cash lease basis. This would be true regardless of whether the cash lease was to immediate family members, distant relatives, or third parties.

Material participation requirement

Under the sixth requirement above, current use valuation is available for real property only when the decedent or a member of his family materially participated in the operation of a farm or other trade or business in connection with that real property. The term "material

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[5] S. Rep. No. 94-1236 (94th Cong., 2d Sess.), p. 610.
[6] H.R. Rep. No. 94-1380 (94th Cong., 2d Sess.), p. 23.

participation" is defined in section 2032A(e)(6) by reference to the tax on self-employment income (sec. 1402(a)). Under the self-employment income tax rules, the determination of whether material participation occurs is based on the facts of each case. Material participation does require assumption of a role in the business operation by the participant, even though relatively little activity is necessary to satisfy the test.

The adoption by the Code of the material participation test for determining eligibility for current use valuation interacts with the social security laws. Under the social security laws, eligible benefits are reduced when the individual has earned income in excess of a specified amount. The social security laws also use the material participation test to determine whether income is earned (and, thus, reduces benefits) or is passive. Thus, if an individual engages in sufficient activity to meet the material participation test in order to qualify for current use valuation, the income he derives from the trade or business would be considered earned and might reduce the amount of his social security benefits.

Determination of current use value

Under present law, the current use value of eligible real estate can be determined under either of two methods: (1) the multiple factor method or (2) the formula method.

Multiple factor method.—The current use value of all qualified real property may be determined under the multiple factor method (sec. 2032A(e)(8)). The multiple factor method takes into account factors normally used in the valuation of real estate (for example, comparable sales) and any other factors that fairly value the property.

Formula method.—If there is comparable land from which the average annual gross cash rental may be determined, then farm property may also be valued under the formula method (sec. 2032A(e)(7)(A)). Under the formula method, the value of qualified farm property is determined by (1) subtracting the average annual State and local real estate taxes for the comparable land from the average annual gross cash rental for comparable land used for farming, and (2) dividing that amount by the average annual effective interest for all new Federal Land Bank loans.[7]

If the formula method is used, the Treasury regulations require that the executor document the actual tracts of cash-rented land upon which he relies. (Treas. Reg. § 20.2032A-4(b)(2)(1)). The Treasury Regulations provide that comparability has the meaning generally ascribed to it under real property valuation rules (Treas. Reg. § 20.2032A-4(d)). Thus, the determination of properties which are comparable is a factual one that must be based on numerous factors, no one of which is determinative. The Treasury regulations then provide that it frequently will be necessary to value farm property in segments where there are different uses or land characteristics included in the specially valued farm. For example, if the formula

[7] Each average annual computation must be made on the basis of the five most recent calendar years ending before the decedent's death.

valuation method is used, rented property on which comparable buildings or improvements are located must be identified for specially valued property on which buildings or other real property improvements are located.

In cases involving areas of multiple land characteristics, actual comparable property for each segment must be used, and the rentals and taxes from all such properties combined (using generally accepted real property valuation rules) for use in the formula method given in this section. However, any premium or discount resulting from the presence of multiple uses or other characteristics in one farm is also to be reflected. All factors generally considered in real estate valuation are to be considered in determining comparability under section 2032A. The Treasury regulations provide the following list of factors to be considered in determining comparability—

(1) similarity of soil as determined by any objective means, including an official soil survey reflected in a soil productivity index;

(2) whether the crops grown are such as would deplete the soil in a similar manner;

(3) the types of soil conservation techniques that have been practiced on the two properties;

(4) whether the two properties are subject to flooding;

(5) the slope of the land;

(6) in the case of livestock operations, the carrying capacity of the land;

(7) if the land is timbered, whether the timber is comparable to that on the subject property;

(8) whether the property as a whole is unified or whether it is segmented, and where segmented, the availability of the means necessary for movement among the different segments;

(9) the number, types, and conditions of all buildings and other fixed improvements located on the properties and their location as it affects efficient management and use of property and value per se; and

(10) availability of, and type of, transportation facilities in terms of costs and of proximity of the properties to local markets.

The Treasury regulations provide that crop share rentals may not be used under the formula method. Consequently, under the regulations, if no comparable land in the same locality is rented solely for cash, the formula method may not be used and the qualified farm property may be valued only by the multiple factor method.

C. Issues Involving Treasury Implementation

Several issues have arisen in the Treasury implementation of section 2032A. Among these are the following:

(1) Whether the definition of "present interest" contained in the Treasury regulations is a proper interpretation of the law.

(2) Whether the Treasury Department's definition of "qualified use" correctly implements the law when applied to cash leases by the decedent to family members.[8]

(3) Whether the Treasury is justified in interpreting the formula valuation method so as to disallow the use of cash equivalents for crop share rentals.[9]

(4) Whether the standards set forth in the Treasury regulations for determining when land is comparable provide adequate guidance or are too burdensome administratively.

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[8] This issue is addressed in several bills introduced in the Senate during this Congress. *See*, S. 392 (sponsored by Senator Riegle and Senator Eagleton), S. 395 (sponsored by Senator Wallop and 29 others), and S. 612 (sponsored by Senator Boschwitz and 9 others). Additionally S.J. Res. 204, passed in December 1980, initially would have prohibited the Internal Revenue Service from enforcing its regulation in respect of cash leases to family members. This prohibition was deleted from the final version of the resolution.

[9] S. 23 (sponsored by Senator Dole and 2 others), S. 392, and S. 395 would allow use of net crop share rentals in the formula.

III. DATA ON FARM REAL ESTATE FINANCING

Federal Land Banks

Federal land banks were the source of an average of 34 percent of the total borrowed farm real estate purchase money between 1977 and 1980. The twelve Federal land banks were established in 1916. Initially capitalized by the Federal Government, this "seed money" was repaid by 1947, and the banks became owned by their borrowers.

Loans are made through more than 500 local Federal land bank associations. Both the banks and the associations are chartered by the Federal Government and are subject to the supervision of an independent Federal agency, the Farm Credit Administration. The banks, however, do not lend Government funds nor are their loans guaranteed by the Government.

The Federal land banks may make loans ranging from five to forty years. The security is usually a first lien on the real estate or its equivalent. Loans can be made to farmers or ranchers; legal entities such as partnerships, corporations, or other types of organizations legally authorized to engage in the business of farming and ranching; farm-related business; and non-farmer rural residents.

Farmers and ranchers may obtain loans for any agricultural purpose and for other requirements. All loans made by the Federal land banks carry a variable interest rate. Rates charged borrowers are dependent on what the banks must pay investors to purchase their bonds, the chief source of the banks' loan funds.

Nearly all of the banks' loan funds come from the sale of securities to investors in the nation's money markets. These securities are backed by the mortgages held by the banks and by their net worth.

Selected Farm Real Estate Financial Data

Table 2 presents a comparison of average interest rates charged by certain farm real estate lenders for 1977–1980 and the prime non-farm rate charged by banks. Table 3 lists the primary sources of farm real estate purchase money (percentages) for 1977–1981 (Jan.)

TABLE 2.—AVERAGE INTEREST RATES CHARGED BY CERTAIN FARM REAL ESTATE LENDERS, 1977–1980

[In percent]

	1977	1978	1979	1980
Federal land banks [1]	8.25	8.56	9.55	[2] 10.48
Life insurance companies	9.33	9.58	10.52	[3] 13.35
Commercial banks [4]	9.20	9.44	13.37	17.20
Farmers' Home Administration [5]	5.00	5.30	7.30	8.20
Prime rate (nonfarm) charged by banks [6]	6.83	9.06	12.67	15.27

[1] Rate shown was a national average of that charged for the month of December of the year shown.

[2] August 1980 rates (the month in which the proposed Treasury regulations were issued) averaged 10.56 percent.

[3] Based on data for the 1st 6 months of 1980 only.

[4] Source: *Agricultural Finance Datebook*, Board of Governors, Federal Reserve System, January 1981.

[5] The President has proposed certain budget changes that would result in all Farm Home Administration loan rates raising to the level of interest earned on Treasury bills.

[6] Source: Council of Economic Advisors, *Economic Indicators.*

TABLE 3.—SOURCES OF FARM REAL ESTATE PURCHASE MONEY, 1977–1981

[In percent]

Source	1977	1978	1979	1980	January 1981 (estimate)
Federal land banks	32.6	33.6	34.1	36.1	38.0
Life insurance companies	13.1	13.9	14.1	14.8	13.4
Commercial banks	12.0	12.2	11.8	10.5	9.0
Farmers' Home Administration	6.5	6.3	5.7	8.0	9.4
Individual and others	35.8	34.0	34.3	30.6	30.2
Total	100.0	100.0	100.0	100.0	100.0

Source: *Farm Real Estate Debt*, Farm Credit Administration, 1980. *Agricultural Finance Outlook*, U.S.D.A., November 1980 (1981 estimates).

NOTE.—Details may not add to totals due to rounding.

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