IRS REGULATIONS INCREASING IMPUTED INTEREST RATES AND INTERPRETING ESTATE TAX LAW CONCERNING VALUATION OF FAMILY FARM AND OTHER BUSINESS PROPERTIES

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

FIRST SESSION

APRIL 27, 1981

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IRS REGULATIONS INCREASING IMPUTED INTEREST RATES AND INTERPRETING ESTATE TAX LAW CONCERNING VALUATION OF FAMILY FARM AND OTHER BUSINESS PROPERTIES

MONDAY, APRIL 27, 1981

U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT OF
THE INTERNAL REVENUE SERVICE
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 1 p.m., in room 2221, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the subcommittee) presiding.

Present: Senators Grassley, Durenberger, Byrd, and Bentsen.

[The committee press release, the background on regulations under sections 482, 483, and 2032A of the Internal Revenue Code and the prepared statement of Congressman Tom Daschle follow:]

Press Release No. 81- 119

PRESS RELEASE

FOR IMMEDIATE RELEASE
April 1, 1981

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Oversight of the Internal Revenue Service
2227 Dirksen Senate Office Bldg.

FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE SETS HEARING ON REGULATIONS INCREASING IMPUTED INTEREST RATES AND INTERPRETING ESTATE TAX LAW CONCERNING VALUATION OF FAMILY FARM AND OTHER BUSINESS PROPERTIES

Senator Charles E. Grassley, Chairman of the Subcommittee on Oversight of the Internal Revenue Service of the Senate Committee on Finance announced today that the Subcommittee will hold a hearing on Monday, April 27, 1981, on recent IRS regulations under Internal Revenue Code sections 482, 483, and 2032A which may have a substantial impact on family farms and other family businesses.

In announcing the Subcommittee hearing, Senator Grassley noted that many members of the public have maintained that these regulations may be adding restrictions and additional tax liabilities not intended by Congress.

Proposed regulations under section 482 would, in certain circumstances, allow the IRS to assume an interest rate of 12% on loans between related entities if interest is not charged at a rate between 11 and 13%. Proposed regulations under section 483 would allow the IRS to assume an interest rate of 10 percent if property is sold on an installment basis with a contract rate of less than 9 percent. This imputed interest rule has the effect of characterizing part of the sales price of property as interest taxable to the seller as ordinary income, rather than capital gain, and creating a corresponding interest paid deduction for the buyer.

Final regulations under section 2032A, adopted July 28, 1980, specify circumstances under which real property used for farming or in other family business use may be valued for estate tax purposes on the basis of the property's actual use. Generally, under the estate tax provisions, property is valued at its "highest or best" use. Section 2032A was enacted in 1976 to reduce estate taxes on farm and business property to help heirs keep the farm or other business within the family.

The Senator stated, "The Subcommittee has a responsibility to review the implementation of these areas of the tax law to make certain that administrative rules do not create tax burdens on family farms and businesses not justified by reasonable interpretation of Internal Revenue Code or legislative history."

Requests to Testify. Witnesses who desire to testify at the hearing on April 27, 1981 must submit a written request to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, to be received no later than noon on April 20, 1981. Witnesses will be notified as soon as practicable thereafter whether it has been possible to schedule them to present oral testimony. If for some reason a witness is unable to appear at the time scheduled, he may file a written statement for the record in lieu of the personal appearance. In such case a witness should notify the Committee of his inability to appear as soon as possible.

Consolidated testimony. Senator Grassley urged all witnesses who have a common position or with the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Subcommittee. This procedure will enable the Subcommittee to receive a wider expression of views than it might othewise obtain. Senator Grassley urged very strongly that all witnesses exert a maximum effort to consolidate and coordinate their statements.

Legislative Reorganization Act. Senator Grassley stated that the Legislative Reorganization Act of 1946, as amended requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed not later than noon on the last business day before the witness is scheduled to appear.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by noon on Friday, April 24, 1981.

(4) Witnesses should not read their written statements to the Subcommittee, but ought instead to confine their oral presentations to a summary of the points included in the statement.

Written statements. Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record on the hearings. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510, not later than Monday, May 11, 1981.

P.R. # 81-119

[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

APRIL 23, 1981

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1981

JCS-12-81

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)

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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.

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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]

[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-

[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.

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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

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[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

Midwest Region	*Percent*
Springfield, Illinois	62
Chicago, Illinois	61
Des Moines, Iowa	50
Fargo, North Dakota	47
Milwaukee, Wisconsin	62
Omaha, Nebraska	65
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	*Percent*
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

[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

[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.

Statement of Congressman Tom Daschle

before the

Subcommittee on Oversight of the Internal Revenue Service
Senate Committee on Finance

April 27, 1981

Mr. Chairman, I appreciate this opportunity to testify before the Oversight Subcommittee this afternoon on the subject of imputed interest rates and specifically the regulations which were proposed by the Internal Revenue Service on August 29, 1980, which would substantially increase the rate of interest imputed under sections 482 and 483 of the Internal Revenue Code of 1954. The Subcommittee has many issues before it for consideration and many witnesses who wish to testify and accordingly my statement will be brief.

Soon after the Internal Revenue Service proposed new regulations last August under sections 482 and 483 of the Internal Revenue Code, there was a spontaneous groundswell of public opposition to the proposed regulations. This opposition was not, as some have suggested, without foundation or merit. Rather, this opposition was the result of the public's examination of the proposed regulations and represented an unequivocal expression of the public's understanding of the adverse consequences which would result from the adoption of the regulations as proposed.

The Internal Revenue Service had proposed the regulations issued under section 482 and 483 would become effective on August 29 and September 29, 1980, respectively. Fortunately, our good friend and colleague, the senior Senator from Montana, was successful in persuading former Assistant Secretary of the Treasury Lubick to delay implementation of the proposed regulations until July 1, 1981, to afford appropriate committees of the Congress the opportunity to examine the proposed regulations. Your decision, Mr. Chairman, to convene this hearing today for the purpose of reviewing the proposed regulations is very much appreciated.

Sales or exchanges of property where payments are deferred for more than one year from the date of sale are subject to the provisions of section 483. Under this section, an interest element to be taxable at ordinary income rates is imputed as a part of the payment if no interest is specified in the sales agreement or if the stated rate of interest is less than the interest rate prescribed by the Commissioner of the Internal Revenue Service.

Under current regulations, the interest rate to be imputed under section 483 is 7% and the so-called test rate used to determine if unstated interest income exists is 6% simple interest. Under the proposed regulations, the interest rate to be imputed under section 483 is 10% which is a 42.9% increase in imputed interest rate and a 66.6% increase in the interest rate to be imputed compared to the current test rate.

What is the consequence of increasing the imputed interest rate to 10% for transactions to which section 483 is applicable? If the interest rate stated in the sales contract does not satisfy the interest rate requirement established by the Commissioner, the interest rate prescribed by the Commissioner is imputed. Consequently a higher interest rate becomes institutionalized and for these transactions a 10% interest rate becomes the interest rate floor.

What is the consequence of an imputed interest rate, an interest rate floor, of 10% for these transactions? As an example of the consequence, assume an Iowa or South Dakota farmer is retiring and offers his farm for sale at fair market value and the sales contract provides for deferred payment and the stated rate of interest is 8%. The proceeds of the sale will provide for the seller's retirement. This is a customary practice for the sale of farmland and a customary use of sale proceeds.

A willing buyer, after estimating return on investment, determines the financial obligation he is assuming under the terms of the contract is the maximum financial obligation which he can successfully assume.

However, the interest rate to be imputed on this transaction is now 10%. What are the options available to the seller? The options unfortunately are few and none are desirable. For example, the seller could possibly defer retirement until such time as a buyer is able to successfully assume the financial obligation resulting from a fair market value purchase price and 10% interest. Or the seller could simply choose to ignore the dictates of a 10% imputed interest rate. Alternatively, it will be suggested, the seller could simply reduce the selling price to less than fair market value in order to comply with the 10% interest rate dictum so that the financial obligation of the buyer would not exceed the maximum financial obligation which he could successfully assume.

These are the options available to the seller, Mr. Chairman, and all are detrimental to him. In many cases the seller can simply not choose to defer retirement. There are extenuating circumstances which make retirement involuntary. If the seller chooses to ignore the 10% imputed interest rate requirement, future imputation of the 10% interest rate by the Internal Revenue Service will effectively reduce retirement income of the seller as a greater share of sale proceeds is characterized as interest income. The alternative of a sale price below fair market value similiarly reduces retirement income as a greater share of sale proceeds is interest income and additionally there could be an effort to categorize the difference between sale price and fair market value as a gift made by the seller to the buyer.

The consequences of a 10% imputed interest rate in this example are either an involuntary delay in retirement or reduced retirement income. Neither of these consequences was the intent of the Congress.

Perhaps the proposal to increase the interest rate imputed under section 483 is a reflection of official concern about the possibility of sellers attempting to decrease tax liability on sale proceeds by understating interest income on the sale of agricultural land. If Internal Revenue Service officials have such a concern, the concern is wholly unjustifiable. Available information unequivocally shows there is no such effort. The results of a U.S. Department of Agriculture survey indicate an interest rate of 8.3% and 8.7% on seller-financed agricultural land sales during the first and third quarters of 1979. If sellers had attempted to lessen interest income on these sales, the interest rate on seller-financed sales during both periods would have been 6%, the so-called test rate according to current regulation which would have been used during both periods to determine if interest income had been understated.

What is the consequence of the proposed 10% imputed interest rate for the buyer? If the seller asks fair market value and the stated rate of interest is sufficient to satisfy the regulatory requirements of the Internal Revenue Service, the buyer may either be unable to afford the purchase price or subsequently be unable to satisfy the financial obligations of the sales contract. The consequence of the higher imputed interest rate is therefore to foreclose agricultural land purchase opportunities. In this context, it is important to note individuals and others, notably merchants and dealers, provided between 30.6% and 35.8% of farm real estate purchase money for the four year period 1977 through 1980 and as noted earlier, the interest rate on seller-financed agricultural land sales during the first and third quarters of 1979 was 8.3% and 8.7%, respectively, which compares to the December, 1979 average interest rate of 10.53% and 13.37% charged by farm real estate lenders like life insurance companies and commercial banks. Additionally, Mr. Chairman, it should be recognized the 10% imputed interest rate which has been proposed under section 483 exceeds the 8.2% interest rate charged by Farmers Home Administration in December, 1980.

These adverse consequences which will result from the adoption of the August 29, 1980 regulations as proposed will certainly not be limited to agricultural real estate sales. Other property sales where deferment of payments for more than one year from the date of the sale is also customary, such as the sale of small businesses and homes, will similiarly be adversely impacted if the regulations in question are adopted as proposed.

In conclusion, Mr. Chairman, I would like to share with the members of the Subcommittee the accurate characterization by one of my constituents of one of the most glaring deficiencies of the proposed regulations. In a recent letter to me, my constituent said, "To adopt one rule for a country of 50 different states with varying economic conditions and with completely different land values and market values is, to say the least, absolutely absurd. There is absolutely no comparison between the land values on the east coast, the land values on the west coast and the land values in the upper central plains states. The standard living is completely different, the availability of money completely different, and the population size demanding the money is grossly different." This assessment addresses the heart of the problem.

I hope my testimony before the Subcommittee this afternoon has been helpful to the Subcommittee and as the author of H.R. 953, the House companion to S. 164 authored by Senator Melcher, which would prohibit the adoption of the regulations as proposed, I hope the Subcommittee will give this matter expedited consideration.

Senator GRASSLEY. I would like to call to order the hearing session we have called for today, a meeting of the Subcommittee on IRS Oversight, of the Committee on Finance.

At this time, I would like to thank my colleagues in the Senate and the House, the administration representatives, and our panels for contributing to the discussion of these important issues. They have a dramatic impact on agricultural America.

The regulations promulgated under sections 482, 483, and 2032(a) have been widely criticized as violating the true intent of Congress.

In some cases, the interpretation of these statutes has caused serious hardship for individuals who are Congress intended beneficiaries.

It is my hope that this oversight hearing will focus on the difficulties that members of the agricultural community are encountering with these regulations.

I think I can safely say that all of my colleagues on this subcommittee are anxious to hear the position of the new administration on these controversial regulations.

We are fortunate to have on our subcommittee, Senator Dole, the chairman of the Committee on Finance.

I am sure Chairman Dole would appreciate hearing the concerns of Members of Congress, and others, and knowing whether or not the administration is having difficulties interpreting congressional intent.

If the administration needs clarification from Congress on certain passages within these code sections, I am sure that the subcommittee will keep these points in mind for the attention of the full committee.

After the administration panelists present their views, representatives of various sectors of the agricultural community will present their views on the regulations on imputed interest, on installment sales transactions and the special use valuation.

Among these commentators will be two individuals from Iowa and Kansas who have been directly affected by the operations of these regulations.

Bob Furleigh is a farmer from my home State of Iowa who may not qualify for special use valuations under the present regulations.

Philip Ridenour is an attorney from Kansas, who attempts to guide his agricultural clients through the highly technical requirements of these regulations.

We are also fortunate to have an excellent sampling of expert opinion from distinguished professors, State administrators, professionals specializing in these issues, and agriculturally related organizations.

Again, the other members of the subcommittee and I appreciate the interest of all of you who have shown an interest in resolving the difficulties surrounding these regulations.

Unfortunately, the ranking minority member of this subcommittee, Senator Baucus, was unable to attend this meeting, but stressed the importance of resolving the troublesome points within these regulations.

Without further delay, I would welcome our first panelists from the administration, Roscoe L. Egger, Commissioner of Internal Revenue, and Hon. John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy.

I did not see Senator Melcher or Senator Andrews, who I know well enough to identify immediately, but I'm afraid I'll have to ask if Representative Daschle is here?

What we are going to do sir, for the Senators, when they show up, I—we will stop this presentation and the questions when our colleagues from both the House and Senate arrive.

So, at this point, I would like to welcome Roscoe and John to the witness table. I would like to say, as is the usual procedure, your statements will be made a part of the record. You are welcome to summarize. You may proceed as you would like.

In welcoming you here, I hope to stress one of the goals of this subcommittee—bringing greater understanding between the Congress and the Internal Revenue Service. If we could restate what congressional intent is and an appreciation on our part of how you interpret law, as is your constitutional and statutory prerogative.

I would also hope we can create a mutual understanding of what your interpretation of the law is and what we think congressional intent is. If we accomplish this, I think we can instill respect for Congress and respect for the IRS from the citizenry at large. More importantly, this effort will reestablish the credibility of Government with the public at large.

Our final goal must be to preserve the system of voluntary compliance. We have to reestablish that voluntary reporting and treatment of the whole process or otherwise, it is just simply going to cause our system of taxation to drop.

Regardless of how great the political power, pressure and police action of an individual Government, it still remains a poor substitute for voluntary cooperation.

Before you proceed, I would like to ask my dear colleague from Texas, Senator Bentsen, if he wants to make any opening statement. You are the first one from our body to appear here. We have a couple who are going to testify. I would like to ask you for any remarks or opening statement you have to make prior to our first witness.

Senator BENTSEN. Thank you, Mr. Chairman.

I just have a deep interest in the subject. I am pleased to participate with you.

Senator GRASSLEY. Thank you.

Senator BENTSEN. I just congratulate you on holding the hearings.

Senator GRASSLEY. Thank you, Senator.

Will both of you be speaking or will one of you be speaking, at least initially?

Mr. EGGER. Both of us, Mr. Chairman.

Senator GRASSLEY. I will say you may proceed however you want to proceed.

STATEMENT OF HON. ROSCOE L. EGGER, COMMISSIONER OF INTERNAL REVENUE

Mr. EGGER. I will proceed first on our statement with regard to sections 482 and 483.

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Mr. Chairman, we are pleased to appear before you today, to discuss the proposed imputed interest regulations under sections 482 and 483.

We would like to take this opportunity to present the results of the review by the Treasury Department and the Internal Revenue Service of these regulations.

At the outset, however, we would like to correct a fundamental misunderstanding that has permeated all aspects of the debate over these regulations.

The Internal Revenue Service has received a large number of comments on these proposed regulations from farmers and other groups.

The majority of these comments are based on an erroneous understanding of how section 483 operates. The comments assume that by providing higher imputed interest rates for deferred payment sales for tax purposes, the proposed regulations would require higher amounts to be paid by purchasers of property.

In fact, section 483 does not affect the amounts paid by the purchaser for the property. It affects only the characterization of these amounts as principal or interest for Federal tax purposes.

Let me illustrate this point with a simple example. Assume I sell a farm to you for $1 million, and the contract of sale provides you will pay $100,000 each year, for ten years. The contract specifies that no interest will be charged.

Section 483 provides that in this situation, some portion of each $100,000 payment will be interest for Federal income tax purposes. The remaining portion will be considered to be a payment of principal.

Despite the application of section 483, you would continue to pay $100,000 each year for ten years, for a total of $1 million. Section 483 does not require that you pay more.

To the extent interest is imputed, I would have interest income for Federal income tax purposes. You would have an interest deduction in the same amount. My gain on the sale and your basis in the farm will be based on the portion of the $1 million representing principal, not the entire $1 million.

Thus, I would have less gain or more loss, and you would have a lower basis in the property than if no interest were imputed at all.

Most of the specific criticisms of the proposed regulations arise from this misunderstanding. For example, it has been asserted that the proposed rates would make it more difficult for young people to purchase farms or homes by increasing monthly amortization payments due to higher interest costs; that the proposed rates are inflationary and would institutionalize higher interest rates; and that the proposed rates would further depress the already seriously depressed housing and real estate industries.

These assertions are all based on the underlying assumption that section 483 actually increases the amounts to be paid under deferred payment sales contracts. As I have indicated, section 483 affects only the characterization of these amounts as interest or principal for Federal income tax purposes.

Thus, these criticisms are misdirected.

I would like now to explain the background of the proposed changes in the regulations under sections 482 and 483, and to set forth the results of our review of these changes.

The principle that the imputed interest rates under sections 482 and 483 should reflect market interest rates has long been a part of the law.

The legislative history of section 483 indicates that its purpose is to prevent a seller of property from manipulating the tax consequences of the sale by increasing the amount of deferred payments for property in lieu of interest. Section 483 directs the Treasury Department to set an appropriate minimum interest rate for these deferred payment sales in order to prevent this abuse. The legislative history of section 483 anticipates that the rate 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 from a bank,

The general purpose of section 482 is to prevent taxpayers from avoiding tax by conducting transactions between commonly controlled trades or businesses on non-arm's length terms.

Specifically, the section 482 regulations have for years provided that taxpayers cannot avoid tax by charging an interest rate very different from the normal market rate on loans between commonly controlled businesses.

In view of the disparity between the current market interest rates and the 7 percent rates imputed under the existing regulations where at least 6 percent interest is not charged, we believe it is necessary to adjust the existing imputed interest rates to bring them more in line with current market rates.

We have therefore concluded that the final regulations will provide, in general, that the minimum interest rate that must be charged under section 483, to prevent imputed interest, is 9 percent, and that the minimum rate that must be charged under section 482 is 11 percent.

These rates are unchanged from those in the proposed regulations. In the event the literal terms of both sections 482 and 483 are met in the same transaction, however, section 483 will be deemed to be controlling.

Senator GRASSLEY. May I interrupt you at this point?

Mr. EGGER. Yes, Mr. Chairman.

Senator GRASSLEY. Senator Andrews from North Dakota has appeared. We had an agreement with the administration witnesses that if either you, Senator Melcher, or Congressman Daschle showed up, that they would let us interrupt since they are on a busy schedule.

So, Senator Andrews, I would like to have you come forth. Just stay where you are, please.

Senator Andrews, I appreciate your testimony. I won't go through the usual complimentary statements that Senators are supposed to make to one another in the interest of efficiency and time.

Will you proceed?

STATEMENT OF HON. MARK ANDREWS, U.S. SENATOR FROM THE STATE OF NORTH DAKOTA

Senator ANDREWS. Well, for not having made those complimentary remarks, you might be in trouble because we are marking up the farm bill right now. [Laughter.]

Senator GRASSLEY. Well, I have no doubt that you are going to take care of our interests.

Senator ANDREWS. You can revise and extend your remarks, Mr. Chairman. I certainly appreciate your making time for me and this panel. I am pleased to learn that you scheduled oversight hearings on two agricultural tax issues that could have quite a negative impact on farm families in rural areas of the Nation.

It seems to be a tossup as to which of these two regulations being promulgated by the IRS would have the more severe impact.

I have contacted IRS to express my concern over both issues.

I have also cosponsored legislation, with many of you on the Finance Committee, to prohibit the adoption of these proposed regulations.

With respect to the proposal to increase the interest rates imputed under sections 482 and 483 of the Internal Revenue Code, I cosigned a letter to Secretary Regan, on March 13, with several of my colleagues, who like me, are concerned about the effect these regulations would have on the farming community.

We asked the Secretary to consider withdrawing the regulations. In the letter we pointed out that withdrawal of the proposed regulations would provide an excellent opportunity to demonstrate the administration is serious about setting a new tone and direction in tax policy and in the use of regulatory authority.

To date, frankly, I have not received any reply to this request. It concerns me a lot that we can't get a reply any sooner than this from a member of the President's Cabinet on an issue that could have such a devastating impact on the farming population.

The letter to the Secretary fully outlined the concerns over the potential impact of the regulations that have been expressed to me by farmers, farm organizations, and small business people.

My main concern with the regulations is the impact they would have on the beginning farmer who is ready to take over the family farm.

It is my understanding that under the proposed regulations, higher interest rates would be required on loans for the sale of property to a family member, than on loans to a nonfamily member. This doesn't make good sense, but it is a darn good way to further jeopardize the continuance of family farming.

I think actually, if I might say, Mr. Chairman, the total disregard of the Secretary of the Treasury to answer a letter from a number of Senators really appalls me. If they are going to be a responsive and open administration, they can at least understand that we wouldn't have sent the letter if we weren't deeply concerned.

If they can't give an answer, perhaps they recognize how totally off-the-wall this proposal is. But, I would hope, Mr. Chairman, that you might, as a member of the Finance Committee, get an answer where we have not been able to.

I am equally concerned about another regulation the IRS would like to see enforced concerning valuation of farm property for estate tax purposes.

Being a strong promoter for estate tax reform ever since coming to Congress, some 18 years ago, I was pleased back in 1976 that we were able to change the law by adding the farm use valuation provisions now known as section 2032(a) of the Internal Revenue Code.

As you know, this provision allows farms, for estate tax purposes to be valued on the basis of productive farm capacity, rather than a prevailing market price, which so often is more a hedge against inflation than a figure that reflects the actual earning potential of it as a piece of farm land.

Congress also recognized back then, that if we failed to enact this type of provision, we were about to witness yet a further decline of a very important economic segment of our population, our family farms.

Not surprisingly, however, the Internal Revenue Service has chosen to interpret this legislation in its usual narrow fashion by issuing regulations disallowing the productive farm capacity valuation if the farm had been cash rented previously.

They don't seem to understand or maybe don't care that cash renting is the usual way of handling a farm business between father and son or two other relatives.

I would suspect, Mr. Chairman, in Iowa as it is in North Dakota, if you are young and starting out and your grandparents have a piece of land you have grown up on and those grandparents are in their sixties or their seventies they arrange a cash rent basis between themselves and you. This is typical. This is normal. This is accepted. This is the way farm families operate. That is why Congress set the bill up that way.

If this system is subjected to a punishing tax, it is going to be flying in the face of congressional intent, and flying in the face of everything that represents normality in farm family transactions.

There is no question in my mind that Congress clearly intended that passive (cash) rental, to a relative, would qualify the estate for 2032(a) valuation, as long as other requirements of this section were met.

I am cosponsoring legislation with Senator Boschwitz, which clearly states that qualified use may be performed by the member of the decedent's family or the decedent.

The Senator was successful in getting an identical amendment to the continuing resolution passed last December, in the Senate, but it was later dropped during the dispute over congressional pay raises.

As a Member of the House, last year, I was responsible in the House Appropriations Committee for including continuing resolution report language prohibiting the IRS from spending any funds to implement this regulation, according to their interpretation of qualified use.

So both Houses have spoken to this issue and have spoken quite clearly.

Based on what I believe to be the congressional intent of these two sections of the law, I would like to see these regulations withdrawn.

If this is not the view of the IRS, I see no other alternative than to make sure we pass in quick order the legislation introduced by Senators Boschwitz and Melcher to prevent these devastating regulations from going into effect.

Both of these regulations put the family farm on the chopping block again. If we mean to protect and preserve the family farming system from further demise, we must see that they are not allowed to go into effect.

Mr. Chairman, again, thanks so much for allowing me to testify before this committee.

My thanks also, to you for allowing me to proceed out of turn.

My apologies to those of you whose testimony we interrupted.

Senator GRASSLEY. Before you leave, I would like to ask Senator Bentsen if he has any questions to ask of Senator Andrews.

Senator BENTSEN. Thank you, Mr. Chairman.

No, I do not, Mr. Chairman.

Senator GRASSLEY. Your comments reiterate positions I have made public in the past. You have been a very vocal spokesman for agriculture in the House. I know you will be an even greater spokesman for agriculture in the Senate.

Thank you.

Senator ANDREWS. The farm families of the Nation can't have a better spokesman, Mr. Chairman, than you, with your background in agriculture in the State of Iowa.

Senator GRASSLEY. Thank you, Senator Andrews.

Senator ANDREWS. It is a pleasure to appear before you.

[The prepared statement of Senator Mark Andrews follows:]

TESTIMONY BY SENATOR MARK ANDREWS, BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE IRS, SENATE FINANCE COMMITTEE

Mr. Chairman: I was pleased to learn that you had scheduled oversight hearings on two agricultural tax issues that could have quite a negative impact on farm families in the rural areas of the nation.

It seems to be a toss up as to which of the two regulations being promulgated by the IRS would have the more severe impact. I have contacted the IRS to express my concern over both issues and have also cosponsored legislation to prohibit the adoption of these proposed regulations.

With respect to the proposal to increase the interest rates imputed under Sections 482 and 483 of the Internal Revenue Code, I co-signed a letter to Secretary Regan on March 13 with several of my colleagues, who, like me, are concerned about the effect these regulations would have on the farming community. We asked the Secretary to consider withdrawing the regulations. In the letter, we pointed out that withdrawal of the proposed regulations would provide an excellent opportunity to demonstrate that the Administration is serious about setting a new tone and direction in tax policy and in the use of regulatory authority.

To date, I haven't received any reply to this request—and, frankly, it concerns me a lot that we can't get a reply any sooner than this from a member of the President's Cabinet on an issue that could have such a devastating impact on the farming population. The letter to the Secretary fully outlined the concerns over the potential impact of the regulations that have been expressed to me by farmers, farm organizations and small business people.

My main concern with the regulations is the impact they would have on the beginning farmer who is ready to take over the family farm. It's my understanding that under the proposed regulations, higher interest rates would be required on loans for the sale of property to a family member than on loans to non-family members. This doesn't make good sense, but it's a darn good way to further jeopardize the continuance of family farming.

I'm equally concerned about the regulation the IRS would like to see enforced concerning valuation of farm property for estate tax purposes.

Being a strong promoter of estate tax reform ever since coming to Congress, I was pleased back in 1976 that we were able to change the law by adding the "farm use valuation" provisions, now known as section 2032A of the Internal Revenue Code. As you know, this provision allows farms, for estate tax purposes, to be valued on the basis of productive farm capacity, rather than the prevailing market price. Congress also recognized back then that if we failed to enact this type of provision, we were about to witness yet a further decline of a very important economic segment of our population—family farms.

Not surprisingly, however, the Internal Revenue Service has chosen to interpret this legislation in its usual narrow fashion by issuing regulations disallowing the productive farm capacity valuation if the farm had been cash rented previously. They don't seem to understand, or maybe don't care, that cash-renting is the usual way of handling a farm business between father and son, or two other relatives. If this system is subjected to a punishing tax, it would be flying in the face of Congressional intent. There is no question in my mind that Congress clearly intended that passive (cash) rental to a relative would qualify the estate for 2032A valuation, as long as other requirements of the section were met.

I'm co-sponsoring legislation with Senator Boschwitz, which clearly states that qualified use may be performed by the decedent or a member of the decedent's family. The Senator was successful in getting an identical amendment to the Continuing Resolution passed last December, but it was later dropped during the dispute over Congressional pay raises. I was responsible in the House for including continuing resolution report language prohibiting the IRS from spending any funds to implement this regulation according to their interpretation of "qualified use."

Based on what I strongly believe to be the Congressional intent of these two sections of the law, I would like to see these regulations withdrawn. If this is not the view of the IRS, I see no other alternative than to make sure we pass, in quick order, the legislation introduced by Senators Boschwitz and Melcher to prevent these devastating regulations from going into effect. Both of these regulations put the family farm on the chopping block again, and if we mean to protect and preserve the family farming system from further demise, we must see that they are not allowed to go into effect.

Senator GRASSLEY. Thank you.

Mr. Egger.

Mr. EGGER. Yes, I will proceed.

As I said, in the final regulations, we are providing that where the literal terms of both sections 482 and 483 are met in the same transaction, or would apply in the same transaction, then the regulations will provide for section 483 to be controlling.

The final regulations under section 482 will in general provide that the Internal Revenue Service can impute a 12-percent interest rate on loans between commonly—controlled trades or businesses, unless the taxpayer charges a rate between 11 and 13 percent, or establishes that a different rate would be an appropriate arm's length rate.

Under present regulations, the comparable rates are 7 percent and the range is 6 to 8 percent.

The final regulations under section 483 will in general provide that unless a contract for the sale of property provides for at least 9-percent simple interest on deferred payments, then a rate of 10 percent, compounded semiannually is imputed.

Under the present regulations the comparable rates are 6 and 7 percent.

Many comments asserted that the proposed rates would have a negative and unfair impact on family farming and family businesses because higher interest rates would be required on loans for the sale of property to a family member than on loans for the sale of property to a nonfamily member. This is based on the assumption that such sales would be governed by section 482 rather than section 483.

The final regulations, as I explained, would eliminate any possible problem in this regard, by providing that, in the event the literal terms of both sections applied to a transaction, then section 483 will override.

Thus, the 9-percent miminum interest rate will be sufficient for sales of property to a family member, as well as for sales of property to a nonfamily member.

Consistent with the letter to Senator Melcher, last December, from Donald Lubick, former Assistant Secretary for Tax Policy, we will not issue final regulations on these issues before July 1, 1981.

We have decided, however, in view of the many taxpayer inquiries regarding the imputed rates, to announce our decision through this statement and through a news release which is being issued today.

We have carefully considered whether the final regulations should maintain the effective dates provided in the proposed regulations. These dates, you will recall, are August 29, 1980, for the regulations under section 482, and September 29, 1980, for the regulations under section 483. We believe it would have been consistent with Mr. Lubick's letter to maintain these effective dates. However, because there has been some considerable confusion about whether Mr. Lubick's letter portended a delay in the effective dates until July 1, 1981, and in order to extend to the Congress every courtesy in its review of the issues raised by the proposed regulations, we have decided that the final regulations will generally be made effective as of July 1, 1981.

Mr. Chairman, I would like the balance of our statement to go in the record in its entirety. That ends the summary.

We will either answer questions on these issues now or wait until we have finished with the 2032A testimony which Mr. Chapoton will give.

Senator GRASSLEY. I think we will go ahead with the Secretary's statement at this point.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. CHAPOTON. Mr. Chairman, I want to cover the problems that have arisen under regulations dealing with the rather complex provisions of section 2032A, of the code.

First, I would like to say in response to Senator Andrews' comment, that our testimony will directly address the questions raised in that letter. A response will go out consistent with this testimony.

I would also mention that in response to that letter, Mr. Eggers and I undertook a thorough review of both of these provisions some weeks ago, particularly the provision under sections 482, and 483, and have had them on the front burner for some period of time. We have not been ignoring this question.

We understand the subcommittee is primarily interested in three areas under the section 2032A, regulations:

First, the circumstances under which property held in trust may qualify for special use valuation; second, whether the "qualified use" test is met where the decedent cash leases the property to a family member; and third, whether the formula method for determining special use valuation may be used where the only comparable property is not cash rented.

Where a family farm constitutes a large part of a decedent's estate, the estate may value the farm for estate tax purposes under a "special use" valuation method under section 2032A, of the code. Although special use valuation is also available for certain other real estate, it applies principally to family farms and we will be thus discussing these issues in the context of farms.

Special use valuation is intended to permit a farm to be valued as a farm even if someone would pay more for the land, because of its value for nonfarm purposes. In order for the farm to be eligible for special use valuation, a number of requirements must be met. These requirements are intended to limit the availability of special use valuation to cases where the farm was, and will remain, a family farm.

Before addressing the specific issues of interest to the subcommittee, some general observations are in order. While the purpose of section 2032A, may be easily summarized—to provide for valuation of farmland based on its use as a farm rather than on other potential uses of the land—the statute is quite complex and, if read literally, goes far beyond its purpose.

The development of the regulations under section 2032A represents an effort to reconcile the literal language of the statute with its purpose. Given the differences between the purposes of the statute, as reflected in its legislative history, and the literal language of the statute, the regulations as a whole, in our view, represent a reasonable attempt to give guidance in this area. However, the Treasury and IRS have determined that certain modifications should be made in the regulations in two areas.

The first area to be addressed is the circumstances under which property held in trust may qualify for special use valuation.

Under the legislation it is required that property pass to "qualified heirs", a statutorily defined term that does not include trusts. However, in recognition of the widespread use of trusts in estate planning, the legislative history of section 2032(A) provides that the rules for special valuation are to apply to property which passes in trust. For this purpose, trust property is deemed to have passed from the decedent to a qualified heir to the extent that the qualified heir has a present interest in the trust property.

The final regulations recognize that property passing in trust may qualify for special use valuation, and define "present interest" in the trust property by a cross reference to the gift tax provisions of the code, where an established body of law has developed for defining that term.

The incorporation of the gift tax definition of present interest has caused problems for "discretionary" testamentary trust. In the typical discretionary trust, the trustee is given the power to accumulate or distribute income, and, in some circumstances, corpus among a group of beneficiaries. To the extent the trust grants absolute discretion to the trustee so that none of the beneficiaries may compel distribution, no one has a present interest in the trust as that term is defined for gift tax purposes. Thus, property passing under a discretionary trust would, under the current regulations, be ineligible for special use valuation.

Senator GRASSLEY. John.

Mr. CHAPOTON. Yes, sir.

Senator GRASSLEY. Senator Melcher has come into the room. He was the first one who was going to testify.

Senator Melcher, we have arranged with the administration's witnesses, that they would let us interrupt them so you could give your testimony.

I would like to welcome Senator Melcher to the witness table, on the right or left, either one. I would rather have you on the right.

Senator Melcher was a former colleague of mine on the House Agriculture Committee, before he came to this body. He knows that I understand his concern about agriculture, but for those of you who don't in the audience, or in the Nation at large, John was, as a member of the House Agriculture Committee, an outstanding spokesman for American agriculture. I have known him to be that as a Member of the U.S. Senate, as well.

I would like to ask you to proceed, Senator Melcher.

STATEMENT OF HON. JOHN MELCHER, U.S. SENATOR, STATE OF MONTANA

Senator MELCHER. Thank you, Mr. Chairman. I am very pleased to have this opportunity to appear before you today and to testify on proposed IRS regulations governing section 482 and 483, of the Tax Code.

On August 29 of last year, when IRS published proposed new regulations which would set imputed interest rates on loans between financially related entities at 12 percent, if the stated interest rates are not at least 11 percent, and would set imputed interest rates at 10 percent on deferred payments, in the case of certain other sales of property, if the stated interest rates are below 9 percent.

The proposed modifications to these sections of the Code would increase imputed rates in such sales of property 50 percent or more or existing levels.

I understand the Department is testifying today and saying that they would modify at least the rate on sales between related parties.

But, when these regulations were published, there was an immediate outcry of opposition from farm groups and small business people and those in the real estate and the whole building industry.

In a short period, the IRS had received some 2,500 written comments opposing these regulatory changes, and many hundreds more flooded congressional offices.

The opposition has continued to grow, because while these new regulations do not create any significant improvement in tax equity, it would have a distinct negative impact on business and the economy in promoting higher interest rates.

Seldom in my experience have I seen such universal opposition to a new set of regulations. This overwhelming expression of opposition to the IRS proposals and the total lack of cooperation from the IRS, which included not even responding to my inquiries for more than 2 months, resulted in my introducing an amendment to the last continuing appropriation bill prohibiting the use of funds to implement the proposed regulations.

I only withdrew my amendment after then Assistant Secretary of Tax Policy, Donald Lubick agreed to postpone issuing the final regulations until at least July 1, 1981, in order to give Congress time to review the issue.

Early in this session of Congress, legislation was introduced from both Houses of Congress. My bill, with Senator Baucus, or Senators Baucus, Heflin, Jepsen, Luger, Pryor, Symms, Pressler, Andrews, Abnor, Zorinsky, Eagleton, Boschwitz, Kasten, and Cochran, as cosponsors, in the Senate, and the companion bill, by Representative Tom Daschle with two dozen cosponsors in the House.

These bills are identical, I believe, and would permanenty kill these proposed regulations.

Mr. Chairman, I believe that is what we ought to do, and I think there is sufficient support to pass this legislation. However, the supporters of this legislation have continued to try to work with the new administration to reach a satisfactory solution short of a total ban.

Twenty-seven of the legislation's cosponsors wrote to Secretary of the Treasury Regan on March 13, 1981, requesting that Treasury withdraw the proposed regulations and work with Congress to devise new language which would protect against tax avoidance, and yet, not needlessly penalize the great bulk of taxpayers affected by these regulations.

Prior to today's testimony, we have had no response. I want to focus my testimony today on two areas.

The first deals with specific questions on the regulations, and the underlying code.

The second raises a question on what our current tax philosophy ought to be in this area.

One of the most often-asked questions about these regulations concerns interfamily transactions.

Now, while the Department has modified their initial proposal, it still bothers me that IRS wants to be in the business of telling members of a family just what they ought to do with each other in transfer of property of one type or another, particularly as first proposed.

I don't think these cases are necessarily decided on a view that was taken by the joint committee which said that if a parent sold a family farm to child upon retirement, the transaction would not be subject to section 482, because the parent would not be engaged in a trade or business.

What about those cases where the parent sells part of a family farm to a child prior to their retirement? Does this mean that section 482 applies, with the result that a family member must pay even a higher interest rate on such a purchase than a total stranger?

Well, that problem is being corrected by the Department's new proposal announced today. We see too much interference by IRS regulations. I find it unconscionable.

Another area concerns the relationship between the tax treatment of the seller and buyer. The argument is made that higher imputed interest rates really benefit the buyer because he or she will get a larger deduction against taxes for interest payment.

It has been pointed out that this isn't exactly accurate. Section 163(d), of the Tax Code, generally limits the deduction for interest on investment indebtedness to $10,000. This limitation has been in the Internal Revenue Code since 1976.

If imputed interest rates are increased, thus increasing the interest costs to purchaser, but the limits on deductions of interest are not likewise increased, the seller's taxes because of the higher interest rate are increased, but the purchaser doesn't get the tax advantage of additional deductions.

Thus, the Treasury single action of raising imputed interest rates has a double cost effect on taxpayers, representing the creation of its own unnecessary, inflationary effect.

This brings us to the question of whether or not taxes are being avoided through the practice of lower than bank rate terms for interest.

The assumption in the Finance Committee report, accompanying the addition of section 483 to the code, in 1964, was that "even where property involved is a nondepreciable capital asset, the difference in tax bracket between the seller and buyer may distort the treatment of the payments, and be advantageous from a tax standpoint."

I have already discussed the question of tax equity between seller and buyer. Now, I want to raise the question of how much revenue loss there may be to the Treasury unless imputed interest rates are increased.

The seller now pays taxes on the capital gains from the sale, plus taxes on the interest, at least 6 percent under current law, while the purchaser is allowed a deduction on the cost of interest.

I do not have the figures on this, but I believe that if the tax committee were to look at the revenue figure, then we would find that in the overwhelming number of transactions that fall under these regulations, the difference in tax bracket between seller and purchaser is not enough to result in significant gains for the Treasury.

Mr. Bert Ely, a corporate financial consultant has worked up some figures on a hypothetical case. I would like to enter these into the hearing record at this time.

Senator Grassley. Without objection, so ordered.

[Appendix to testimony by Bert Ely follows:]

APPENDIX TO TESTIMONY BY BERT ELY

IMPACT OF CHANGE IN INTEREST "TEST RATE" UPON

TOTAL FEDERAL TAX REVENUES, GIVEN CERTAIN ASSUMPTIONS

ASSUMPTIONS

BASIC PREMISE: This appendix reflects the price discounting theory set forth in the attached testimony: that as interest expense changes in a deferred payment situation, principal payments (purchase price) change inversely by the same amount so that total payments to the seller remain constant.

SELLER: Married taxpayer sells an incorporated business in which he has a cost basis of $1,000. He receives no downpayment, but contracts to receive $117,230.50 every six months for five years. Interest is to be at the IRS Test Rate; the balance of each payment is to represent a portion of the purchase price, which in turn is to be subject to capital gains tax. The taxpayer has deductions and exemptions each year of $13,400. All of the taxpayer's other income is assumed to be taxed at the taxpayer's incremental tax rate; that is, his other income, considered to be coming in on top of his income from selling the company, is excluded from this analysis. However, no Alternate Minimum Tax is due.

BUYER: Pays interest out of the earnings of the acquired company. Since earnings are well in excess of $100,000 per year, corporate taxes are reduced 46 cents for each dollar of interest paid to the seller.

INTEREST RATE AT CURRENT 6% TEST RATE

Seller's Taxes

Year ;	Principal payment ;	Taxable income from gain +	Interest income =	Adjusted gross income −	Excess deductions/ exemptions =	Taxable income ;	Amount of tax
1	$ 177,078	$ 70,760	$ 57,383	$128,143	$10,000	$118,143	$ 53,140
2	187,862	75,070	46,599	121,669	10,000	111,669	48,996
3	199,303	79,641	35,158	114,799	10,000	104,799	44,829
4	211,440	84,491	23,021	107,512	10,000	97,512	40,530
5	224,317	89,638	10,144	99,782	10,000	89,782	35,969
Totals	$1,000,000	$399,600	$172,305	$571,905	$50,000	$521,905	$223,464

Buyer's Taxes

Year	Interest expense	x Tax rate	= Tax Savings
1	$ 57,383	.46	$(26,390)
2	46,599	.46	(21,436)
3	35,158	.46	(16,173)
4	23,021	.46	(10,590)
5	10,144	.46	(4,666)
Totals	$172,305		$(79,255)

Net Federal income tax revenues $144,209

APPENDIX E - Page 2

INTEREST RATE AT PROPOSED 9% TEST RATE

Seller's Taxes

Year	; Principal payment	; Taxable income from gain	+ Interest income	= Adjusted gross income	- Excess deductions/ exemptions	= Taxable income	; Amount of tax
1	$154,373	$ 61,683	$ 80,088	$141,771	$10,000	$131,771	$ 61,861
2	168,579	67,359	65,882	133,241	10,000	123,241	56,402
3	184,093	73,558	50,368	123,926	10,000	113,926	50,441
4	201,034	80,327	33,427	113,754	10,000	103,754	44,213
5	219,533	87,718	14,928	102,646	10,000	92,646	37,659
Totals	$927,612	$370,645	$244,693	$615,338	$10,000	$565,338	$250,576

Buyer's Taxes

Year	Interest expense	x Tax rate	= Tax Savings
1	$ 80,088	.46	$ (36,840)
2	65,882	.46	(30,306)
3	50,368	.46	(23,169)
4	33,427	.46	(15,376)
5	14,928	.46	(6,867)
Totals	$244,693		$(112,558)

4.3% less than revenues at 6% rate - - - - Net Federal income tax revenues $ 138,018

INTEREST RATE AT FORMER 4% TEST RATE

Seller's Taxes

Year	; Principal payment	; Taxable income from gain	+ Interest income	= Adjusted gross income	- Excess deductions/ exemptions	= Taxable income	; Amount of tax
1	$ 194,263	$ 77,631	$ 40,198	$117,829	$10,000	$107,829	$ 46,617
2	202,111	80,768	32,350	113,118	10,000	103,118	43,838
3	210,277	84,031	24,184	108,215	10,000	98,215	40,945
4	218,772	87,426	15,689	103,115	10,000	93,115	37,936
5	227,610	90,957	6,851	97,808	10,000	87,808	34,805
Totals	$1,053,033	$420,813	$119,272	$540,085	$50,000	$490,085	$204,141

Buyer's Taxes

Year	Interest expense	x Rate	= Tax Savings
1	$ 40,198	.46	$(18,491)
2	32,350	.46	(14,881)
3	24,184	.46	(11,125)
4	15,689	.46	(7,217)
5	6,851	.46	(3,151)
Totals	$119,272		$(54,865)

3.5% more than revenues at 6% rate - - - - Net Federal income tax revenues $149,276

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Senator MELCHER. Mr. Ely's examples show that there may actually be a loss of revenue to the Treasury from a higher imputed interest rate.

So, serious questions can be raised as to whether the proposed regulations provide greater equity for taxpayers and also whether they bring in any significant amount of revenue to the Treasury.

But the issue goes even beyond these considerations. President Reagan has pledged himself to a new direction of American economic life, one that will lead to economic recovery, one that will put reliance on private business rather than the Government, and one that will end needless Government interference in private dealings of our citizens.

These proposed regulations do not fit that new direction.

The regulations are inflationary.

The background report for the hearing states section 483 does not increase the total amount of sales, prices and interest payments made under a contract. Instead, part of the sales price is recharacterized as interest under the imputed rate. Any of us who have been in business know that is simply not the way the real world works. When sellers find out that they are going to have to pay taxes on a minimum of 10 percent interest, they will increase the interest charged to that level, thus increasing the overall cost to the property and adding to inflation.

Further, this will make it difficult for young people to purchase homes, farms and businesses. National figures show that every time the interest rates go up a percent, millions of young people are pushed out of the homebuying market. Increasing interest rates is only one more way of putting the purchase of a first home, farm or business out of range for many people.

Mr. Chairman, I suspect that bell is for me to quit, is that right?

Senator GRASSLEY. Yes. We would like to keep on time if possible.

Senator MELCHER. That is all right. I reached virtually the conclusion of my remarks.

I only want to reemphasize that I don't believe we need IRS involved in this particular area. I hope not only the regulations are rejected, I hope that underlying authority is either modified or repealed.

Senator GRASSLEY. Thank you very much.

Of course, if you desire, your entire testimony will be included in the record.

Before you leave Senator, I would like to ask in the order in which they have come into the room, if either Senators Byrd or Durenberger have any questions, or opening statements to make.

First, Senator Bentsen, do you have any questions of Senator Melcher?

Senator BENTSEN. None other than to congratulate him on his statement.

Senator GRASSLEY. Senator Byrd?

Senator BYRD. Thank you, Mr. Chairman. I have no questions.

Senator GRASSLEY. Senator Durenberger.

Senator DURENBERGER. Thank you, Mr. Chairman.

Yes, Mr. Chairman. I do have an opening statement I would like to be made a part of the record.

Senator GRASSLEY. Do you want to say something in regard to your opening statement or just have it included?

Senator DURENBERGER. The purpose of my statement is to lay out my view of the problem and congratulate you on bringing your House background and your farming background and your commitment to the problem.

Senator GRASSLEY. Thank you very much.

Senator DURENBERGER. I would add my compliment to a Member of the Senate last year, to the Senator from Montana for rising on the floor at what most people considered a relatively inopportune moment and bringing this matter to our attention and getting some delays and helping with this problem.

Senator GRASSLEY. Thank you, Senator Durenberger.

Thank you, Senator Melcher, for your attendance.

Senator MELCHER. Thank you, Senator Grassley.

Senator GRASSLEY. And your testimony.

[The prepared statements of Senators Dole, Durenberger and Melcher follows:]

STATEMENT OF SENATOR DOLE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

APRIL 27, 1981

MR. CHAIRMAN --

YOU HAVE CHOSEN TWO VERY SIGNIFICANT ISSUES FOR THE FIRST HEARING THIS YEAR BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE. IT WOULD BE DIFFICULT TO FIND RECENT ACTIONS OF THE IRS WHICH HAVE STIRRED AS MUCH CONCERN AMONG FARMERS AND SMALL BUSINESSMEN AS THE REGULATIONS ON IMPUTED INTEREST AND SPECIAL USE VALUATION.

LAST YEAR, WHEN THE TREASURY DEPARTMENT ISSUED PROPOSED REGULATIONS RAISING IMPUTED INTEREST RATES AND PUBLISHED FINAL REGULATIONS TO IMPLEMENT THE SPECIAL USE VALUATION RULES, WE ALL BEGAN TO RECEIVE A SUBSTANTIAL VOLUME OF MAIL FROM OUR CONSTITUENTS. THESE REGULATIONS OBVIOUSLY HAVE TOUCHED A NERVE WITH MANY OF OUR CITIZENS, AND UNDERSTANDBLY SO.

IMPUTED INTEREST RATES

ALL AMERICANS HAVE WATCHED WITH DISBELIEF AS INTEREST RATES HAVE SHARPLY RISEN OVER THE LAST FEW YEARS. WHEN THE TREASURY DEPARTMENT ISSUED PROPOSED REGULATIONS RAISING INTEREST RATES ASSUMED FOR TAX PURPOSES, MANY AMERICANS WERE OUTRAGED THAT THE GOVERNMENT WAS DENYING PARTIES THE ABILITY TO CONTRACT PRIVATELY AT LESS THAN COMMERCIAL INTEREST RATES. FURTHERMORE, MANY CITIZENS WERE AMAZED THAT THE GOVERNMENT COULD ASSUME A HIGHER INTEREST RATE FOR TRANSACTIONS BETWEEN RELATED PARTIES THAN IT WOULD FOR TRANSACTIONS BETWEEN STRANGERS.

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THE TWO STATUTORY PROVISIONS INVOLVED ARE SECTIONS 482 AND 483 OF THE INTERNAL REVENUE CODE. SECTION 482 ALLOWS THE IRS TO ALLOCATE ITEMS OF INCOME, DEDUCTIONS, CREDITS OR ALLOWANCES BETWEEN ORGANIZATIONS, TRADES, OR BUSINESSES CONTROLLED BY THE SAME INTERESTS. UNDER REGULATIONS NOW IN EFFECT, THE IRS COULD ASSUME AN INTEREST RATE OF 7 PERCENT IF RELATED PARTIES DID NOT SET FORTH A RATE OF BETWEEN 6 AND 8 PERCENT. UNDER THE PROPOSED REGULATIONS, THE IRS WOULD BE ABLE TO ASSUME A RATE OF 12 PERCENT IF THE PARTIES DID NOT ESTABLISH A RATE BETWEEN 11 AND 13 PERCENT.

SIMILARLY, UNDER SECTION 483, IF PROPERTY IS SOLD ON AN INSTALLMENT BASIS AND LESS THAN 6 PERCENT INTEREST IS STATED IN THE CONTRACT, THE IRS MAY SET A RATE OF 7 PERCENT FOR TAX PURPOSES. THE PROPOSED REGULATIONS WOULD ALLOW THE IRS TO ASSUME A RATE OF 10 PERCENT IF THE CONTRACT RATE IS LESS THAN 9 PERCENT.

THIS SENATOR RECOGNIZES THAT THE CONGRESS DELEGATED THE AUTHORITY TO SET THESE INTEREST RATES TO THE IRS SO THAT THE RATES MIGHT BE ALTERED AS ECONOMIC CONDITIONS CHANGED. THIS SENATOR IS ALSO AWARE THAT THE CONGRESS INTENDED AT THE TIME SECTION 483 WAS ENACTED THAT THE INTEREST RATE ASSUMED APPROXIMATE COMMERCIAL RATES. HOWEVER, IT CERTAINLY SEEMS THAT THERE IS REASON TO QUESTION WHETHER THE CURRENT SYSTEM IS ADEQUATE IN A WORLD WITH CONSTANTLY FLUCTUATING INTEREST RATES. IT ALSO SEEMS, AT LEAST TO THIS SENATOR, THAT IT WAS QUESTIONABLE JUDGMENT TO IMPOSE A HIGHER INTEREST RATE FOR SECTION 482 PURPOSES THAN FOR SECTION 483. WHILE IT MAY BE THAT NOT ALL RELATED PARTY TRANSACTIONS COULD BE CONSIDERED TO BE BETWEEN COMMONLY CONTROLLED ENTITIES, THE PROPOSED

DISPARITY IN RATES BETWEEN SECTION 482 AND 483 HAS CREATED, AND COULD CONTINUE TO CREATE, SUBSTANTIAL CONFUSION IN FAMILY BUSINESS TRANSACTIONS.

Special Use Valuation

Mr. Chairman, final regulations governing the special use valuation for farm property, section 2032A of the Internal Revenue Code, were issued on July 28, 1980. The regulations in their final form have caused considerable concern in the farm community because they seem to be at variance, in some ways, from the goals of section 2032A as passed by Congress. It is good that the Subcommittee is taking this opportunity to review the regulations, so that we can see what the problems are and how they might best be solved.

One of my own concerns with the Treasury interpretation of the special use valuation provisions has been the denial of special use valuation where land is leased on a crop-share rather than a cash basis. This means that in areas where crop-share rentals are the rule rather than the exception, special use valuation is effectively denied. In those cases, even though nearby land may be comparable, it cannot be used as a standard of valuation if it is leased on a crop-share basis. It is not clear that this result is compelled by the language of section 2032A, and in fact the first version of the regulations proposed by the Treasury to implement section 2032A allowed crop-share rentals as a standard of valuation. That was back in 1978, and I am not sure what has changed since then to justify the reversal of position.

MR. CHAIRMAN, THERE ARE OTHER PROBLEMS WITH THE SPECIAL USE REGULATIONS, AND I AM SURE THE WITNESSES WILL BRING THESE OUT AND SUGGEST WAYS TO DEAL WITH THEM. SOME OF THESE PROBLEMS ARE THE SUBJECT OF PENDING LEGISLATION: I MYSELF HAVE A BILL THAT WOULD, I BELIEVE, RESOLVE THE CROP SHARE QUESTION DESCRIBED ABOVE. BUT OUR JOB TODAY IS TO SEE WHAT THE DIFFICULTIES ARE, AND, I HOPE, TO DETERMINE WHETHER SOME OF THEM CAN BE TAKEN CARE OF WITHOUT THE NEED FOR FURTHER LEGISLATION.

IT IS ALWAYS PREFERABLE TO RESOLVE MATTERS THROUGH THE ADMINISTRATIVE PROCESS IF THAT CAN BE DONE. IF IT CANNOT, WE WILL SEE WHAT LEGISLATIVE CHANGES ARE APPROPRIATE.

I KNOW MANY MEMBERS ARE CONCERNED WITH THE LIMITATION IN THESE REGULATIONS ON CASH LEASES TO FAMILY MEMBERS, WITH THE DEFINITION OF A 'PRESENT INTEREST' FOR PURPOSES OF QUALIFYING FOR SPECIAL USE VALUATION, AND WITH THE STANDARDS OF COMPARABILITY THAT THE IRS REQUIRES VALUING FARM PROPERTY. SEVERAL MEMBERS ARE HERE TODAY TO TESTIFY ON THESE ISSUES, AND I BELIEVE THERE PRESENCE DEMONSTRATES THE CONTINUING CONCERN OVER THE WAY THIS LAW HAS BEEN INTERPRETED AND ADMINISTERED. I LOOK FORWARD TO HEARING THE TESTIMONY, AND I HOPE THAT WE CAN FIND A COMMON GROUND OF AGREEMENT.

IN CONCLUSION, MR. CHAIRMAN, THE SUBJECTS AT ISSUE TODAY MAKE CERTAIN THAT THIS HEARING WILL BE CONSIDERED TIMELY AND IMPORTANT TO A SIGNIFICANT SEGMENT OF THE PUBLIC.

DAVE DURENBERGER
MINNESOTA

United States Senate
WASHINGTON, D.C. 20510

MR. CHAIRMAN, THANK YOU FOR HOLDING THESE HEARINGS TODAY REGARDING PROPOSED REGULATIONS UNDER SECTIONS 482, 483, AND 2032A OF THE INTERNAL REVENUE CODE AND THEIR EFFECT ON FAMILY FARMS AND BUSINESSES IN MINNESOTA.

I AM PLEASED BECAUSE THE LEADERSHIP OF THE 97TH CONGRESS, PARTICULARLY THAT OF THE DISTINGUISHED CHAIRMAN OF THE SENATE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE, MR. GRASSLEY OF IOWA, IS ADDRESSING THE HARDSHIPS THAT THESE REGULATIONS HAVE AND WILL IMPOSE ON FAMILY FARMERS IN OUR NATION.

AS THE SENIOR SENATOR FROM MINNESOTA I AM PERHAPS IN A UNIQUE POSITION TO SPEAK OUT ON BEHALF OF FAMILY FARMERS. MINNESOTA HAS OVER 92,000 FAMILY FARMS WITH THE LARGEST NUMBER OF FAMILY FARM WORKERS IN THE UNITED STATES. NEARLY 90 PERCENT OF ALL FARMS IN MINNESOTA ARE OWNED AND OPERATED BY FAMILY MEMBERS. FAMILY FARMING IS A REALITY IN MINNESOTA.

MINNESOTA HAS 30 MILLION ACRES OF FARM LAND. THE AVERAGE FARM SIZE IS 288 ACRES. THE AVERAGE FARM VALUE IS ABOUT $1,200 PER ACRE, BUT THIS FIGURE IS MISLEADING BECAUSE OF THE LOW LAND VALUES IN NORTHERN MINNESOTA. FARM LAND VALUES

IN SOUTHERN MINNESOTA ARE CLOSER TO $2,000--2,500 PER ACRE. THEREFORE, IT IS NOT UNCOMMON FOR A MINNESOTA FAMILY FARM TO HAVE $720,000 IN REAL ESTATE VALUE ALONE.

NEEDLESS TO SAY, THE REGULATIONS BEING DISCUSSED TODAY HAVE A DEVASTATING EFFECT IN MY STATE.

MR. CHAIRMAN, IT IS IMPORTANT TO NOTE THAT THE WORD "FAMILY" IS AS IMPORTANT AS THE WORD "FARM." IT TAKES AN ENTIRE FAMILY -- MOM, DAD, AND THE CHILDREN -- TO BUILD AND MAINTAIN A SOLVENT FARM ENTERPRISE. AND THESE REGULATIONS STRIKE AT THE HEART OF THIS FAMILY UNIT. THE FEDERAL GOVERNMENT IS DICTATING INTEREST RATES ON FAMILY FARM PROPERTY TRANSACTIONS. FURTHERMORE, THE IRS REGULATIONS UNDER SECTION 2032A STRIKE AGAIN AT THE FAMILY FARM. I'LL DEAL MORE WITH THAT ISSUE LATER.

A LAWYER FROM WELLS, MINNESOTA, WHO REPRESENTS FAMILY FARMS AND BUSINESSES, WROTE TO ME SAYING "...IF THESE REGULATIONS UNDER 482 AND 483 ARE SUPPOSED TO REFLECT THE MARKET CONDITIONS FOR CERTAIN TYPES OF TRANSFERS, THEN THE PROPOSED REGULATION DOES NOT DO THAT. I HAVE BEEN ENGAGED IN THE GENERAL PRACTICE OF LAW IN SOUTHERN MINNESOTA FOR TEN YEARS AND HAVE NEVER DRAWN A CONTRACT FOR DEED ON FARM PROPERTY BETWEEN UNRELATED PARTIES FOR AN ANNUAL INTEREST RATE OF MORE THAN 8 PERCENT. IN FACT, THE MAJORITY OF THE CONTRACTS HAVE BEEN BETWEEN 6 AND 7 PERCENT."

ON BEHALF OF THE STATE OF MINNESOTA, OUR STATE COMMISSIONER OF AGRICULTURE TESTIFIED BEFORE THE INTERNAL REVENUE SERVICE TO CONVEY THE OPINIONS OF MINNESOTANS THROUGHOUT THE STATE THAT THE IMPUTED INTEREST RATES ON RELATED PARTY TRANSACTIONS DISCRIMINATE AGAINST FAMILY FARMERS AND ARE INFLATIONARY.

AND THE CITY FOLKS ARE NOT ANY HAPPIER ABOUT IT. IN A LETTER FROM MINNEAPOLIS, ONE MAN STATES THAT THE RETROACTIVE NATURE OF THE REGULATION PRECLUDES PRUDENT BUSINESS PLANNING AND INCREASES THE UNCERTAINTY INHERENT IN OUR TAX LAWS. AND THAT'S ANOTHER PROBLEM THAT BOTHERS ME, MR. CHAIRMAN. I DON'T LIKE TO SEE TAX LAWS, MUCH LESS REGULATIONS, THAT PROMOTE SPECULATION AND UNCERTAINTY. WE NEED, AND WE NEED DESPARATELY, TO BUILD SOME PERMANANCY INTO OUR TAX LAWS AND REGULATIONS.

A FRUSTRATED TAXPAYER FROM KASOTA MINNESOTA WROTE TO ME AND SAID "...I HAVE RECENTLY HAD TO SELL MY FARM. THE REALTORS TOLD ME THAT INTEREST RATES WERE GOING ANYWHERE FROM 7 TO 15 PERCENT. THERE IS NO AVERAGE. THEY ARE UP AND DOWN, ALL OVER, DEPENDING UPON WHAT TWO PEOPLE COULD AGREE ON. THIS, OF COURSE, IS PARTIALLY CAUSED BY THE EXPREMELY POOR ECONOMY THAT HAS BEEN CAUSED BY EXCESSIVE GOVERNMENT REGULATION IN THE FIRST PLACE. MY FARM WAS ON THE MARKET FOR MANY MONTHS WITH VERY LITTLE ACTIVITY BECAUSE NO ONE COULD AFFORD TO BUY IT WITH THE RIDICULOUS INFLATION THAT THE GOVERNMENT HAS GIVEN US. FINALLY A MILLIONAIRE DID COME ALONG WHO COULD

AFFORD TO BUY IT. WE NEGOTIATED THE SALE FOR TWO WEEKS. HE PROPOSED A VERY LOW-INTEREST RATE OF 8 PERCENT, AND ONLY AFTER MUCH NEGOTIATION OF PRICE AND INTEREST RATE DID I FINALLY GET HIM UP TO 9-3/4 PERCENT." THE INTEREST RATES UNDER SECTION 482 AND 483 ARE RIDICULOUS FOR TRANSACTIONS IN MINNESOTA.

MR. CHAIRMAN, LET ME TURN TO AN EQUALLY COMPELLING PROBLEM IN CURRENT IRS REGULATIONS UNDER SECTION 2032A. THE REGULATIONS REQUIRE A CROP-SHARE ARRANGEMENT TO SATISFY THE QUALIFIED USE REQUIREMENT. YET, THIS STRIKES AGAINST THE SOCIAL SECURITY PROVISIONS IN OUR LAWS BY REQUIRING DAD TO CROP-SHARE HIS FARM TO HIS OWN CHILDREN IN ORDER TO HAVE HIS FARM QUALIFY FOR THE SPECIAL USE ESTATE TAX VALUATION. IN DOING SO, DAD NEVER SEES ONE DOLLAR OF THAT SOCIAL SECURITY HE SWEATED FOR. CLEARLY, MR. CHAIRMAN, THIS IS NOT THE INTENT THAT CONGRESS HAD IN MIND WHEN THE SPECIAL USE VALUATION PROVISION WAS PASSED. AND IT IS MY INTENT TO SEE THAT THESE REGULATIONS ARE CHANGED SO THAT THE FAMILY FARM HAS AT LEAST A FAIR CHANCE OF GETTING PASSED ON. I'VE INTRODUCED LEGISLATION THAT ADDRESSES THIS PROBLEM AS WELL AS OTHER PROBLEMS IN SECTION 2032A.

I AGREE THAT IN ORDER TO QUALIFY FOR THE LOWER ESTATE TAX VALUATION, THE FARM OR BUSINESS MUST BE OPERATED BY A

FAMILY MEMBER. THAT MAKES SENSE AND IS A PART OF THE LAW. AND INHERENT IN OPERATING A BUSINESS THAT ONE OWNS IS THE CONCEPT OF OWNING AN EQUITY OR CONTINGENT INTEREST IN THE BUSINESS. IF THINGS GO WELL, THE OWNER PROSPERS AND IF THEY DON'T, THEN THERE IS A LOSS TO THE OWNER. BUT REQUIRING THE DECEDENT TO CROP-SHARE TO HIS SON IS NOT NECESSARY TO ESTABLISH THAT THE PROPERTY IS BEING USED IN A QUALIFIED USE. ONE WOMAN WRITES IN A LETTER TO ME "...IT IS A MATTER OF WORDING ONLY BECAUSE A FATHER WHO WORKED THE FARM WITH HIS SON HAS MOST CERTAINLY AN EQUITY INTEREST (I.E., RECEIVED A RETURN ON THE LAND THAT WAS CONTINGENT ON FARM EARNINGS)."

ANOTHER WRITER PUTS IT THIS WAY: "ONE EXAMPLE I SUBMIT IS THE CASE OF A FATHER-SON SITUATION; WHAT DIFFERENCE DOES IT MAKE IF THE SON PAYS THE FATHER CASH RENT (FUNDS EARNED SOLELY FROM THE FARMING OPERATION): OR IF HE SELLS CORN OR MILK AND THE ELEVATOR OR CREAMERY PAYS THE FATHER?" MR. CHAIRMAN, THERE IS NO DIFFERENCE IN THIS SITUATION. CLEARLY, THE PROPERTY IS BEING USED AS A FAMILY FARM AND A MEMBER OF THE FAMILY IS MATERIALLY PARTICIPATING IN THE TRADE OR BUSINESS OF FARMING.

I AM PLEASED THAT THE SUBCOMMITTEE'S HEARING TAKES AN IMPORTANT FIRST STEP IN SOLVING THE PROBLEMS IN TRANSFERING FAMILY FARMS FROM ONE GENERATION TO ANOTHER. I LOOK FORWARD TO WORKING WITH YOU, MR. CHAIRMAN, AND OUR COLLEAGUES ON THE FINANCE COMMITTEE IN ELIMINATING THESE PROBLEMS FOR THE FAMILY FARMERS.

TESTIMONY OF
SENATOR JOHN MELCHER

BEFORE THE
SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE

COMMITTEE ON FINANCE

April 27, 1981

MR. CHAIRMAN. I AM PLEASED TO HAVE THE OPPORTUNITY TO APPEAR BEFORE YOUR SUBCOMMITTEE TODAY AND TESTIFY ON PROPOSED IRS REGULATIONS GOVERNING SECTIONS 482 AND 483 OF THE TAX CODE.

ON AUGUST 29, 1980, THE IRS PUBLISHED PROPOSED NEW REGULATIONS THAT WOULD SET IMPUTED INTEREST RATES ON LOANS BETWEEN FINANCIALLY RELATED ENTITIES AT 12 PERCENT, IF THE STATED INTEREST RATES ARE NOT AT LEAST 11 PERCENT; AND WOULD SET IMPUTED INTEREST RATES AT 10 PERCENT ON DEFERRED PAYMENTS IN THE CASE OF CERTAIN OTHER SALES OF PROPERTY, IF THE STATED INTEREST RATES ARE BELOW 9 PERCENT. THE PROPOSED MODIFICATIONS TO THESE SECTIONS OF THE CODE WOULD INCREASE IMPUTED INTEREST RATES IN SUCH SALES OF PROPERTY 50 PERCENT OR MORE OVER EXISTING LEVELS.

WHEN THESE REGULATIONS WERE PUBLISHED, THERE WAS AN IMMEDIATE OUTCRY OF OPPOSITION FROM FARM GROUPS, SMALL BUSINESS PEOPLE, AND THOSE IN THE REAL ESTATE AND HOME BUILDING INDUSTRIES. WITHIN A SHORT PERIOD, THE IRS HAD RECEIVED SOME 2,500 WRITTEN COMMENTS OPPOSING THESE REGULATORY CHANGES, AND MANY HUNDREDS MORE FLOODED CONGRESSIONAL OFFICES. THE OPPOSITION HAS CONTINUED TO GROW BECAUSE, WHILE THESE NEW REGULATIONS DO NOT CREATE ANY SIGNIFICANT IMPROVEMENT IN TAX EQUITY, THEY WOULD HAVE A DISTINCT NEGATIVE IMPACT ON BUSINESS AND THE ECONOMY THROUGH PROMOTING HIGHER INTEREST RATES.

SELDOM IN MY EXPERIENCE HAVE I SEEN SUCH UNIVERSAL OPPOSITION TO A NEW SET OF REGULATIONS. THIS OVERWHELMING EXPRESSION OF OPPOSITION TO THE IRS PROPOSALS, AND A TOTAL LACK OF COOPERATION FROM THE IRS -- WHICH INCLUDED NOT EVEN RESPONDING TO MY INQUIRIES FOR MORE THAN TWO MONTHS -- RESULTED IN MY INTRODUCING AN AMENDMENT TO THE LAST CONTINUING APPROPRIATIONS BILL, PROHIBITING THE USE OF FUNDS TO IMPLEMENT THE PROPOSED REGULATIONS. I ONLY WITHDREW MY AMENDMENT AFTER THEN-ASSISTANT SECRETARY OF TAX POLICY, DONALD LUBICK, AGREED TO POSTPONE ISSUING THE FINAL REGULATIONS UNTIL AT LEAST JULY 1, 1981, IN ORDER TO GIVE CONGRESS TIME TO REVIEW THE ISSUE.

EARLY IN THIS SESSION OF CONGRESS, LEGISLATION WAS INTRODUCED IN BOTH HOUSES OF CONGRESS -- MY BILL WITH SENATORS BAUCUS, HEFLIN, JEPSEN, LUGAR, PRYOR, SYMMS, PRESSLER, ANDREWS, ABDNOR, ZORINSKY, EAGLETON, BOSCHWITZ, KASTEN, AND COCHRAN AS COSPONSORS IN THE SENATE, AND A COMPANION BILL BY REPRESENTATIVE TOM DASCHLE WITH TWO DOZEN COSPONSORS IN THE HOUSE -- THAT WILL PERMANENTLY KILL THESE PROPOSED REGULATIONS.

I BELIEVE THERE IS SUFFICIENT SUPPORT TO PASS THIS LEGISLATION; HOWEVER, THE SUPPORTERS OF THIS LEGISLATION HAVE CONTINUED TO TRY TO WORK WITH THE NEW ADMINISTRATION TO REACH A SATISFACTORY SOLUTION SHORT OF A TOTAL BAN. 27 OF THE LEGISLATION'S COSPONSORS WROTE TO SECRETARY OF THE TREASURY REGAN ON MARCH 13, 1981, REQUESTING THAT TREASURY WITHDRAW THE PROPOSED REGULATIONS AND WORK WITH CONGRESS TO DEVISE NEW LANGUAGE WHICH WOULD PROTECT AGAINST TAX AVOIDANCE AND YET NOT NEEDLESSLY PENALIZE THE GREAT

BULK OF TAXPAYERS AFFECTED BY THESE REGULATIONS. TO DATE WE HAVE HAD NO RESPONSE.

I WANT TO FOCUS MY TESTIMONY TODAY ON TWO AREAS.

THE FIRST DEALS WITH SPECIFIC QUESTIONS ON THE REGULATIONS AND THE UNDERLYING CODE; AND THE SECOND RAISES QUESTIONS ON WHAT OUR CURRENT TAX PHILOSOPHY OUGHT TO BE IN THIS AREA.

ONE OF THE MOST OFTEN ASKED QUESTIONS ABOUT THESE REGULATIONS CONCERNS INTRA-FAMILY TRANSACTIONS. ACCORDING TO THE LANGUAGE OF THE PROPOSED REGULATIONS, PARAGRAPH 1.482-2 SETS MINIMUM IMPUTED INTEREST RATES ON TRANSACTIONS BETWEEN FINANCIALLY RELATED PARTIES AT 12 PERCENT UNLESS THE STATED INTEREST FALLS IN A SAFE-HAVEN RANGE OF 11 TO 13 PERCENT. THIS IS HIGHER EVEN THAN THE INTEREST RATES FOR NON-RELATED PARTIES. IN ITS BACKGROUND REPORT TO YOUR SUBCOMMITTEE, THE JOINT COMMITTEE ON TAXATION STATES,

> "...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."

I AM GLAD TO SEE THE COMMITTEE'S CONCLUSION, AS FAR AS IT GOES. TO DATE, I HAVE NEVER BEEN ABLE TO GET ANYONE IN THE IRS TO EVEN AGREE TO THIS MUCH OF A DECISION.

HOWEVER, I DON'T THINK THAT THIS STATEMENT GOES NEARLY FAR ENOUGH:

WHAT ABOUT CASES WHERE THE PARENT SELLS PART OF THE FAMILY FARM TO A CHILD PRIOR TO THEIR RETIREMENT?

DOES THIS THEN MEAN THAT SECTION 482 APPLIES, WITH THE RESULT THAT A FAMILY MEMBER MUST PAY EVEN A HIGHER INTEREST RATE ON SUCH A PURCHASE THAN A TOTAL STRANGER?

THAT SEEMS RIDICULOUS TO ME, BUT NEITHER THE JOINT TAX COMMITTEE NOR THE IRS HAS SAID ANY DIFFERENT.

WE NEED TO GET THIS QUESTION ANSWERED. IF SUCH TRANSACTIONS ARE EXEMPT FROM SECTION 482, THEN LANGUAGE SPELLING THIS OUT OUGHT TO BE PART OF THE REGULATIONS SO THAT TAXPAYERS KNOW WHERE THEY STAND. AS IT IS NOW, THEY MAY HAVE TO GO THROUGH LENGTHY APPEALS AND EVEN COURT CASES TO GET A FINAL DECISION.

WE SEE TOO MUCH OF THIS IN IRS REGULATIONS, AND I FIND IT UNCONSCIONABLE. THE TAXPAYERS HAVE A RIGHT TO KNOW THE TAX IMPLICATIONS OF TRANSACTIONS BEFORE COMMITMENTS ARE MADE.

ANOTHER AREA CONCERNS THE RELATIONSHIP BETWEEN THE TAX TREATMENT OF THE SELLER AND BUYER. THE ARGUMENT IS MADE THAT HIGHER IMPUTED INTEREST RATES REALLY BENEFIT THE BUYER, BECAUSE HE OR SHE WILL GET A LARGER DEDUCTION AGAINST THEIR TAXES FOR THE INTEREST PAYMENT. IT HAS BEEN POINTED OUT TO ME THAT THIS ISN'T EXACTLY ACCURATE. SECTION 163(D) OF THE TAX CODE GENERALLY LIMITS THE DEDUCTION FOR INTEREST ON INVESTMENT INDEBTEDNESS TO $10,000. THIS LIMITATION HAS BEEN IN THE INTERNAL REVENUE CODE SINCE 1976. IF IMPUTED INTEREST RATES ARE INCREASED, THUS INCREASING THE INTEREST COST TO PURCHASERS, BUT THE LIMITS ON DEDUCTION OF INTEREST ARE NOT LIKEWISE INCREASED, THE SELLER'S TAXES ON THE HIGHER INTEREST PAYMENTS ARE INCREASED AND THE PURCHASER DOESN'T GET THE TAX ADVANTAGE OF ADDITIONAL DEDUCTIONS. THUS, THE TREASURY'S SINGLE ACTION OF RAISING IMPUTED INTEREST RATES HAS A DOUBLE COST EFFECT ON TAXPAYERS, REPRESENTING THE CREATION OF ITS OWN UNNECESSARY, INFLATIONARY EFFECT.

THIS BRINGS US TO THE QUESTION OF WHETHER OR NOT TAXES ARE BEING AVOIDED THROUGH THE PRACTICE OF LOWER THAN BANK RATE TERMS FOR INTEREST. THE ASSUMPTION IN THE FINANCE COMMITTEE REPORT ACCOMPANYING THE ADDITION OF SECTION 483 TO THE CODE IN 1964 WAS THAT:

"EVEN WHERE 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."

I HAVE ALREADY DISCUSSED THE QUESTION OF TAX EQUITY BETWEEN SELLER AND BUYER. NOW I WANT TO RAISE THE QUESTION OF HOW MUCH REVENUE LOSS THERE MAY BE TO THE TREASURY UNLESS IMPUTED INTEREST RATES ARE INCREASED.

THE SELLER NOW PAYS TAXES ON THE CAPITAL GAINS FROM THE SALE, PLUS TAXES ON THE INTEREST (AT LEAST 6% UNDER CURRENT LAW); WHILE THE PURCHASER IS ALLOWED A DEDUCTION ON THE COST OF THE INTEREST. I DON'T HAVE THE FIGURES ON THIS, BUT I BELIEVE THAT IF THE TAX COMMITTEE WERE TO LOOK AT THE REVENUE FIGURE, THEY WOULD FIND THAT IN THE OVERWHELMING NUMBER OF TRANSACTIONS THAT FALL UNDER THESE REGULATIONS, THE DIFFERENCE IN TAX BRACKET BETWEEN SELLER AND PURCHASER IS NOT ENOUGH TO RESULT IN SIGNIFICANT GAINS FOR THE TREASURY. MR. BERT ELY, A CORPORATE FINANCIAL CONSULTANT, HAS WORKED UP SOME FIGURES ON A HYPOTHETICAL CASE, AND I WOULD LIKE TO ENTER THESE INTO THE HEARING RECORD AT THIS TIME. MR. ELY'S EXAMPLES SHOW THAT THERE MAY ACTUALLY BE A LOSS OF REVENUE TO THE TREASURY FROM HIGHER IMPUTED INTEREST RATES.

SO, SERIOUS QUESTIONS CAN, I THINK, BE RAISED AS TO WHETHER THE PROPOSED REGULATIONS PROVIDE GREATER EQUITY FOR TAXPAYERS, AND ALSO WHETHER THEY BRING IN ANY SIGNIFICANT AMOUNT OF REVENUE TO THE TREASURY. BUT THE ISSUE GOES EVEN BEYOND THESE CONSIDERATIONS.

PRESIDENT REAGAN HAS PLEDGED HIMSELF TO A NEW DIRECTION IN AMERICAN ECONOMIC LIFE -- ONE THAT WILL LEAD TO ECONOMIC RECOVERY, ONE THAT WILL PUT RELIANCE ON PRIVATE BUSINESS RATHER THAN THE GOVERNMENT, AND ONE THAT WILL END NEEDLESS GOVERNMENT INTERFERENCE IN THE PRIVATE DEALINGS OF OUR CITIZENS. THESE PROPOSED REGULATIONS DO NOT FIT THAT NEW DIRECTION.

FIRST, THE REGULATIONS ARE INFLATIONARY. THE BACKGROUND REPORT FOR THE HEARING STATES:

> "SECTION 483 DOES NOT INCREASE THE TOTAL AMOUNT OF THE SALES PRICE AND INTEREST PAYMENTS MADE UNDER A CONTRACT. INSTEAD, PART OF THE SALES PRICE IS RECHARACTERIZED AS INTEREST UNDER THE IMPUTED RATE."

ANY OF US WHO HAVE BEEN IN BUSINESS KNOW THAT IS SIMPLY NOT THE WAY THE REAL WORLD WORKS. WHEN SELLERS FIND OUT THEY ARE GOING TO HAVE TO PAY TAXES ON A MINIMUM OF 10 PERCENT INTEREST, THEY WILL INCREASE THE INTEREST CHARGED TO THAT LEVEL, THUS INCREASING THE OVERALL COST OF THE PROPERTY, AND ADDING TO INFLATION.

FURTHER, THIS WILL MAKE IT DIFFICULT FOR YOUNG PEOPLE TO PURCHASE HOMES, FARMS AND BUSINESSES. NATIONAL FIGURES SHOW THAT EVERY TIME THE INTEREST RATES GO UP A PERCENT, MILLIONS OF YOUNG PEOPLE ARE PUSHED OUT OF THE HOME BUYING MARKET. INCREASING INTEREST RATES IS ONLY ONE MORE WAY OF PUTTING THE PURCHASE OF A FIRST HOME, FARM OR BUSINESS OUT OF REACH FOR MANY YOUNG PEOPLE.

IN THE WEST, INCLUDING MY OWN STATE OF MONTANA, THIS IS SHOWING UP IN THE DECREASING NUMBER OF FAMILY FARMS. OVER THE PAST SIX YEARS, WE HAVE LOST MORE THAN 200,000 FARMS NATIONWIDE,

AND FAMILY FARMS AND RANCHES IN MONTANA ARE DISAPPEARING AT A RATE OF APPROXIMATELY 500 A YEAR. MOST OF THE FARMS AND RANCHES SOLD IN MONTANA TODAY ARE SOLD ON DEFERRED PAYMENT PLANS. IF IMPUTED INTEREST RATES INCREASE, AS PROPOSED IN THESE REGULATIONS, WE WILL SEE THE FAMILY FARM DISAPPEAR EVEN FASTER.

LAST, BUT NOT LEAST, THESE PROPOSED REGULATIONS WILL FURTHER DEPRESS THE ALREADY HARD-HIT HOUSING AND REAL ESTATE INDUSTRIES. WE SHOULD BE WORKING TO GET INTEREST RATES DOWN, NOT PUSH THEM HIGHER. THAT IS THE WAY TO ECONOMIC RECOVERY, AND THAT IS THE WAY WE SHOULD BE MOVING.

I BELIEVE THESE REGULATIONS ARE FLAWED AND THAT INCREASING IMPUTED INTEREST RATES ACROSS-THE-BOARD IS ILL-ADVISED. I HOPE THAT YOU, MR. CHAIRMAN, AND THE REST OF YOUR SUBCOMMITTEE AGREE WITH ME AND HELP TO GET THE IMPROVEMENTS MADE, OR GET THE PROPOSED REGULATIONS WITHDRAWN.

82-821 O—81——5

Senator GRASSLEY. Senator Byrd, do you have an opening statement?

Senator BYRD. No. Thank you, Mr. Chairman.

Senator GRASSLEY. I would now like to go back to the witnesses and have you continue with your statement.

Senator BENTSEN. Mr. Chairman.

Senator GRASSLEY. Senator Bentsen.

Senator BENTSEN. Could I comment to Mr. Chapoton concerning his statement?

Senator GRASSLEY. Yes.

Senator BENTSEN. I have another committee to go to.

Senator GRASSLEY. Yes, you may do that.

Senator BENTSEN. Let me say first, in reading your statement, I am very pleased that you took care of the President's problem on trusts.

I think that you approached this in a realistic manner in saying that where you have all of the beneficiaries being descendents of the deceased, and even though the trustee has the discretion of the allocation of some of the distribution, that you feel the equity is such that, as I understand it, that trust would qualify for such use.

Mr. Chapoton. That's correct, Senator.

Senator BENTSEN. Now on the second point, I am not quite satisfied. That is the question of crop rental and the sharing of crop rental and the question of cash payments.

In most of Texas you can't get cash rentals. That is particularly true in some of the arrid areas where the question of rain is high risk. Nobody is going to pay you a cash rental for your land.

Now, the point is made in your statement, you get into more subjective questions in the evaluation of the shared crop. But, you know, the tenant really doesn't send you so many bushels of corn or grain. He sells it and he brings it to the elevator, the weights and what the payments are and you get your appropriate percentage.

I do note that you say you will consider legislation on this point. I am sure you will have it, I assure you. I have produced some. I think Senator Dole has and perhaps Senator Wallop.

I do think it is something that has to be resolved and I don't believe it is that subjective. I think it can be done with definition and specificity. I would strongly urge you to take care of those kinds of valuations in those areas where you just don't have the cash rentals.

Mr. CHAPOTON. Senator, we would be happy to work with you on that. We do think it would be advisable to deal with the formula by legislation. In some areas of the country, it is not as subjective as others.

We have addressed that very concern. We feel, given the strict statutory language and the subjectivity that it does arise in some parts of the country, that it should be addressed legislatively.

We would cooperate in doing so.

Senator BENTSEN. I thank the Secretary. I particularly thank the chairman for letting me go ahead.

Senator GRASSLEY. Yes.

Mr. Secretary, would you proceed then?

Mr. CHAPOTON. Mr. Chairman, I will proceed with the summary of my statement. I have been on the point that property passing under a discretionary trust would, under the current regulations, be ineligible for special use valuation.

I was making the point that the current regulations generally deal with the problem of trust property, we think correctly, but we believe that a modification is merited. That is, if all the potential beneficiaries and remaindermen of a discretionary trust are members of the decedent's family, and therefore would be qualified heirs if the property passed to them directly, strict adherance to the gift tax definition of a present interest would appear unnecessary.

The purpose of the present interest rule is to determine the extent to which the trust property is held for qualified heirs, and we think this can be taken care of by amendment of the regulations. We will do so, to allow special use valuation for property held in trust where all the beneficiaries and potential beneficiaries are members of the decedent's family, even though the trust is a discretionary trust.

The second area to be addressed is the availability of the relief of section 3032A, where the decedent has entered into a cash lease with members of his or her family.

One requirement for a special use valuation relates to the management and use of the farm during the 8-year period ending on the date of the decedent's death.

Under the legislation, the property must be used for a "qualified use" during 5 or more of these 8 years.

The term "qualified use" is defined for farm purposes as devotion of the property to, and I quote, "use as a farm for farming purposes."

The final regulations under the legislation provide that the mere passive rental of the property will not satisfy this test; the decedent must own an equity interest in the farm operation.

The issue is whether the regulations should continue to preclude net leasing or other passive rental arrangements between the decedent and members of the decedent's family.

The source of the rule in the regulations is the legislative history under the legislation. The relevant committee report provides, "real property may qualify for special use valuation * * * if it is devoted to * * * use as a farm for farming purposes. However, there must be a trade or business use. The mere passive rental of property will not qualify."

While this legislative history can be read to support the position taken in the final regulations, the Treasury and IRS have determined that the purposes of section 2032A may be better served by providing that the trade or business requirement may be satisfied by either the decedent or a member of the decedent's family. For example, the present rules prohibit special use valuation to those who desire to provide a net lease or other passive rental arrangement in their retirement years with close family members. We believe that a passive rental by a decedent to a member of the decedent's family should not disqualify the property from special use valuation in that circumstance.

I might add, parenthetically, that the legislative history that I quoted above is subject to many interpretations. It goes on for a full paragraph that really leads you to confusion as to what the statute provides.

We think this is what the statute was intended to provide. We think this new interpretation is consistent with the intent and can be supported by the legislation and by the legislative history. So, we are going to take that position in an amendment to the regulations.

The third area is the area that Senator Bentsen referred to; that is, the method of valuation under section 2032A.

The legislation provides two methods for valuation. The first employs a mathematical formula intended to minimize subjectivity in farm valuation. It is based in part upon the average, and I quote, "gross cash rental for comparable land."

The second method, available to all property eligible for special use valuation, applies a list of commonly accepted appraisal factors, including the capitalization of income from the property.

Proposals have been made that would amend the formula method to permit net crop share rentals, as well as gross cash rentals, to be taken into account.

In many areas of the country, as Senator Bentsen has pointed out, farmland is rented on an "in kind" or crop share basis rather than for cash. In these areas, where no comparable land is cash leased, the mathematical formula cannot be applied. If no comparable land is rented for cash, an estate would not be entitled to use the formula method, and yet would still be entitled to section 2032A relief; the value for farming purposes would be determined under the alternative multiple factor method.

We believe that the existing regulations correctly interpret the statute to preclude crop share rental property from being treated as comparable land under the formula. The formula is clearly based upon gross cash rentals. The reason for the formula method—provide a valuation method that is both simple and objective—would be defeated if crop share rentals were allowed to be converted into cash share rentals of comparable value, with the subjective judgments such conversion would require in many areas of the country.

Although calculation of the value of net crop share rentals would introduce an element of complexity into the formula, the Treasury is willing to consider legislation that would permit crop share property to be used in calculating value under the formula method. The Treasury believes, however, that any legislation in this area should also address other aspects of the formula method which currently undervalue farmland for farming use in most instances.

The Treasury believes that the undervaluation problem in the current formula can be remedied most simply by providing a more realistic capitalization rate. Such a rate could be developed from published Department of Agriculture data.

I will just go on to conclude my statement, Mr. Chairman, that to the extent legislation is considered in connection with section 2032A of the Code, we think that a number of problems in that statute should be addressed that have presented a great deal of difficulty to us in interpretation. It is a very complex piece of legislation. Hopefully, if it is addressed again, it could be simplified.

Thank you, Mr. Chairman.

Senator GRASSLEY. Thank you.

Obviously, we will have some questions that we want to discuss with you, those of us present.

First of all, I would like to announce for the remaining panelists, that out of courtesy to Senator Durenberger, I am going to move the panel consisting of Neal E. Harl and Paul Hasbargen to the next in line, after we get done questioning Mr. Egger and Mr. Chapoton.

So, would you prepare to go early. I apologize to those who may be kicked back a little bit.

At this point, I would like to start my questioning.

Would you, for the sake of the committee and the audience, summarize where there has been a decision made, where there has been some change to satisfy criticism of the regulations each of you has discussed.

So, Mr. Egger, would you be the first to summarize?

Mr. EGGER. The principal change we will make is to eliminate any further question about whether the mere fact that a sale transaction occurs between family members will cause section 482—and its higher imputed interest rate—to apply.

We are going to make it clear, as I said, in the final regulations that under those circumstances, section 483 will override section 482 so that the rate of interest imputed in all deferred payment sale transactions will be uniform whether the transactions are between related family members or between unrelated people.

The second important point we reviewed together and reached a decision on was the effective date.

The regulations, as proposed by our predecessors, provided for a September 29, 1980, effective date for section 483, and an August 29, 1980, effective date for section 482.

Although we felt there might be some inequities, particularly in the case of people who acted on those regulations expecting that those effective dates would remain the same, nevertheless, we did learn through conversations with various people outside the Administration that there was substantial confusion about whether the letter sent by our predecessors indicated a July 1, 1981, effective date. We finally concluded that, to avoid any inequities that might occur in the latter respect, we would simply make the effective date July 1, 1981, rather than have any questions raised as to retroactivity.

I might tell you that the final regulations will also include some grandfather provisions which will protect any taxpayers whose transaction does not in fact close before July 1, 1981, but where the transaction has been set forth in a binding agreement prior to the original effective dates.

Those are the two principal areas.

Senator GRASSLEY. Mr. Secretary, could I ask you to summarize?

Mr. CHAPOTON. Yes, Mr. Chairman. In the 2032A area, there are two principal changes that we are announcing. One is that in case of a decedent leaving the property in a discretionary trust, the regulations in effect now provide that such gifts will disqualify the property for special use valuation. The amendment of the regulations will provide that a discretionary trust will not disqualify the gift for special use valuation, provided all the beneficiaries and potential beneficiaries of the trust are qualified heirs.

The second rule is that with respect to a cash lease, a passive type lease which would have disqualified the property from being within a qualified use under the existing regulations, we will provide that it will not disqualify the property if it is a net cash lease or passive lease to a family member. Under this change, in the latter years of a person's life, a farmowner's life, if he does make a passive lease of property to a family member, the property may still qualify for special use valuation, provided it meets the other tests of the statute.

Senator GRASSLEY. Very well.

Senator Durenberger, could I get you to ask your questions now? I have some more questions to ask, but I am not quite prepared to ask them.

Senator DURENBERGER. Thank you, Mr. Chairman.

I want to clarify one thing on the second point you made; is there any retroactivity to that?

Mr. CHAPOTON. The rule would be changed retroactively, yes.

Senator DURENBERGER. It would?

Mr. CHAPOTON. Yes.

Senator DURENBERGER. I think it is best if I take my time to compliment both of you on sort of a refreshing sense of realism that you have brought to the whole process of examining both of these.

I can readily understand the problems with 482 and 483, because we are getting the same letters that IRS has been getting and the confusion that is out there, particularly in the rural parts of the country.

I can also appreciate the problems that the IRS has had, because of the nature of the institution.

I just completed 3 days of traveling through my State talking about small business and the estate tax and all the interrelationships, and the problems particularly with the family farm.

There is no way that this Government, whether it be the legislative side or the bureaucracy, can in any way keep up with what is happening to the farm real estate in particular in this country.

So, Buck, relative to what I see in your statement in terms of a sense of searching for a formula that will as accurately and as thoroughly as possible reflect the difference between the commonly accepted appraisal principles and those that reflect the reality of our basic policy commitments to the family, not just a family farm, but the farm family out there, shows a really welcome sense of realism.

I just hope and wish that the people that talked to me last week and who told me that the Internal Revenue Service was running this country rather than the Senate, "What the hell did they need me for," you know, could share with me today this sort of new sense of realism.

I would just add, as part of what my opening statement says, I think it has come none too soon. What is happening out there is incredible. I trust that Paul and his statement will cover some of these things from a Minnesota perspective. We have more family farms than anybody else in the country, and so more farm families.

Our statistics are behind Illinois and Kansas and some of those other States in terms of land valuation, and yet, we are growing faster, I think, probably than anywhere else in the country.

I have one question. It relates to the decision that the head of the family is making in advance of his death or her death, as the case may be. I take it we need some legislative solution to the problem of people who want to retire or people who become disabled in advance of their death, to make sure that they would qualify in some way for special use; is that correct?

Mr. CHAPOTON. That is correct, depending on how long prior to death a person retired or became disabled, which is certainly something you cannot plan on, it would have to meet the use test for the required period of time prior to death.

Senator DURENBERGER. Roscoe, let me ask you a question relative to 483. I am informed that the new 483 regulations still provide a 10-percent interest if there is not a simple 9 percent stated in the contract.

Mr. EGGER. If there is not a minimum 9-percent simple interest provided in the contract itself; yes, that is correct.

Senator DURENBERGER. In Minnesota, for some reason or another, the market rates are still lower than 10 percent. I am just wondering if there is some sort of a safe harbor test like that that is provided under 482 where you can prove there is a lower prevailing rate.

Mr. EGGER. There isn't. We have looked at our authority to do that and section 483 is different from section 482 in that respect. I would seriously question whether we have the authority to provide for a taxpayer to come in and prove that a different rate is appropriate.

So, unfortunately, we are bound by whatever the prevailing rates are across the country. We can't be selective in this regard, for example by treating taxpayers in Minnesota differently than we do taxpayers from some other State.

So, we have tried to be as reasonable as we can be. Obviously, the intent of section 483 was spelled out for us. We are simply trying to carry that out.

But, we believe on balance that the 9-percent interest rate does not seem unreasonable under today's circumstances.

Senator DURENBERGER. So the ball is back in our court?

Mr. EGGER. Yes, that is correct.

Mr. CHAPOTON. Senator, if I could correct the statement made a minute ago, my staff just pointed out to me that by the rule we are announcing today, that is, on a net cash lease basis, a family member's material participation in the farm will qualify the farm.

So, actually, I do not believe we need any further legislation at all. In the cash lease situation, the number of years intervening between the cash lease and date of death would not be relevant as long as a family member materially participated in the farm.

So, I think we would have taken care of that problem, but let me caution you to say that in looking at this statute, nothing is very sure. You have to read it three times, and then a fourth, to be certain you know what you are saying. It is very complicated.

Senator DURENBERGER. Thank you both very much.

Thank you, Mr. Chairman.

Senator GRASSLEY. Thank you, Senator.

Mr. Egger, section 482 applies to loans and advances between two or more related organizations, trades or businesses, owned or controlled by the same interests.

Many have expressed concern that section 482 may apply to inter-family loans. Could you outline the factors that would determine whether section 482 would apply to a transaction between members of the same families?

In other words, does the service believe that relationships and the term "same interests" are different?

Mr. EGGER. Well, I think we have made it clear that we are eliminating that problem in the final regulations we will provide that where section 482 applies because of the common control language and section 483 also applies, then section 483 will override section 482.

So that we are trying hard in these final regulations to eliminate that problem.

Senator GRASSLEY. Let me be more specific then. If there is an inter-family loan between father and son, just a loan, would you apply 482 or the interest rates in 482?

Mr. EGGER. Yes. If it is a plain loan, yes indeed. We would have no choice.

Senator GRASSLEY. Regardless of whether there are trade or businesses involved?

I think I can give you a very simple example. I loan money to my son to go out and buy machinery.

Mr. EGGER. All right.

Senator GRASSLEY. I have no interest in that machinery.

Mr. EGGER. Yes.

Senator GRASSLEY. But I am loaning him the money to do it.

Mr. EGGER. Because section 482 only applies to loans between commonly controlled businesses, a purely personal loan between family members, whether it is to buy an automobile or to pay for college or whatever, would not be covered by section 482.

Senator GRASSLEY. Thank you very much.

I have another question. Would section 482 apply to a transaction such as the sale of farmland by a parent to a child if the two family members conducted separate businesses?

In other words, does the fact of a family relationship establish common control?

Mr. EGGER. That would be a question in the case of the farming operations. In other words, there would be a question whether section 482, because of its reference to commonly controlled businesses would apply to loans in connection with sales between family members.

Thus, the family relationship could be regarded as creating common control in these sets of circumstances.

Senator GRASSLEY. I am very pleased with your answer. I don't want to undo that. There is a difference, because there is a transaction in the second instance where a parent sells land to a son or any other person in the family. There is a transaction.

I want to make it clear that in the first instance I was talking about there wasn't a transaction.

Mr. EGGER. Well, let me say this. If we are only talking about the sale of land between family members, the mere fact that they may own some other business together is irrelevant. Because, what we are talking about is the transaction which may be subject to sections 482 and 483.

In the case of your example, that would be the sale of land. We would look to that transaction and to the applicable rules under sections 482 and 483, as to that transaction.

Section 483 would be the one to apply in that case.

Senator GRASSLEY. I would like to ask you if you are going to follow the *Bringham* v. *Commissioner case* (598, 2d, 1375, Fifth Circuit, 1979), where 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.

Mr. EGGER. I am not familiar with the details of that case, but it sounds like a perfectly appropriate rule to me and sounds appropriate under section 482.

Senator GRASSLEY. Let me check the staff a moment.

If you follow—I am not a lawyer, I want to tell you right off the bat, but if you follow a circuit court decision, nationwide, it will be the first time it has happened as far as I know. It is one of the faults of the service's administration of the law—am I not right on that?

Senator DURENBERGER. I am a lawyer. You are correct. [Laughter.]

Senator GRASSLEY. Maybe I ought to go to law school and then I will know for sure.

Senator DURENBERGER. You are doing fine. [Laughter.]

Senator GRASSLEY. Mr. Egger, would the Internal Revenue Service be willing to publish a ruling to clarify the application of section 482, to interfamily loans. That is what I was speaking about in my first question to you. Or would that make it too simple or too clear?

Mr. EGGER. I think that when these regulations are placed in final form and they are effective, that is the best route to go in terms of any more specific interpretations. That is a pattern we typically follow. I would certainly see no reason not to do it here.

If we find that after the regulations are out, there is still confusion, then, of course, we will use that route to clarify it.

I would hope we anticipate as many of those problems as we can in the actual drafting of the final regulations so as to leave as few areas of misunderstanding as possible.

Senator GRASSLEY. Now on the subject of the level of interest rates. A publication which reaches many farmers throughout Iowa, the Wallace's Farmer, listed the average interest rates on contract sales in Iowa as eight and forty-four one-hundreths percent from April 1979 to April 1980, and cited the Omaha Federal Land Bank research director as a source for that statistic.

When the proposed regulations were first published many bankers in Iowa complained that the prevailing rate of interest at that time for loans for agricultural farmland was 8¼ percent.

The bankers were concerned this alteration of the regulations requiring a 9-percent stated contract rate of interest would be inflationary.

I realize that the failure to state an interest rate of 9 percent does not increase the dollar amount of each payment a buyer owes a seller, it only affects the ratio of interest to principal, without the payment for tax purposes.

Nevertheless, this is not apparent to many small commercial lenders or taxpayers, assuming taxpayers understand the rule only affects the tax characterization of those payments, such a system confuses and complicates an already detailed tax system.

So, my question is, what would the service do if interest rates again fall below 8 percent?

Mr. EGGER. Well, if interest rates in general fall below 8 percent, then, obviously, we would have to revise the regulations once more and bring them into line with the market rate.

It certainly is my understanding and my information at this point that interest rates across the board on sales of property are considerably above the 8-percent rate which might be applicable to specific property in a specific location.

Unfortunately, we don't have the luxury of being able to pick and choose when applying section 483. It applies across the board, not only to farmers, but to other transactions as well.

Senator GRASSLEY. Well, would the service prefer to set the interest rate to a more flexible standard in light of our current economic situation of widely fluctuating interest rates?

Mr. EGGER. We have considered that very carefully. I, personally, and others as well within the administration, like the concept, but I am satisfied, after having examined it carefully, that the problems both for the taxpayer on one side and for the tax administrator on the other side, simply make it too complicated.

I believe, in the final analysis, that the simplicity and ease of administration of a single rate outweigh the benefits of a floating rate.

Senator GRASSLEY. How many returns did Treasury adjust last year because interest rates were insufficient to meet the test in sections 482 and 483?

Mr. EGGER. I don't have that information.

Senator GRASSLEY. Could you supply it for the record?

Mr. EGGER. I certainly will.

[The information follows:]

Our examination division does not compile statistics on this basis.

Senator GRASSLEY. How much revenue does Treasury hope to gain by increasing the interest rates in section 482 and 483 to levels stated in the proposed regs?

Mr. EGGER. I will have to give you that.

Senator GRASSLEY. Will you supply that for the record, please?

Mr. CHAPOTON. Senator, if I might respond to that question, also. I would say just off the top of my head that it is not a revenue-raising type of change. In order to say that the change would raise revenue, you would have to assume that borrowers are in lower brackets than lenders, and we don't know that. It is required in the law that we set an imputed rate of interest and that is what these regulations do.

Senator GRASSLEY. Very well.

Mr. Secretary, does the IRS have any evidence that 2032A has been used by passive investors as an estate planning tool to reduce the taxable estate?

Mr. CHAPOTON. As far as I know, we have no evidence of that fact. I have seen the possibility mentioned in one or two articles, but we do not know of that actually taking place, no sir.

Senator GRASSLEY. Then, as long as you don't know, I don't suppose there is any need for my second question, but I could ask it more generally, because I was going to ask you specific loss of revenue.

Do you anticipate loss of revenue? Is that a basis for determination of change of regulation?

Mr. CHAPOTON. No, that is not the basis of the determination of the change. It is—I am not sure the loss of revenue is the concern about the formula method. There is concern about the formula method though because of the significant difference in values reported under the formula method versus other methods for determining farm value of property.

Senator GRASSLEY. Let me interject something here to Mr. Egger. It just came to my mind, and I was intending to ask it before. But, I think to follow along the line of testimony of both Senator Andrews and Senator Melcher.

Maybe some of the adjustment in your regulations is a positive response to what I am going to say. But, is there an appreciation in the IRS, and the Treasury Department generally, that when we pass laws that take care of tax problems for big corporations like one corporation loaning money to another corporation, when that gets down to affecting the small family farmer or the small main street business person, to the detriment of the family farm and the main street business person, that is not congressional intent.

Is there an appreciation that those small institutions in our economy ought to be treated a little bit different than major corporations?

Mr. EGGER. I don't think there is any question that we appreciate it, Mr. Chairman. Where it is appropriate, under the statutes as passed by Congress we certainly take these considerations into account.

As I mentioned earlier, we have no wish certainly in this Administration nor in the Internal Revenue Service, to bear unnecessarily heavily on any segment of the taxpaying public. Our problem is that we are bound by the words of the statute. We are bound by the terms.

We simply haven't the luxury, as I said earlier, of being selective about it.

Senator GRASSLEY. Legitimately then, the ball is right back in my court and that is probably where it maybe belongs. If you recognize problems in legislation introduced by Senators, please tell us of these difficulties.

We don't see you coming to us enough with suggestions when something meant for larger institutions of American society is hurting the smaller ones. Maybe suggestions from you would be beneficial.

Mr. EGGER. We certainly intend to. I think I have said to you and to the Finance Committee, in prior hearings, that it is my intention, as the Commissioner of Internal Revenue, to bring to your attention those disparities when we see them, when we see them coming or when we see them after they happen, we intend to bring them to your attention and to work with you as much as we can, to solve them administratively wherever it is possible, and if that is not possible, then to work with you on a legislative solution.

I think I am speaking for the Assistant Secretary as well, but he is here.

Mr. CHAPOTON. I concur wholeheartedly in Mr. Egger's statement.

Senator GRASSLEY. Very well.

Now, back to you, Mr. Secretary, can you suggest any criteria for distinguishing a farmer from a passive investor or a better definition for material participation?

Mr. CHAPOTON. I do not today have words to suggest in that regard. We wrestled with that very problem in reviewing these regulations. You have all sorts of different farmers from tree farmers to farmers that spend a great deal more time taking care of their farm than is required of tree farmers and what is material participation in one case may not be regarded as material participation in the other, in the eyes of most people.

So, we don't have an answer to it, but I have to concede it is a problem.

Senator GRASSLEY. Do you have some expertise downtown that could help us?

Mr. CHAPOTON. I am afraid the expertise in this type of a thing, as is so often the case when we are writing regulations, has to come from information from people in the field, that is, from the different fact situations that we encounter.

We certainly have heard a great deal, have received a great deal of information in response to the publication of these regulations. So, maybe we can address the problem more fully than we could without that, though the question is going to be difficult to resolve even with full information

Senator GRASSLEY. I think you may have answered my next question on parents renting to someone within the family, as it relates to the problem of the conflict between cash rent disqualifying people for special use, but qualifying parents for social security.

But, we still have the problem for the people who can't rent to a family member, yet, cannot satisfy the social security requirements.

Mr. CHAPOTON. That is correct. I think that that problem would remain, a cash lease to an unrelated party would disqualify the property.

Senator GRASSLEY. Yes. I don't know to what extent you know, obviously I am thrilled that you have gone as far as you have. Of course, the remaining problem would be with the relationship with social security, and I suppose this isn't the forum to deal with that, but it could be dealt with by the full Finance Committee.

Another question, would increasing or eliminating the cap on the special use reduction encourage passive investors to purchase farm property as an estate planning device?

Mr. CHAPOTON. We would be concerned about that, yes sir. We can't state unqualifiedly that it would, but when you raise it to more than half a million dollars, we would definitely be concerned about that impact.

Senator GRASSLEY. Do you think a change like that would have an inflationary effect on the price of farm land?

Mr. CHAPOTON. It could. That has been suggested in articles written on the present special use valuation provision. Certainly, if that is a problem under the present rules, it would be more of a problem if you raise the cap.

Senator GRASSLEY. What is the cost of administering section 2032(A)?

Mr. CHAPOTON. The cost of administering it?

Senator GRASSLEY. Yes.

Mr. CHAPOTON. We could make an estimate of that, Mr. Chairman. I certainly don't have that off the——

Senator GRASSLEY. I would appreciate that for the record.

Mr. CHAPOTON. Yes, sir.

Senator GRASSLEY. Under the current definition of material participation is there uniformity in the Service's administration of this tax?

Mr. CHAPOTON. There is probably not uniformity, total uniformity in the administration within the various IRS districts on any factual question such as that. It is a constant problem in administering the tax laws. But, I do not personally know of any great disparity on that point. We would be happy to hear about it if there are some.

Senator GRASSLEY. Let me say, uniform enforcement of the tax laws would be one of the best ways we could improve the credibility of Government generally, but specifically, the IRS.

I was wondering if you think there was any of the standards currently used to determine comparability that could be deleted?

Mr. CHAPOTON. In connection with our review of these regulations, we reviewed those standards. We concluded they were sound.

Senator GRASSLEY. Should there be special rules for the valuation of timberland?

Mr. CHAPOTON. Mr. Chairman, we just haven't addressed that question.

Senator GRASSLEY. Well, would you think about it and let us know in writing?

Mr. CHAPOTON. Yes, Sir. We will be happy to.

[Material was subsequently submitted:]

DEPARTMENT OF THE TREASURY,
ASSISTANT SECRETARY,
Washington, D.C., June 30, 1981.

Hon. CHARLES E. GRASSLEY,
Chairman, Subcommittee on Oversight, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: At the April 27, 1981 hearing before your Subcommittee, you requested an estimate of the cost of administering section 2032A, and our views on whether the regulations under code section 2032A should provide special rules for the valuation of timberland.

The Internal Revenue Service does not maintain records indicating the cost of administering each section of the Internal Revenue Code. We have, however, estimated, based upon a sample of cases, that the annual cost of administering section 2032A is approximately $500,000.

We have examined the issue of providing special rules for the valuation of timberland and believe that no special rules are necessary. The regulations currently in effect provide guidance with respect to valuing a wide range of property, including nonfarm property, subject to the section 2032A election, and there does not appear to be any reason this guidance cannot be readily applied to timberland. However, we would be pleased to review any specific suggestions which you or other interested parties would make.

Sincerely,

JOHN E. CHAPOTON,
Assistant Secretary (Tax Policy).

Senator GRASSLEY. Then if——

Mr. CHAPOTON. I might——

Senator GRASSLEY. Go ahead.

Mr. CHAPOTON [continuing]. Pressure on special valuation of different types of assets is probably brought about by inflation and by the resulting increase in the estate tax burden on estates that are shoved up into a high estate tax bracket. A lot of this should be addressed in connection with an entire review of the estate tax provisions of the code which this Congress will certainly undertake, and which this administration is currently reviewing.

Senator GRASSLEY. How quickly and what instrumentality will the IRS use to notify the attorneys throughout the Nation of the policy changes on issues of present interest and passive rental?

Mr. EGGER. The thought here would be to put out proposed amendments to the regulations. We could, I guess, consider whether a press release should be out at the present time. My own feeling is that we should put the regulation amendments out so people can really see what they have to say.

Mr. CHAPOTON. I believe I would agree with that. Tax regulation changes such as this are picked up and in the usual case are very clearly described by the tax services. The word seems to get out pretty quickly. I don't know what more we could do to publicize it.

Senator GRASSLEY. Mr. Secretary, my last question, would you prefer raising the unified credit instead of broadening the special use valuation rule?

Mr. CHAPOTON. Mr. Chairman, that question is a bit broad for the moment, but my personal preference I think would be, yes sir, I would prefer raising the unified credit in dealing with the specific types of property.

Mr. EGGER. Mr. Chairman, may I ask for a clarification of one of your earlier questions?

Senator GRASSLEY. Yes.

Mr. EGGER. You asked the Secretary about the cost of administering section 2032A, and since I strongly suspect that I will get that question instead of him, I want to be sure that you are talking about the cost of administration versus what the difference it is making in terms of tax revenue.

Senator GRASSLEY. Yes.

Senator Durenberger, do you have any followup questions?

Senator DURENBERGER. Thank you, Mr. Chairman.

I have just one, Mr. Chairman. It is often argued that the lower interest rates in contracts for deed arrangements are some kind of tax management device to get a higher price than you would under a loan or the kind of rates that are being suggested here, the higher rates. I am just wondering what evidence either of you have that that theory applies to agricultural lands in this country.

Mr. EGGER. I don't think I have any different thoughts about that than I do about other transactions. We know that because of differences in tax rates, that is, levels of income, taxpayers, and particularly related taxpayers, would try to shape transactions as between themselves in order to provide the maximum tax advantage or the least tax cost.

So, I don't have any evidence it is any more prevalent in the case of agricultural property than in the case of any other transactions among family members.

Senator DURENBERGER. Do you have any evidence that it is not at all prevalent in agricultural transactions?

Mr. EGGER. No.

Senator DURENBERGER. You do not have that kind of evidence available?

Mr. EGGER. We don't have that kind of evidence; that's correct.

Senator DURENBERGER. Would it be possible to get that kind of evidence?

Mr. EGGER. I seriously question how reliable the evidence that we might get would be. We could make an inquiry and determine whether it would be feasible.

Senator DURENBERGER. Now you are destroying all the nice things I said about you earlier.

I think there is a lot of that information out there. I think all you would have to do is start talking to people that deal at the State level with this problem every day. Talk to the States that are in the business of trying to provide farm security for people, for young farmers in particular.

Talk to the dozen or so legislatures who right today are trying to design legislation. They have accumulated a lot of that sort of evidence. I would suggest to you that you take a look at it.

Mr. CHAPOTON. You mean in effect a survey of the rates charged in contracts for sale of farm land?

Senator DURENBERGER. Yes.

Are contracts for deed prevalent in the 6 to 8 percent range or something like that.

Mr. CHAPOTON. Right.

Senator DURENBERGER. As against the conventional mortgage or Federal land bank mortgages at a somewhat higher rate. Do you find evidence of what you indicated earlier in the theory that people use the lower interest rate in order to gain the advantages of capital gains tax.

Mr. EGGER. I am sorry but I misunderstood your question earlier. I thought you were asking whether we had evidence that people enter into these transactions from a pure tax motivation point of view versus——

Senator DURENBERGER. That is part of the question.

Mr. EGGER. All right. We will provide information here because I am satisfied there would be quite a difference between bank financing rates versus rates in transactions which are owner-financed. Perhaps we can draw some conclusions from that.

Senator DURENBERGER. Well, I am sure you will find a difference in rates. I am concerned about whether or not it is having an impact on the transactions that take place out there so far as value of land is concerned.

Mr. CHAPOTON. Senator, do you mean that the higher interest rate could depress the value of land or increase the value of land?

Senator DURENBERGER. No. My concern is that there is an implication here that the contract for deed is being used as a vehicle to take advantage of the tax code in effect and the benefits that come with the capital gains tax, thus driving up land prices.

In other words, the sale price is higher with a lower interest rate. I am not sure you are going to find that to be the case. You might find that in New York City real estate or here in Washington, D. C. But, I am not sure that when you go into the agricultural parts of this country that you are going to find that that is the case.

Senator GRASSLEY. Does the staff or the minority have any questions they want to submit for the record?

[No response.]

Senator GRASSLEY. Very well.

I want to thank both of you, Mr. Secretary and Mr. Commissioner, for your participation. I particularly want to thank you for what changes you have made and I look forward to working with you to bring about more changes that some of us feel need to be yet made. I also welcome your participation on clarifications in following on where maybe you have been blamed because of the rigidity of legislation already on the books. I want to apologize and hopefully we can correct that.

Thank you both very much.

Mr. EGGER. Thank you, Mr. Chairman.

Mr. CHAPOTON. Thank you, Mr. Chairman.

Senator GRASSLEY. Yes.

[The prepared statement of Hon. John E. Chapoton and Hon. Roscoe L. Egger follow:]

For Release Upon Delivery
Expected at 1:00 p.m.

JOINT STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
AND
THE HONORABLE ROSCOE L. EGGER
COMMISSIONER OF INTERNAL REVENUE SERVICE
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON FINANCE
APRIL 27, 1981

Mr. Chairman and Members of the Subcommittee:

We are pleased to appear before you today to discuss the proposed imputed interest regulations under sections 482 and 483. We would like to take this opportunity to present the results of the review by the Treasury Department and the Internal Revenue Service of these regulations.

At the outset, however, we would like to correct a fundamental misunderstanding that has permeated all aspects of the debate over these regulations.

The Internal Revenue Service has received a large number of comments on these proposed regulations from farmers and other groups. The majority of these comments are based on an erroneous understanding of how section 483 operates. The comments assume that by providing higher imputed interest rates for deferred payment sales for tax purposes, the proposed regulations would require higher amounts to be paid by purchasers of property. In fact, section 483 does not affect the amounts paid by the purchaser for property; it affects only the characterization of these amounts as principal or interest for Federal tax purposes.

We would like to illustrate this point with a simple example. Assume A sells a farm to B for $1 million and that the contract of sale provides that B will pay A $100,000 each year for 10 years. The contract specifies that no interest will be charged. Section 483 provides that in this situation some

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portion of each $100,000 payment will be interest for Federal income tax purposes. The remaining portion will be considered to be a payment of principal.

Notwithstanding the application of section 483, B still pays A $100,000 each year for 10 years or a total of $1 million. Section 483 does not require that B pay A more than the amount specified in the contract. To the extent interest is imputed, A will have interest income for Federal income tax purposes. B will have an interest deduction in this amount. A's gain on the sale and B's basis in the farm will be based on the portion of the $1 million representing principal, not the entire $1 million. Thus, A will have less gain (or more loss) and B will have a lower basis in the property than if no interest were imputed.

Most of the specific criticisms of the proposed regulations arise from this misunderstanding. For example, it has been asserted (1) that the proposed rates would make it more difficult for young people to purchase farms or homes by increasing monthly amortization payments due to higher interest costs; (2) that the proposed rates are inflationary and would institutionalize higher interest rates; and (3) that the proposed rates would further depress the already seriously-depressed housing and real estate industries. These assertions are all based on the underlying assumption that section 483 actually increases the amounts to be paid under deferred-payment sales contracts. As I have indicated, section 483 affects only the characterization of these amounts as interest or principal for Federal tax purposes. Thus, these criticisms are misdirected.

We would now like to explain the background of the proposed changes in the regulations under section 482 and 483 and to set forth the results of our review of these changes.

The principle that the imputed interest rates under sections 482 and 483 should reflect market interest rates has long been a part of the law. The legislative history of section 483 indicates that its purpose is to prevent a seller of property from manipulating the tax consequences of the sale by increasing the amount of deferred payments for property in lieu of interest. Section 483 directs the Treasury Department to set an appropriate minimum interest rate for these deferred payment sales in order to prevent this abuse. The legislative history of section 483 anticipates that the rate 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 from a bank. Set forth in the appendix are excerpts from the legislative history to 483 setting forth in more detail the purposes of this provision and guidelines for Treasury regulations.

The general purpose of section 482 is to prevent taxpayers from avoiding tax by conducting transactions between commonly-controlled trades or businesses on non-arm's length terms. Specifically, the section 482 regulations have for years provided that taxpayers cannot avoid tax by charging an interest rate very different from the normal market rate on loans between commonly-controlled businesses.

In view of the disparity between the current market interest rates and the 7 percent rates imputed under the existing regulations if at least 6 percent interest is not charged, we believe it is necessary to adjust the existing imputed interest rates to bring them more in line with current market rates. We have therefore concluded that the final regulations will provide, in general, that the minimum interest rate that must be charged under section 483 to prevent imputed interest is 9 percent and that the minimum rate that must be charged under section 482 is 11 percent. These rates are unchanged from the proposed regulations. In the event the literal terms of both sections 482 and 483 are met in the same transaction, section 483 will be controlling.

The final regulations under section 482 will, in general, provide that the Internal Revenue Service can impute a 12 percent interest rate on loans between commonly-controlled trades or businesses unless the taxpayer charges a rate between 11 and 13 percent or establishes that a different rate would be an appropriate arm's length rate. Under the present regulations, the comparable rates are 7 percent and 6-8 percent.

The final regulations under section 483 will, in general, provide that unless a contract for the sale of property provides for at least 9 percent simple interest on deferred payments, a rate of 10 percent, compounded semiannually, is imputed. Under the present regulations, the comparable rates are 6 and 7 percent.

Many comments asserted that the proposed rates would have a negative and unfair impact on family farming and family businesses because higher interest rates would be required on loans for the sale of property to a family member than on loans for the sale of property to a non-family member. This is based on the assumption that such sales would be governed by section

482 and not section 483. The final regulations will eliminate any possible problem in this regard by providing that, in the event the literal terms of both section 482 and section 483 apply to a transaction, section 483 will override section 482. Thus, the 9 percent minimum interest rate will be sufficient for sales of property to a family member as well as for sales of property to a non-family member.

Consistent with the letter to Senator Melcher last December from Donald C. Lubick, former Assistant Secretary for Tax Policy, we will not issue final regulations on these issues before July 1, 1981. We have decided, however, in view of the many taxpayer inquiries regarding the imputed interest rates, to announce our decision through this statement and through a news release. A copy of the news release, which is being issued today, is attached.

We have carefully considered whether the final regulations should maintain the effective dates provided in the proposed regulations. These dates are August 29, 1980 for the regulations under section 482 and September 29, 1980 for the regulations under section 483. We believe it would have been consistent with Mr. Lubick's letter to maintain these effective dates. However, because there may have been some confusion about whether Mr. Lubick's letter portended a delay in the effective dates until July 1, 1981 and in order to extend to Congress every courtesy in its review of the issues raised by the proposed regulations, we have decided that, in general, the final regulations will be made effective as of July 1, 1981.

The final regulations under section 482 will provide certain "grandfather" rules for interest paid pursuant to a non-demand loan or advance entered into on or after July 1, 1981 but pursuant to a binding contract entered into prior to August 29, 1980. Similarly, the final regulations under section 483 will provide certain "grandfather" rules for payments on account of a sale or exchange of property entered into on or after July 1, 1981 but pursuant to a binding written contract (including an irrevocable written option) entered into before September 29, 1980. However, there will be no such "grandfather" rules with respect to binding contracts entered into after these dates.

Appendix

Excerpts from the Legislative History to Section 483

(b) General reasons for provision. Your committee agrees with the House that there 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 non-depreciable 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 your committee believe that manipulation of the tax laws in such a manner is undesirable and that corrective action is needed. Senate Rep. No. 830, 88th Cong. 2d Sess., 101, 102 (1964).

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. A rate of 5 percent, for example, would appear appropriate under existing circumstances. House Rep. No. 749, 88th Cong., 1st Sess., at 72-73 (1963); Senate Rep. No. 830, supra at 102.

NEWS RELEASE

The Treasury Department today announced the results of its review of the proposed regulations issued last August under sections 482 and 483 of the Internal Revenue Code. Regulations were proposed at that time to adjust the existing rates to more closely approximate the higher market rate of interest. Although final regulations will not be issued before July 1, 1981, the Treasury Department made the announcement in response to numerous inquiries by taxpayers concerning possible changes in the imputed interest rates and the effective date provisions.

In general, the final regulations will provide (i) that the minimum interest rate that must be charged under section 483 to prevent imputed interest is 9 percent simple interest and (ii) that the minimum rate that must be charged under section 482 to prevent imputed interest is 11 percent simple interest. These rates are unchanged from the proposed regulations. However, if the literal terms of both sections 482 and 483 apply to a transaction, then the minimum interest rate to prevent imputed interest will be 9 percent simple interest.

The final regulations under section 483 will, in general, provide that unless a contract for the sale of property provides for at least 9 percent simple interest on deferred payments, a rate of 10 percent, compounded semiannually, is imputed. Under the present regulations, the comparable rates are 6 and 7 percent.

The final regulations under section 482 will, in general, provide that the IRS can impute 12 percent simple interest on loans between commonly-controlled trades or businesses unless the taxpayer charges a rate between 11 and 13 percent or establishes that a different rate would be an appropriate arm's length rate. Under the present regulations, the comparable rates are 7 percent and 6-8 percent.

Many comments on the proposed regulations expressed concern that by providing a higher rate under section 482 than under section 483, sales of property to family members or other related parties would be subject to the higher rates of section 482, thus providing a possible disincentive to sell property, such as a family farm, to family members. The final regulations will eliminate any such possible .

disincentive by providing that, in the event the literal terms of both section 482 and section 483 apply to a transaction, section 483 will override section 482. Thus, the 9 percent minimum interest rate provided under the section 483 regulations will be sufficient for all sales of property subject to section 483, including any sales of property to family members potentially subject to section 482.

Other comments indicated a misunderstanding of the manner in which section 483 operates. Specifically, many comments assumed that if interest is imputed under section 483, a greater total amount must be paid by the purchaser for the property. As illustrated below, this is not how section 483 operates.

Asssume _A_ sells a farm to _B_ for $1 million and that the contract of sale provides that _B_ shall pay _A_ $100,000 each year for 10 years. Since no interest is provided for in the contract, the contract fails the 9 percent minimum rate (i.e., test rate) established under section 483. As a result, some portion of each $100,000 payment will be considered interest for federal tax purposes. The remaining portion of each $100,000 payment will be considered to be a payment of principal. The amount of each payment considered to be interest will reflect 10 percent interest, compounded semiannually. (Tables and instructions are provided in the regulations to determine this amount). The effects of the application of section 483 are the following:

1. _B_ still pays _A_ only $1,000,000 in 10 installments of $100,000 each;

2. _A_ must report the amount considered to be interest as interest income on his federal tax return and _B_ is allowed an interest deduction for the same amount;

3. _A_'s gain on the sale and _B_'s basis in the property will be based on the portion of the $1,000,000 representing principal and not on the entire $1,000,000. Thus, _A_ will have less gain (or more loss) on the sale and _B_ will have a lower basis in the property than if the entire $1,000,000 were deemed principal.

This example illustrates that only the federal income tax consequences of the transaction has been changed. The contract between the parties continues to define all matters other than the federal income tax consequences of the transaction.

In general, the effective date of the final regulations under sections 482 and 483 will be July 1, 1981. However, special "grandfather" rules will apply under the section 482 regulations to interest paid pursuant to a non-demand loan or advance entered into on or after July 1, 1981 but pursuant to a binding contract entered into prior to August 29, 1980. Also, special "grandfather" rules will apply under the section 483 regulations to payments on account of a sale or exchange of property entered into on or after July 1, 1981 but pursuant to a binding written contract (including an irrevocable written option) entered into before September 29, 1980.

Senator GRASSLEY. Now, I would like to call to the witness table, Neil E. Harl, Charles P. Curtiss, distinguished professor, Iowa State University, Ames, Iowa and Paul Hasbargen, professor of agricultural economics, University of Minnesota.

Senator Durenberger, I am sure that you would like to introduce Paul.

Senator DURENBERGER. Thank you, Mr. Chairman.

I would start by saying I am pleased that Paul is here. We have, besides being blessed with 92,000 family farms, we are blessed at our university with a variety of talents, as I am sure you are in your State, Mr. Chairman, of people who have been in the public service business probably longer than we, with a commitment to the family farms.

Paul Hasbargen and several of his associates there have over the period of time that I have been in public service, made immense contributions to the formulation of public policy in our State, in the area of agricultural economics.

I think he is as important a witness as we are going to hear as we do our oversight of the Internal Revenue Service.

I am pleased that he had the time to be here today.

Senator GRASSLEY. Mr. Harl is distinguished by his publications on this general subject of State taxes, but most recently, because of writings he has done since the 1976 estate tax law was passed, and you know, in complimentary fashion, I think it can be said that a lot of people have made some judgments of how they ought to plan their estates based upon the writings of Neil Harl.

I would like to ask Neil if he would start.

STATEMENT OF NEIL E. HARL, ACCOMPANIED BY CHARLES F. CURTISS, PROFESSORS, IOWA STATE UNIVERSITY, AMES, IOWA

Dr. HARL. Thank you, Mr. Chairman, Senator Durenberger.

I am pleased indeed to be here, and I appreciate the opportunity to appear before this subcommittee and to provide commentary.

I have a one-page summary, which is a bit more reasonable than the 22-page longer piece which is submitted for the record.

My written testimony is divisible into three parts basically, on use valuation, and then I will conclude with some comments on the imputed or unstated interest rules.

The first part of the written testimony is a brief examination of some policy considerations.

The second part of the written testimony is a listing of areas where technical problems exist, some of which have just been resolved, apparently, so we won't need to spend much time on those items.

The third part of the written testimony involves a look at three areas where we think more fundamental changes may be worth considering.

In mention of the policy side, and this will be brief indeed, any substantial change in the scope of coverage or in the quantitative benefit amount available, we think probably should be undertaken only with adequate attention to the policy implications. Some of those have been touched on in earlier testimony this afternoon.

The first is the potential of inducement for mere investors to acquire land to obtain the tax benefit. This is what we call the gate that is needed to preclude mere investors of all types from taking advantage of a benefit targeted for family farms and ranches.

The second is the problem of encouraging older individuals to retain land until death so that in at least some families older individuals see an advantage in not making transfers during life.

The third is the tendency for the benefit to be capitalized into land values.

The fourth is the fact that the greatest benefit tends to accrue to those with the largest estate, not just looking at the $500,000 maximum reduction of gross estate, but the fact that the benefit from the $500,000 amount is greatest for those in the 70-percent tax bracket.

Finally, the expected effect on farm firms.

Most of these are in the nature of long-term considerations. We cannot offer to you quantitative estimates of these policy matters based upon our 4 years of experience.

We think however, that we are moving into a time when we will be able to do more empirical research in this area.

Special attention is directed to the areas in the law that need technical attention. We identify four. I would like to add one more, for the record.

The first two have been addressed by the Internal Revenue Service today including the qualified use test which has essentially precluded the use of cash rental arrangements even between family members.

As I understand the statement of the Internal Revenue Service, they are saying that section 2032A(b)(2), would be interpreted to permit the qualified use test to be met by members of the family, as well as by the decedent-to-be.

I think this is a reasonable interpretation. The major question I have is that this matter ought to be conveyed to attorneys and taxpayers as soon as can be done in light of previous Internal Revenue Service policy. There are matters in litigation and there are matters in planning for which this is a very vital concern.

So, I would simply indicate that the sooner the better, in terms of getting that information into the hands of users.

The second technical area is the present interest test. I guess I have some concerns remaining there. Essentially, what we are talking about is a problem that is almost totally limited to the use of the sophisticated will and trust.

Ironically, this is the kind of trust we have been encouraging people to use for the past 20 years.

We have estimated that probably 95 percent of the wills and trusts of the fairly sophisticated type drafted in the past 20 years, probably wouldn't meet the present interest test, as we understand that test in the form of letter rulings.

So, again, if there is a change of policy, we think that should be communicated as quickly as possible to users. Otherwise, there seems to be little recourse other than a massive recall, and I mean massive, of sophisticated wills and trusts that have discretionary powers within them, discretionary both with respect to income and with respect to principal. Moreover, if we must do that, it will essentially mean we will have to convert the trust into an instrument resembling a legal life estate, which means we have taken the flexibility out of it.

So this again, I think is an important matter, a very vital matter, and I would urge the Service to communicate their position on this just as soon as it is in a condition so that it can be determined what the parameters are of that position.

This is a very complex area and one that is quite important, because it is an integral part of the planning process.

The third technical area which has arisen in a number of instances is the definition of family member. Generally speaking, that definition is broad enough so it doesn't cause too many problems, but it does cause problems in two situations, both of which are identified in my more lengthy testimony. One I would like to call to your attention, and that is the following example.

Let us assume two brothers have been farming together for many years. Each owns a half section of land. One of them dies and leaves the land to the spouse. The land is farmed thereafter by the family of the deceased brother. That would not be an eligible, material participator.

I believe that the statute should be modified to include the family of a deceased spouse. This type of case is not at all atypical. We have encountered a number of those, particularly in the middle west. We think that the change suggested would be worthwhile.

Another point is the proportionate recapture of the benefits from the special use valuation election. At the present time, the position of the IRS seems to be that there would be a disproportionately large recapture in the event of a partial disposition of special use valuation land.

For example, if you elect for a half-section of land, and then must sell 80 acres, apparently at the present time the position would be that you would recapture a disproportionately large amount of the tax benefit.

We believe that is probably at odds with the general belief of what the recapture rule should be; morever, there is a question of statutory interpretation. We would commend that to you for your attention.

Finally, there is a requirement that the property must pass by inheritance and not by purchase to be eligible for special use valuation. We are finding that estates are having difficulty with this where there is a sale of farm property during the process of estate settlement. We think a technical amendment would be very useful permitting purchase by family members. So, if a farming son bought the others out during the course of estate settlement, that would not preclude the special use election. At the present time, it would appear that it would, in fact, do so.

We will turn now to the three areas for which I would suggest consideration of a more major nature.

In the first one, we believe that, as presently constituted, the special use valuation provision does not deal with an even hand with farm tenants, compared with owners of land.

We would suggest that attention be given to extending the special use valuation election to cover both farm personal property, machinery, livestock and equipment—as well as farmland.

There are several reasons for this. One is that the mix of land and farm personality varies tremendously by type of farming area.

Also, if a tenant dies, the tenant may receive no benefit whatsoever from special use valuation, and yet there is a going farm business.

We believe that in the same basic way in which installment payment of Federal estate taxes is handled, it would be well to consider extending the 2032(A) election to all property used in the business.

It would also, as a side benefit, take some of the pressure off the capitalization of the benefit into land value, if use valuation were extended to all types of farm property.

A second major point has to do with the problem of cash rent leases. This has been a problem all over the United States.

As one who is involved rather substantially in continuing legal education, in quite a number of States, I can say with some confidence, that there are areas in this country where cash rents do not exist or essentially do not exist.

We believe that the time perhaps is here for considering a simplification of section 2032(A), and that is to consider making special use value a statutory percentage of fair market value and to dispense totally with the cash rent concept.

I think that if we can agree upon a statutory percentage, we could simplify immensely the tasks of electing and acquiring necessary information. A percentage concept would deal equitably with all types of farming.

All that would be necessary would be to value the property, apply a statutory percentage, and the task would be completed.

Third and finally on that point, we believe that there would be some merit in considering converting the 2032(A) benefit into a credit. It would be a credit in the nature and in the manner of the unified credit, but a separate credit which would then prevent the higher tax bracket individual or estate from gaining the greatest benefit.

For example, if we were to set the credit equal to 32 percent of the deduction amount, which would be a typical amount for a farm estate of the type that we are talking about here today, then that would be worth the same amount, $32,000, whether one happened to be in the 32-percent tax bracket or the 70-percent tax bracket.

We think especially as we begin thinking of lifting the cap on 2032(A) that there is merit in considering the credit, but a separate credit apart from the unified credit, so that it would still be identified as one for the benefit of the farm and ranch small business.

We see this as a way to limit the loss of revenue and also to limit the incentive for the high tax bracket investor to become involved. We think it is one of the more practical ways in which that problem can be curbed.

Very, very quickly in closing, on imputed interest, the section 482 and section 483 problem, we have urged there four things. One, that the Service may clarify the scope of application of section 482 because of the widespread confusion and we would urge that be done as soon as possible because there continues to be concern among taxpayers about whether section 482 applies to a parent-child transaction, for example.

Second, that the section 482 rate, which is the controlled entity rate, parallel the rates under 483. Not until this time have those rates departed substantially from the rate under section 483.

For example at the present time, the rate for 483 is a 6 percent rate refigured at 7. The 482 rate is a rate of 6 percent to 8 percent. The 482 rate is still in the same ballpark.

The proposed regulations move out ahead and create a higher rate for the unstated interest for the controlled entity. We have no trouble requiring controlled entities to toe the mark with the same rules as with the family transaction, but we have a little trouble with a higher rate.

Third, we would urge the Service to adjust these rates more frequently. We think one of the problems here is that we had a big jump all at once and there had not been a change for 5 years. We believe that this rate probably should be changed more frequently.

We would also suggest, finally, that attention be given as a policy matter to considering the reasonableness of that rate in light of the length of the obligation.

That is to say, if one has a 2-year contract, making the minimum interest rate reasonably close to the rate that would exist in the short term market for interest rates seems reasonable.

If one is talking about a 25- or 30-year land contract, then that interest rate does not necessarily bear the same close relationship to the short term or current interest rate as you would expect for a short-term obligation.

I believe that there ought to be attention given to the length of term, especially in a time of great fluctuation in interest rates.

Thank you, Senator.

Senator GRASSLEY. Thank you, Neil.

Now, I would like to go to Paul before we have any questions.

STATEMENT OF PAUL HASBARGEN, PROFESSOR OF AGRICULTURAL ECONOMICS, UNIVERSITY OF MINNESOTA

Mr. HASBARGEN. Thank you, Mr. Chairman. It is certainly a pleasure to be here today. I thank Senator Durenberger for his kind words.

I do have a prepared testimony which I believe the members have received and visitors may pick up. I will try to summarize that in the interest of time.

I will start with some words of wisdom from Proverbs that the borrower is a slave to the lender and raise a question as though is it the place of government, IRS in this case, to issue and implement regulations that will lead to an increase in the bondage of these debtors, of the borrowers.

As we look at who is borrowing, as pointed out, it tends to be your beginning farmer in many cases or farmers with less capital or especially the ones I am concerned about.

We are finding this year in evidence already, that these people are now asked to pay more and it is the people—you might say the rich, those who have large assets are gaining by this increase in interest rate because it has been, as Senator Durenberger indicated, above previous market rates.

I really want to question the reasonableness of the rates, the issue that Dr. Harl closed on.

Let me address two or three different economic relationships then. First, let's look at graph 1. You will see the direct correlation between changes—on page 7 of the report—changes in corporate bonds or in other words, changes in interest rate compared with changes in inflation.

We all know as inflation rates go up interest rates have to go up and so, it has been inflation that is pushing interest rates up.

One question asked right there and this is the same point that my friend, Mr. Harl raised, what happens in the future? If we lock into a contract for 15 years and we are forced to do it at 9 percent or 10 percent we are really prejudging what that inflation rate is going to be.

The second graph then shows what has happened to the cash flow problem. That is on page 8, graph 2. The net return, similar to the net return to bonds, net return to land, our farm agent records are shown going back 30 or 40 years. This fluctuated in the area of 3 or 4 percent.

If this return to land stays at 3 percent—we had a nice blip in there in 1973 after the Russian grain deal prices went up and there were some windfall gains. But, that meant return to land as bid down to 3 percent on current value.

It is as interest rates go up, that cash deficit, cash flow deficit for the person buying land becomes more and more serious.

Now, in my notes on top of page 2 I refer to an article that I did about a year ago, "Land Prices: Why So High? Will They Go Higher?" The basic conclusion in that report is that two major factors influence land prices. One is the level of farm income. Second, is the level of inflation rate. As inflation rates have increased, we bid that expectation of continued high inflation rates in the land values.

So, on two counts it is the inflation rate, itself, which most economists would agree that Government itself has much to do with the level of inflation rate that we see in the economy, if you include the Federal Reserve System in the general definition of Government.

So here we are looking at a case where first we have Government actions which push up inflation rates which in turn push up both interest rates and land prices.

Then those rural people who elect to transfer land at either a lower price than the market rate, so-called market rate, that is the top of the market that has plugged in currently at 6- to 7-percent inflation rate expectation and at lower interest rates are going to be prohibited from doing it.

Now, this I point out on page 2, this sort of viewpoint that IRS in the new regulations, is putting forth. Expectations for continued high inflation rates is one against the viewpoint of this administration which if you look in President Reagan's message to Congress the program for economic recovery, they have a projection for the Consumer Price Index dropping from 11 to less than 5 percent by 1986.

Second, and importantly I think, is that this new imputed level of interest rate is in conflict with the judgment of the marketplace. I think Senator Durenberger correctly asked the question—What evidence is available in terms of the existing interest rate for contract for deeds as opposed to conventional mortgages?

I would point out that there are some very important differences. One, the typical contract for deed has no stipulation for changing the interest rate if interests rates do, in fact, come down. Typically these contractor deeds are set at 10 years to 15 years to 20 years. Ten to 15 is the most common in Minnesota.

Therefore, if this regulation forces, and we are seeing evidence of this, a rate which otherwise would have been 7 percent, 8 percent or even 6 percent in some cases up to 9 percent, they are in essence acting against the marketplace.

There is evidence from the marketplace—the Minnesota Department of Agriculture the last 3 years prior to the loan, over 200 loans came in about half of which were family, but both family and nonfamily of those 200 loans only two of them were over 8-percent interest rate.

So, I must conclude that the prevailing interest rate on land contracts was below 9 percent in Minnesota, very definitely below 9 percent especially for low equity purchasers just getting into the business.

The impact, of course, is that these people then have to—say if it went up 2 percentage points it means about an extra $3,000 per year payment for these low-equity borrowers and there is evidence that many of them because of this increase, have not been able then to buy a farm.

Let me give you just one actual example that is on hold now in the Department of Agriculture. Someone who is going to have his farm sale at 6 percent. After the announcement, they had not finished their plans, they have sent it in, asked for approval under this program. Even at 6 percent, if it is changed, of course, we will have to go 9 percent.

Now, I have a table I think on the back of page 10 which illustrates the impact that this particular example would have on the cash flow requirements. You will notice the minus signs. Under the 6-percent contract the minus signs start at $60 and $70 and I am putting in a generous 7-percent inflationary increase in earnings. Most farmers looking at sales contracts are bidding in maybe at 5 or 6 percent.

At the 9 percent interest on the contract, this negative cash flow jumps from $70 to $124 in the first year. By year 10, it changes from $11 to $63. In other words, about $52 or $53 more.

Also, you have to go about 4 or 5 years longer before you get into the black. In other words, the negative cash flows are larger and longer if you have a higher interest rate.

Now, I know that IRS does have the concern. I address in the middle of page 4 about this tradeoff for tax purposes. I myself have been guilty of trying to educate people on it and argue that this tradeoff does exist. It is interesting that you do not find very much of this in the country. When I ask land brokers to what extent they see it, they don't see much of it.

We have an annual survey, Mr. Chairman, in our department that provides data over a period of years and there again we see no evidence that land contracts sell at lower rates. I think there are other reasons.

On top of page 5 I point out some conclusions that probably would justify on an economic basis why you would expect the marketplace to have a lower interest rate on contract for deeds.

One of them, alluded to here earlier, was the fact that you are locking in an interest rate for 15 years without prepayment options.

Second, often you cannot borrow money on this and so there are some disadvantages to the buyer. The seller has the advantage that he is able to spread his capital gains over a period of years. You dont see this tradeoff between interest rate and price to the extent that theory would suggest that you might.

Well, in finishing off then, let me just suggest that this future rate of inflation is being sort of expected to continue at this 9 percent. Unfortunately, if 3 years from now interest rates, inflation rates, and subsequently interest rates are quite a bit lower, people who bought this year at 9 percent because of this regulation change are locked into that for 15 years.

I raise the question rhetorically if Government sort of forces them in are they going to help to bail them out when they are in financial difficulty because they are paying loans of $3,000 or $4,000 more a year and maybe much more than that.

Let me close then, and I am sorry it ran over time here a bit. In conclusion, a few recommendations. One, a required minimum interest rate on contracts should be at some fraction of Federal Land Bank interest rates, perhaps two-thirds. This is what we see in the marketplace.

Second, requirements should be based on a moving average and should be announced regularly, not have a 50-percent jump at one time.

The minimum interest rate suggested under these two should be the same and I think that has been taken care of by IRS.

Fourth, the four major concerns of rural America that have been identified in a survey I refer to can all be handled, I think, by congressional actions that will help to bring inflation under control and this jump to 9 percent is going just the opposite. I think it tends to increase inflation, rather than decrease.

So, I do close there, with the last word from the 22d chapter of Proverbs, "He who oppresses the poor to increase his own wealth or gives to the rich will only come to want."

We here, I expect, we in Government are trying to get and I include myself in that category since I, with the university system, hope to increase wealth from the larger tax take and the poor are these beginning farmers that are ususally relatively poor whereas the current landowners have been made rich by inflation.

I think there is an admonition we might keep in mind as you Senators take a look at what you might do in setting these rates in the future, Mr. Chairman.

Senator GRASSLEY. I only have one question of the panel and that is to Neil Harl. Before I ask that question, we would all like to spend a lot time picking your brain on these various problems, but you know from past experience, at least Neil knows and I presume you know dealing with Senator Durenberger, that we know how to get a hold of you by phone if nothing else to use your expertise in this area.

I know the Iowa Bar Association has been working closely with you, Neil, on some of these very problems you are here to discuss because in the last part of December I had a meeting with that committee in Iowa to discuss these very matters.

So, then I would like to ask Neil—and the reason I am asking this because you didn't address this, but you have spoken to it in the past—on the subject of marital deduction. All of us are concerned about the estate tax marital deduction.

I have heard that electing section 2032A could reduce or even eliminate the deduction on property left to a surviving spouse. Would you comment on this point?

Mr. HARL. Let me start out by saying this. I think that the proper answer to that question may relate to some technical problem in the way the property passes through the trust or will.

Let me try to lay that out in the following fashion. If you have a typical trust or will and the property passes into both the marital share and the nonmarital share, as it often would because land is a big item in a typical farm estate, there is no problem with the land that goes into the marital share in terms of the present interest test which we discussed a moment ago. There is a very serious problem, however, with respect to the nonmarital share. That is one problem that does arise.

A second problem is a potential gifting problem, depending upon which value you use when you fund the marital share because you may be dealing with land that has a fair market value of $2,000 an acre and a use valuation of half that or $1,000 an acre. Depending upon which value you use to fund the marital share, you may have triggered a potential gift in the process. We are quite concerned about that problem. It is a very technical one, but a highly practical problem because this is such a widespread matter.

There is another way to answer your question and that is that whenever you elect to use the marital deduction, in effect, you reduce the benefits of a use valuation election by roughly half because you are able to deduct under the marital deduction up to 50 percent of the adjusted gross estate.

If you elect the use valuation, you are essentially reducing, in effect, the heft that you would have in claiming the marital deduction. That is just the practical side of looking at two deductions that are claimed sequentially and it reduces essentially the value you have from use valuation.

So, those are the two aspects of your question that I can see rather readily. If there are other aspects, I would be pleased to respond, Senator.

Senator GRASSLEY. Well, at this point, I had thought we ought to have that information for the record and I appreciate your clarification of that and I suppose if there is any way at all to be dealt with we will be looking at that.

Senator Durenberger?

Senator DURENBERGER. Let me just follow up on that last statement—what happens to the other side of the typical farm family. In other words, what happens to the valuation, what are the tax consequences for children, male and female and then the problems if you use the marital deduction, the problems of the older surviving spouse who wants to immediately or as soon as possible pay her respects to the children. Could you comment on that problem?

Mr. HARL. If we are dealing with the postdeath disposition of the land, for example, from the surviving spouse to the children in an intervivos type disposition, if done to a member of the family, this of course would not be a recapture event. This would not trigger recapture because transfers to a member of the family, as statutorily defined, would not trigger recapture of Federal estate tax benefits.

Even if we are dealing with a small corporation and the gift were in the form of stock to the family members, it still would not trigger recapture.

So, in general, this does not really preclude, inhibit or provide a chilling effect for those kinds of transfers from the surviving spouse to the children.

There is, of course, an important income tax basis consideration because when you elect use valuation you also peg the basis at its Federal estate tax value which is much below fair market value. Therefore, when a transfer occurs by gift intervivos from the surviving spouse to the children, you have a carryover of a low basis.

If the children later sell the land, they are, of course, going to have capital gains tax to pay.

Senator DURENBERGER. I am concerned about the problems that occur when that decision by the widow—I don't want to use sexist terms, but I will use the majority situation terms—needs to make the decision about a gift or sale to the children. There is a gift tax limitation currently in the law of $3,000 a year and I suppose a substantial farm even under reduced valuation, a substantial amount of money, then I take it she pays for the problems of capital gains tax that are made on the sale.

Mr. HARL. One thing we must keep in mind here, Senator, is that special use valuation is a creature only of Federal estate tax. It has no effect on calculating Federal gift tax, nor does it have an effect on calculating the income tax.

In fact, this is one of the problems, as a practical matter, with 2032A from a planning point of view. It provides an enormous encouragement for the retention of property until death for if you hold the land until death, you get a wipe out of gain, a new basis; you stand a chance, at least, of a 2032(A) election; and you also don't have the problem of the taxable gift being pulled back into the taxable estate at the time of death.

We must remember that when a surviving spouse makes a gift to the children using the $3,000 Federal gift tax annual exclusion, that gift is going to be based on fair market value of the property, not the use valuation.

So, it means that, perhaps, double the amount of property would exist there if they are focusing on the use valuation. The land is worth roughly twice that much for Federal gift tax purposes.

Senator DURENBERGER. But, she has the same basis problem in terms of capital gains, doesn't she?

Mr. HARL. Yes, because there is the low basis that derives from the special use valuation election and even if there is a recapture, that old, low basis continues; there is no upward adjustment in basis just because there is a recapture, which is another important point, kind of a technical one, but it is a significant one.

Senator DURENBERGER. Thank you. Paul, let me ask you first about your cohort, one party of cohorts testimony, relative to one of your cohort's recommendations, whether we might put into statute a special valuation procedure that is a percentage of market value.

Now, the first couple of seconds I heard that it sounded like a simple solution to a very complicated problem. The more I thought about it in terms of the problems we have had with what is happening to the land values and how the disparity between using a capitalization of income test versus the other market value test, the more I like it. Do you think that is a great idea to put that sort of thing into the statute or should we continue to struggle with finding a formula that is fair to agricultural property?

Mr. HASBARGEN. Under the statute relative to which of the——

Senator DURENBERGER. Special valuation.

Mr. HASBARGEN. I am not the specialist in our department on that particular one, Senator Durenberger. It certainly sounded reasonable to me in terms of my understanding of it.

Senator DURENBERGER. One of the extremely interesting points you made in your written statement that comes just before the quotation from Proverbs, I think, is about the inflationary psychology business. I think you might amplify on this a little bit, but you talk about the long-term expectations of rural people relative to inflation as being relatively low.

I wonder if you would comment just briefly on the nature of that problem and why you believe it is significant for us to consider that as we react to the imputed interest issue.

Mr. HASBARGEN. Just a brief comment. This output on the back of the page I do use to develop a computer program to look at what is the maximum you could bid for a price for land.

In talking to farmers, I find them talking 5 or 6 percent. In meeting with farmers around the State on land prices and how you overcome this problem of financing, the steps of cash flow, they for the most part do not have these expectations for the high inflation rates. They are at this lower level.

Therefore, it is very rational for them to one, look at a little bit lower price of land, they say that is inflated land, we are not going to hopefully have this 12 percent inflation but rather back to 5 or 7 percent.

Second, they want to put their interest rates and in light of the fact that you are locking something in for 15 years, they want to make that reasonable.

Third, I would admit that many times in selling to the neighbor's boy, certainly you can see it is families, but often for nonrelated people. I think I related a little incident there of the gray haired lady. I am glad you weren't around the State and heard some of the same things. This is, why does IRS have to tell us one, how much I can sell it for and second, what interest rate? We would like to sell it for lower to let the person get started.

I do point out and I think it is very important, that the market in rural America, at least in our part of the country—in Dakota and Minnesota—these contract deeds have been lowered. This is a judgment of those people who are entering into the contract, is what the interest rate and land price should be.

I do not find this evidence a trade off. I admit that I am sure it exists in some cases, but for many of these people they just want to be a little more conservative in both the price and the land, especially if you are looking at the long term.

I did through a graph in there which I didn't allude to, but from Leuthold Associates of Minneapolis, who say, every time in the past inflation rates have gone up, they have come down again. If they do in fact, come down again, then I think this is on the conscience.

One, that we push these people to a higher interest rate. This has negated some sales that otherwise would have happened and these people are going to be locking in a negative flow for a longer period of time.

Senator DURENBERGER. I am told my time is up but I would like to suggest to you if you have time, that the record of this hearing together with the record of other hearings we have the issue of estate taxes would be complemented by any additional evidence that you have on the issue of the lack of these trade offs for tax purposes.

Also, your testimony relative to what the actual rates are on contractual debt arrangements in our State compared to the kinds of rates that the IRS is composing by regulation of future contracts.

I appreciate the testimony of both of these witnesses.

Senator GRASSLEY. Thank you, Senator Durenberger. I want to thank the panel once again, all for their expert testimony.

As I have already made allusion to, you will be called upon again.

You can count on that. Maybe not in this formal way, before we make some decisions, but at least in a very informal way to seek your guidance.

Thank you both very much.

Mr. HARL. We are genuinely grateful to be here. Thank you, Senator.

Mr. HASBARGEN. Thank you, sir.

[The prepared statements of the preceding panel follow:]

Special Use Valuation of Land and Imputed Interest

Statement
for
Subcommittee on Oversight of the Internal Revenue Service

Senate Finance Committee

April 27, 1981

by
Neil E. Harl*

I. Special Use Valuation

Over the past four years, special use valuation of land has become firmly established as an important planning concept for reducing federal estate tax liability in farm and ranch estates. 1/ Few federal tax provisions rival special use valuation in terms of potential tax reduction. 2/

Experience with use valuation to date has produced three types of problems--(1) policy problems, which are of general interest; (2) planning problems, which are of primary interest to those whose estates are potentially eligible for use valuation and (3) administrative problems, which are of primary interest to electing estates and the Internal Revenue Service. 3/

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1/ See generally 5 Harl, Agricultural Law § 43.03[2] for a detailed discussion of special use valuation.

2/ The maximum possible reduction of federal estate tax is $350,000 which could be achieved for an estate in the 70 percent federal estate tax bracket with the maximum reduction of gross estate of $500,000. See I.R.C. § 2032A(a)(2).

3/ Time and space do not permit a full discussion of the administrative problems with special use valuation. For an expanded discussion of those problems see Harl, "Experiences and Problems With 'Use' Valuation of Land," paper presented at meeting of the Commissioner's Advisory Group, Internal Revenue Service, Washington, D.C., June 10, 1980.

A. Policy Problems

1. Expected capitalization of benefits into land value

The benefits to farm and ranch estates of special use valuation result from reduced federal estate tax liability because of a lower taxable estate as well as reduced liquidation costs (as assets are sold to pay federal estate tax) inasmuch as the need for liquidity is reduced. To evaluate the benefits from special use valuation, the major provisions of the statute were incorporated into the Iowa State University Computer-Assisted Estate Planning Model. 4/ The procedure for estimating the special use value of farm real estate was based on the capitalized value of gross cash rents minus property taxes. Cash rents were estimated based on the fair market value of the real estate with cash rent data collected and published by the United States Department of Agriculture regressed as a function of land values from the Iowa Land Value Survey. 5/ A separate equation was estimated for each of the nine crop reporting districts in Iowa to estimate the special use value of qualified real property. 6/

The estimated benefits of special use valuation from operation of the model (assuming farmland valued at $1450 per acre and a will transferring all property to the surviving spouse at the death of the first spouse to die and to the children at the subsequent death of the surviving

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4/ See Boehlje and Harl, "'Use' Valuation Under the 1976 Tax Reform Act: Problems and Implications," 19 Jurimetrics 100 (1978).

5/ See Harris, Lord and Weirich, "1978 Iowa Land Value Survey," FM 1762, Iowa State University, March 1979.

6/ The statistical properties of the equations indicated that "land value" and "land value squared" are significant explanatory variables in the regression equation at the 0.05 probability level. All equations had an R^2 of 0.99 or better indicating that those two variables explain over 99% of the variation in cash rents. Boehlje and Harl, *supra* note 4 at 118-119.

spouse) are summarized on a per acre basis in Table 1. Because benefits accrue at death, which is assumed to be at some point in the future, the present value of benefits is evaluated by discounting the benefits at an appropriate rate.

Table 1. Value of benefits from "use" valuation per acre of land

Net worth (dollars)	Present value of benefits (8 percent)				
	Benefits per acre	Assuming death in:			
		5 years	10 years	15 years	20 years
			Dollars		
500,000	252	172	117	79	54
750,000	267	182	124	84	27
1 million	261	178	121	82	56

Because of the requirement that qualified real property must be used in farming (or another closely held business use) for five or more of the eight years before death, Table 1 shows the present value of benefits for estates of $500,000, $750,000 and $1,000,000 in assets assuming death in five years and also assuming death in 10, 15 and 20 years. For example, if qualified real property is purchased with an expectation of death five years later, the present value of the benefit from special use valuation totals $172 per acre for a $500,000 estate. As expected life increases, the present value of benefits from special use valuation declines. These figures indicate the price premium that could be paid for real property that would qualify for special use valuation.

Such reductions in values of qualified real property for federal estate tax purposes are expected to produce several responses by eligible individuals. (1) With increasing age, farmers and ranchers would be encouraged to move toward a greater investment in eligible land and less investment in noneligible assets. One result could be that older farmers would be enabled to outbid younger farmers for a particular tract of land. (2) Those eligible for special use valuation would be in a position to outbid mere investors for a particular parcel of land. (3) The size of benefits accruing from special use valuation would be expected to attract additional interest in land as an investment. The major impact on investment patterns would be felt as investors able to meet the pre-death and post-death requirements for special use valuation eligibility could be expected to seek an ownership position in land sufficient to permit the maximum reduction in gross estate of $500,000. If no restrictions were placed on eligibility, it would be expected that additional capital would flow into farmland, driving up the price, until investors were once again indifferent between investing in farmland with the accompanying benefits of special use valuation and investing in other assets at fair market value. The expected result would be a one-time increase in land value with subsequent purchasers paying a higher price for land. The extent to which the above would occur is dependent upon the extent to which the pre-death and post-death requirements serve as effective "gates" to preclude investors from taking advantage of special use valuation.

Encouragement to retain land until death

Because gifts of farmland during life are valued for federal gift tax purposes at fair market value [7/] and sales of farmland during life are

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[7/] See 6 Harl, Agricultural Law § 46.02[1] (1980).

likewise governed by fair market value considerations (in ascertaining whether the transaction would be treated as part-gift, part-sale), additional motivations are provided for retaining land until death.[8/]

Equity considerations

Equity implications are also apparent from the special use valuation provision with those in the highest federal estate tax brackets (more than $5,000,000 taxable estate) receiving the greatest benefit. The $500,000 limit on reductions of gross estate is "worth" all the way from zero to $350,000 depending upon estate size.

Encouraging continuation of farm and ranch businesses

The requirements for pre-death and post-death material participation,[9/] the requirement that the decedent (before death) and each qualified heir (after death) must have an equity interest in the farm operation[10/] and the proscription of sale of special use value land for 15 years after death provide strong motivation for continuation of farm and ranch businesses beyond the generation of their founding. Congressional action in the Tax Reform Act of 1976 providing for reduction in the federal estate tax burden for farm and ranch firms seems to have taken place under the assumption that the family farm as a production entity continues

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[8/] The prospect of a new income tax basis for property retained until death provides a strong motivation to retain ownership of farmland until death. See I.R.C. § 1014(a). Moreover, taxable gifts during life made after 1976 are included in the taxable estate at death as part of the unification of federal estate and gift tax in accounting for lifetime use of the unified credit. See I.R.C. § 2001(b)(1)(B).

[9/] See I.R.C. §§ 2032A(b)(1)(C), 2032A(c)(7)(B), 2032A(e)(6).

[10/] See Treas. Reg. § 20.2032A-3(b)(1) (1980).

as an economic entity through time. Pre-death and post-death requirements for special use valuation of land (and for installment payment of federal estate tax)[11] are difficult to meet if the farm firm ceases to function as a production entity at retirement or death even if the land is retained and rented to a tenant as noted below. Thus, the Congress appears to have assumed that the way to assure the survival of the family farm as a concept was to work to assure the survival of family farms as economic entities. Yet most farm and ranch businesses, traditionally, have been "born" and have "died" within a generation. Very few farm and ranch businesses have continued as a going economic entity into the next generation.

In many instances, the parents have assisted some children in becoming established in farming with the farming children eventually spinning off into their own economic orbits. In other cases, the heirs are all pursuing off-farm vacations. But in both instances, the family firm does not continue to function beyond the death or retirement of the parents even though the land may continue to be owned within the family. In recent years, a small but growing number of farm operations--referred to elsewhere as "super firms"[12] have pursued an objective of continuation into the next generation. In general, these are the larger operations with the most to gain economically from seeking continuity of the core family operation. To the extent that continuation of farm and ranch businesses occurs, with the largest firms being the ones most likely to continue and benefitting the most by continuation, an expected long-range effect could be a hastening in the trend toward fewer and larger farm and ranch businesses.

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[11] See I.R.C. §§ 6166, 6166A.

[12] See 5 Harl, Agricultural Law § 41.07[3] (1980).

B. Planning problems

An assessment of the severity of the planning problems is dependent upon the perceived purpose or purposes behind the legislation. If special use valuation was designed to ease the federal estate tax burden for those farm and ranch businesses actually continuing beyond the life span of the founders, the planning problems are fewer in number than if the purpose was to benefit also those who had previously been involved in an operating farm or ranch business. 13/

1. Material participation test

The special use valuation rules specify that the decedent-to-be or a member of the family of the decedent-to-be must materially participate in the operation of the farm (or other business). 14/ Similarly, each qualified heir or member of the qualified heir's family must continue material participation in the 15-year period after death. 15/

The necessary level of material participation is difficult to achieve for retired farmers leasing their land to an unrelated farm tenant during the pre-death period. A cash rent or non-material participation crop share lease (which are desirable types of leases during the age 62 to 72 period when self-employment income above a specified level reduces social security benefits) would not assure material participation unless the farm or ranch tenant was a member of the family. Beyond age 72 (70 after 1981), failing

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13/ It is presumed herein that it was not the objective of the legislation to reduce the federal estate tax burden for mere investors in farmland.

14/ I.R.C. § 2032A(b)(1)(C).

15/ See I.R.C. § 2032A(c)(7)(B). Technically, cessation of material participation for three or more years in any eight year period ending after death triggers recapture of special use valuation benefits.

health may preclude material participation even though earnings beyond that age do not reduce social security benefits.

If the purpose of special use valuation is viewed narrowly, in terms of benefitting only operating family farms, then ineligibility of retired farmers leasing land to an unrelated farm tenant may be of little policy concern.

2. Qualified use test

In the final regulations issued on July 31, 1980, [16/] The Department of the Treasury articulated an additional test that has come to be generally referred to as the "qualified use" test. That test requires that the decedent-to-be (in the pre-death period) and each qualified heir (in the post-death period) must have an equity interest in the farm or ranch operation. [17/] In the pre-death period, the test must apparently be met at the time of death [18/] and for five or more of the last eight years before death. [19/] In the post-death period, the test must apparently be met by each qualified heir for the entire 15-year recapture period after death. [20/]

16/ Treas. Reg. § 20.2032A-3(b)(1)(1980).

17/ Ibid.

18/ I.R.C. § 2032A(b)(1)(A)(i).

19/ See I.R.C. § 2032A(b)(1)(C)(i).

20/ See I.R.C. § 2032A(c)(7)(A). It should be noted that there is no grace period for meeting the qualified use test in the post-death period as there is for the material participation test. Compare I.R.C. § 2032A(c)(7)(A) with I.R.C. § 2032A(c)(7)(B).

The requirement of an equity interest in the farm or ranch operation apparently means that a cash rent lease, even to a family member as farm tenant, would render the land ineligible for special use valuation.[21] Apparently, a crop share lease, even a non-material participation crop share lease, would meet the requirement.

For estates in audit when the qualified test was announced and those individuals unable to shift to an acceptable type of lease, the qualified use test has created substantial problems. Moreover, in some areas of the country such as grazing areas, crop share leases essentially do not exist.

Fundamentally, a question is raised about the necessity of the qualified use test. It is submitted that the "material participation" test and the "qualified use" test were designed to accomplish two objectives: to assure that eligible land was used in farming (or another closely held business) and that the decedent or a member of the family was actively involved in the farming operation. It is believed that the two objectives would be met if the qualified use test were satisfied upon a showing that the land was used in farming (or another closely held business) with the task left to the material participation test to prescribe the minimum relationship of the decedent (or the

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[21] See Ltr. Rul. 8107142, November 19, 1980.

It appears that a cash rent lease to a partnership or corporation as farm tenant would meet the test if the decedent (or qualified heir, as the case may be), owned 20% or more of the entity or owned some significant part but less than 20% and the entity had 15 or fewer owners.

decedent's family) to the farm (or other) business.

3. Present interest test

The regulations make it clear that real property is eligible for special use valuation only if a qualified heir receives a present interest in the property from the decedent. [22] This test is met, of course, for property left outright to a family member. The problem is most pronounced where real property is left in a conventional two-trust marital deduction will (a standard estate planning technique) or other type of sophisticated trust.

In a typical two trust marital deduction will, a portion of the decedent's property (typically one-half of the estate less estate settlement costs and deductions) is left to the surviving spouse outright or nearly so. For real property passing into this part of the trust, which is deductible under the federal estate tax marital deduction, the present interest test generally does not pose a problem.

The problem comes with real property passing into the other compartment of the trust--the so-called non-marital share. Usually, the surviving spouse is given the right to the income from the non-marital share but the trustee is often given discretionary powers over distributing income to others (usually children or grandchildren or both) and invading principal of that part of the trust to benefit others, usually family members. If a trustee has such a discretionary power over income or principal to benefit others, the interest of the surviving

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[22] Treas. Reg. § 20.2032A-3(b)(1)(1980).

spouse as qualified heir could be diminished. The Internal Revenue Service has taken the position that such an interest is not a present interest as required by the regulations.[23/] It is noted that two-trust marital deduction wills are quite commonly used by planners and most such wills would not meet the present interest test as is now required. It is estimated that at least 95 percent of such wills, drafted in the past twenty years, contain unacceptable discretionary powers.

If the present interest test prevails, one result would be a massive recall of wills and trusts with the trustee's discretionary powers reduced substantially. The price would be loss of the flexibility inherent in the trust and one of the major reasons for the creation of such a trust.

An obvious solution to the problem would be to recast the present interest test statutorily to sanction arrangements in which discretionary powers that were limited to family members as potential beneficiaries would meet the test. Such a change would create potential problems of liabilities for additional federal estate tax on recapture. It would seem necessary to impose liability on all members of the class of potential beneficiaries for any recaptured tax.

[23/] See Ltr. Rul. 8020011, February 7, 1980. The problem potentially goes beyond marital deduction wills. Any situation in which property transfers have been deemed to be gifts of future interests for federal gift tax purposes could conceivably fail the special use valuation future interest test. For example, transfer of a minority interest in corporate stock with a history of no dividend declaration has been deemed to be a transfer of a future interest for federal gift tax purposes where the stock was subject to restrictions on stock transfer. Berzon v. Commissioner, 534 F.2d 528 (2d Cir. 1976).

4. Definition of family member

The term "family member" [24/] is important for special use valuation purposes in defining who is a qualified heir,[25/] in specifying who can be an eligible material participator before death,[26/] in stipulating minimum ownership of qualified real property before death [27/] and in specifying who can be a material participator during the 15-year recapture period after death. [28/] In general, the definition of family member is sufficiently broad to encompass most individuals likely to be involved as potential material participators. However, the definition of "family member" has created problems in two situations:

> Situation I: two brothers have been farming together for several years. Each owns 320 acres of land in individual ownership. At the death of brother A, the land is left to A's wife, C, outright. If the surviving brother, B, continued to farm the land owned by C, B would not be a member of the family of C, who would be the qualified heir. Therefore, material participation would have to be supplied by C or by a member of C's family or federal estate tax benefits would be recaptured.

[24/] See I.R.C. § 2032A(e)(2).

[25/] I.R.C. § 2032A(e)(1).

[26/] I.R.C. § 2032A(b)(1)(C)(ii)

[27/] I.R.C. § 2032A(b)(1)(C)(i).

[28/] I.R.C. § 2032A(c)(7)(B). It should be noted that, for purposes of recapture, material participation must be by the decedent or a member of the decedent's family during the time the real property was held by the decedent and by the qualified heir or a member of the qualified heir's family during the time the real property was held by the qualified heir. Ibid.

A solution to this problem would be to include within the definition of family member the members of the family of a deceased spouse.

Situation II: At the death of H, a farm operator, the farmland is left to H's wife I, for life, then to their son, J who is involved with them in the farming operation, for life, then to J's wife, K, for life, with the remainder interest to the grandchildren. It is noted that, for real property to be eligible for special use valuation, all interests in the land must be held by qualified heirs. The question is whether K is a member of H's family. Without a doubt she would be a member of the family so long as J lives. If J should predecease H, however, there is a substantial question whether K would be deemed a member of H's family.[29/]

A solution to this problem is to make it clear that the term "spouse" includes the unremarried surviving spouse.

5. Proportionate recapture

The statute makes it clear that disposition (or the occurrence of any other disqualifying event) [30/] of the entire tract of land subject to special use valuation leads to recapture of the full amount of the

[29/] The statute merely refers to ". . . the spouse of any . . . descendant" of the grandparents of the decedent (or qualified heir, as the case may be). I.R.C. § 2032A(e)(2).

[30/] See I.R.C. §§ 2032A(c)(1), 2032A(c)(7).

recapture tax if the event occurs within the first ten years after the decedent's death with a pro rata step down in recapture between the tenth and fifteenth years. 31/

If a recapture event occurs as to only a part of a tract of land subject to a special use valuation election, the question is what part of the federal estate tax benefit from special use valuation is recaptured. Logic, equity and at least one interpretation of the statute 32/ suggest that partial dispositions lead to a proportionate recapture. However, the position of the Internal Revenue Service seems to be that partial dispositions lead to disproportionately large recapture of the federal estate tax benefits. 33/

A relatively brief amendment to the statute would assure that the amount of recapture tax due would be proportional to the amount of land subject to the recapture event.

C. Additional modifications suggested

In addition to the amendments to Section 2032A suggested in the preceding section, three modifications of a more major nature are advanced for consideration. These additional modifications are designed to continue the reduction of federal estate tax burden for owners of small firms, to avoid the distortions and potential distortions in resource allocation that are inherent in special use valuation as presently existing and as presently being administered and to eliminate

31/ I.R.C. § 2032A(c)(3).

32/ See 5 Harl, Agricultural Law § 43.03[2][g] (1981).

33/ See Hartley, Final Regs. Under 2032A: Who, What and How to Qualify for Special Use Valuation, 53 J. Tax. 306, 308, n. 22 (1980).

the unfairness existing in application of the statute in areas without a significant amount of cash rented land.

1. <u>Extending special use valuation to all farm or ranch assets</u>

As enacted in 1976, special use valuation is applicable only to real property. Thus, the benefits of reduced federal estate tax liability are denied to estates of farm and ranch tenants. Moreover, the benefits accrue unevenly across the agricultural sector with the relationship of land to all farm assets varying by type of farming or ranching operation as well as by tenure of operator. Moreover, as noted above, limiting special use valuation to real property has the effect of capitalization of part or all of the benefit involved into land values.

In the interests of avoiding distortion in resource allocation and in the interests of fairness to all farmers and ranchers, it is suggested that the special use valuation concept be available for all assets in a closely held farm or ranch business including machinery, livestock, and equipment (as well as land) such as the tax on assets in a closely held business is presently subject to installment payment. [34/] If the objective is to ease the burden of federal estate tax for those with significant interests in farm and small business operations, there is no compelling reason to limit the application of special use valuation to land. Moreover, including other business assets should lessen the capitalization of the federal estate tax benefit from special use valuation into land.

[34/] See I.R.C.§§ 6166, 6166A.

2. Availability of cash rents

At present, some agricultural areas have great difficulty in applying use valuation because of cash rents on comparable land. Although a substantial percentage of rented land in some agricultural areas is subject to a cash rent lease, in other areas such rental arrangements are relatively rare and in some areas virtually non-existent. Moreover, with cash rented tracts ineligible for special use valuation of land[35/] and installment payment of federal estate tax, [36/] an even lower incidence of cash renting can be expected in the future particularly in light of the fact that cash rent leases tend to be entered into by older lessors. Apart from the inequities of the present provision, it is submitted that it is not good tax policy for availability of a tax provision to be dependent upon availability of data that are related not at all to the tax in question and that vary by type of farming.

Even if cash rented tracts of comparable land exist in an area, a substantial economic cost is often incurred in locating the cash rented tracts, obtaining the cash rent information and proving the comparability of the land.

Therefore, because of the difficulties inherent in valuing land by capitalizing adjusted gross cash rents, and in the interests of tax simplification and uniformity of application, it is suggested that

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[35/] See N. 21 supra and accompanying text.

[36/] See Rev. Rul. 366, 1975-2 Cum. Bull. 472.

special use valuation be calculated as a statutory percentage of fair market value for the eligible assets subject to the statutory maximum limitation.[37/]

3. Advantages of a credit

Inherently, deductions are of greatest value to those with the largest estates. Thus, special use value is worth $350,000 for an estate in the 70 percent tax bracket but only $170,000 if the average applicable tax bracket is only 34 percent. In order to avoid the problem of making special use value worth more to those with larger estates, it is suggested that the reduction in gross estate be transformed into a credit in the manner and style of the unified credit so that the value of the concept would be the same for all estates. For example, if the credit were to be set equal to 32 percent of the reduction in gross estate, a reduction of $100,000 attributable to special use valuation would generate a credit of $32,000 whether the estate was in the 32 percent or 70 percent tax brackets. With a deduction rather than a credit, a reduction of gross estate of $100,000 would be worth $70,000 to an estate with a taxable estate of more than $5,000,000. In addition to targeting the benefits of special use valuation on estates of modest size, such a credit would also reduce the loss of revenue attributable to special use valuation.

37/ The Internal Revenue Service has reported that special use valuation as an average percentage of fair market value (on an unweighted basis) has ranged from 29% in the Los Angeles District up to 76% in the Philadelphia District. See Hartley, *supra* note 33 at 308.

II. Imputed Interest

Since 1964, minimum interest rates have been specified by regulation for certain designated types of deferred payment obligations.

A. The general rule

Section 483 of the Internal Revenue Code provided the authority for the rule of general applicability. Initially, the minimum interest rate was four percent, and if interest of less than four percent was utilized in a deferred payment obligation, the Internal Revenue Service would refigure the interest at five percent compounded semi annually. In 1975, the minimum interest rate was raised from the four-five percent range to a six percent minimum rate with interest figured at seven percent compounded semi annually if interest of less than six percent was used in installment obligations. Under proposed regulations,[38/] for obligations entered into on or after September 29, 1980, the "test rate" of interest would be nine percent; if interest of less than nine percent was used in a deferred payment obligation, the seller would be required to report interest at ten percent compounded semi annually.[39/]

The reason for such an "unstated" or "understated" or "imputed" interest rule was the tendency for buyers and sellers of property to agree to raise the selling price and reduce the interest rate. As a

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38/ 45 Fed. Reg. 57739 (August 29, 1980).

39/ Prop. Treas. Reg. §§ 1.483-1(c)(2)(ii)(C), 1.483-1(d)(1)(ii)(C).

result, the seller would have less interest received (which is taxed as ordinary income) and more capital gain which is taxed preferentially (60 percent deductible for sellers other than regularly taxed corporations).[40/]

The unstated interest rule does not, necessarily, alter the burden of buyers as taxpayers. It merely addresses the manner in which sellers must report their gain from the transaction and focuses attention upon the fact that if a transaction has been fully negotiated and then an increase in interest rate is announced, there should be a reduction in the selling price of comparable economic magnitude. The problem lies in the difficulty in getting taxpayers to see that the reasonableness of a particular interest rate for a deferred payment obligation can be assessed only in light of the selling price. Similarly, the reasonableness of the selling price of an asset sold under a deferred payment arrangement can be determined only if considered along with the interest rate.

As an example, assume that a seller and buyer had agreed to a transaction involving the sale of 320 acres of farmland under an eight percent, 20-year contract at $2,000 per acre for the land. Upon discovery by the seller of the existence of the proposed regulations specifying a minimum of nine percent interest, the contract is renegotiated. To leave the parties where they were before, the selling price per acre should be reduced to somewhere between $1800 and $1900 per acre depending upon the type of payment schedule used. Thus, the

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40/ I.R.C. § 1202(a).

change in the minimum interest rate need not necessarily affect the buyer's burden except as (1) the buyer pays more interest, which is deductible from ordinary income, (2) the buyer pays more in principal which is not currently deductible, (3) the seller receives more in interest which is taxable as ordinary income and (4) the seller receives less in principal and so has less capital gains to report. All four factors would normally be taken into account (including the relative income tax bracket of seller and buyer) as the contract is renegotiated.

The 9-10 percent rates seem to be within the Treasury's authority to establish and change periodically the minimum interest rate on deferred payment obligations. The concern of many is the substantial increase that came all at one time. A number of transactions were in process at rates ranging between eight and nine percent, all of which have been impacted by the proposed regulation. We should keep in mind that deferred payment obligations, by their nature, involve intermediate to long-term commitments to make payments. While the short-term interest rates are indeed high, many sellers are willing to require a long-term interest rate well below the current prime rate in the apparent belief that the current prime rates may be viewed as somewhat aberrational in nature.

It is suggested that the Department of the Treasury be encouraged to adjust the interest rate more frequently, then once every six years with smaller shifts than proposed in 1980.

B. The special rule for controlled entities

Section 482 of the Internal Revenue Code gives broad authority to the Internal Revenue Service to reallocate income, deductions and credits in order to prevent the distortion of income between tax paying entities and to publish regulations providing guidelines for inter-entity business activity. Among other provisions, the regulations published under Section 482 of the Internal Revenue Code deal with interest rates for loans between business entities subject to common control. For example, if a taxpayer were to loan funds or sell property to a wholly owned corporation, the provision would be applicable. Similarly, if one corporation were to loan funds or sell property to another corporation, with the two corporations subject to common ownership, the provisions would apply.

Specified minimum rates under this provision have been applicable to transactions under this section since 1964. Before 1975, the specified interest rate was to range between four and six percent. Between 1975 and August of 1980, the interest rate was to range between six and eight percent. Effective August 29, 1980, proposed regulations have specified an interest rate of 11-13 percent.[41/]

There are two problems, as we see it, with the proposed regulations under Section 482: (1) There has been confusion as to the applicability of the 11-13 percent rate, with the belief by some that the rate applies to transactions between related parties, and (2) the specified interest

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41/ Prop. Treas. Reg. § 1.482-2(a)(2)(iii).

rate is substantially above the interest rate specified under the general rule of Section 483 for deferred payment obligations. Not until the 1980 regulations were proposed were the rates significantly different from the deferred payment rates. While we have no difficulty with a rule requiring the same rate of interest between controlled entities as would apply otherwise, we have some difficulty with a rule requiring a substantially higher interest rate for transactions between controlled entities.

Therefore, it is suggested: (1) That the Internal Revenue Service make it clear as to the scope of application of the regulations under Section 482, and (2) that the interest rate specified under Section 482 parallel the rates applicable under Section 483, as has traditionally been the case.

STATEMENT BEFORE THE SENATE IRS OVERSIGHT SUBCOMMITTEE

April 27, 1981

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University of Minnesota

"The rich rules over the poor, and the borrower is a slave to the lender." (Prov. 22.7)

This is wisdom. But, is it necessary for a government agency to issue and implement regulations that will lead to an increase in the bondage of debtors? By forcing some borrowers to pay above-market interest rates, the announced changes in sections 482 and 483 of the Internal Revenue Code will discriminate against some new entrants into the business world.

It is the low equity, beginning farmer who most often is granted a low interest rate when buying a farm. Consequently, one effect of these changes is in direct conflict with one agricultural policy objective of this nation--to preserve its family-farm oriented agricultural structure.

A major hurdle that the aspiring farmer must overcome is to get control of adequate land resources. A farm may be either rented or purchased. The purchase alternative has the advantage of more security. However, it has the disadvantage of higher cash flow requirements. The magnitude of this disadvantage has been increasing rapidly in recent years because of government actions that have led to escalating inflation rates. High, persistent inflation rates lead to expectations that such rates will continue. This expectation is bid into interest rates.

The interest rate, therefore, has two components--the real, market interest rate, plus the inflation premium. The real interest rate has for many years hovered near the 3 percent level. See graph 1, where bond yields and inflation rates (as measured by the GN deflator) are plotted over a period of years. Note that the inflation rate has increased sharply since 1965. The increased inflation rate has pushed bond prices to their current high levels because, of course, higher interest rates are necessary in order that savers (bond holders) get a positive rate of interest after adjusting for the declining purchasing power of the dollar.

As nominal interest rates increase, the cash flow deficits associated with farm land purchases also increase. Because, the real return to land--like the real return to bonds--hovers near the 3 percent level. Therefore, as higher inflation rates pushed nominal interest rates from 5 percent to 9 percent, the increasing annual cash flow deficits during the early years of farm loan repayments have made the farm land purchase alternative progressively more and more prohibitive for beginning farmers. This concept is portrayed in graph 2.

Not only does the interest cost of a land purchase increase with higher inflation rates--the annual principle repayment also increases. This occurs because expectations of continued inflation get capitalized into higher land prices, These higher land prices are justifiable if the expected inflation rate continues.* But, the distribution of returns to land is skewed by inflation--with large returns 10 to 20 years after purchase in contrast to low returns during the early years of the purchase that are not adequate to match normal mortgage or contract-for-deed repayment schedules. Thus, the high interest rates and the high land prices currently observed in the market place are both direct results of recent high inflation levels.

Therefore, the growing cash flow deficit problem faced by purchasers of farmland is a direct result of government actions (including those of the Federal Reserve Board) which have fostered higher inflation rates and expectations that these higher rates will continue. Future government actions will bring about changes in these expectations. Will these future actions perpetuate current inflation levels or bring them under control? Is it not the intent of congress and this administration to lower future inflation rates? If so, this committee should be made aware of the fact that we are, today, discussing proposed regulations by an agency of government (the IRS) that, in effect, forces a certain viewpoint about future inflation rates--that they will remain high--upon all citizens who draw up sales contracts.

This viewpoint is, in fact, contrary to the expressed goals and economic projections developed by the executive branch of government--to which this agency is responsible to. President Reagan's message to congress giving his "Program For Economic Recovery" (House Document No. 97-21) included a projection of the Consumer Price Index dropping from 11.1 percent in 1981 to 4.2 percent in 1986.

The new imputed levels of interest rates also conflict with the judgement of the market-place as to the appropriate interest rate on contract-for-deed land sale transactions. It was apparently based on prevailing interest rates in lending institutions such as the Federal Land Bank. Their rates have increased to over 10 percent--but they will decline again if the rate of inflation declines. And, given the Land Bank's policy of variable interest rates, current borrowers would get the benefit of any future decline in inflation/interest rates.

However, the typical contract-for-deed has no such stipulation. The interest rate agreed upon is maintained through the life of the contract--usually 10 to 20 years. Also, many contract-for-deed payments do not permit prepayment without penalty as do institutional loans. Furthermore, equity in a contract-for-deed often does not qualify for collateral for a loan. Consequently, the market place for these loans is not the same as the Federal Land Bank and a lower interest rate should be expected to prevail in the market place.

What rate has prevailed?

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* See tables 1 and 2 of attached article "Land Prices: Why So High? Will They Go Higher?", Minnesota Agricultural Economist, No. 662, August-September-October 1980, Agricultural Extension Service, University of Minnesota.

Table 1. Maximum bid price based on land productivity and alternative annual growth rates in net income over the next 30 years (excludes land appreciation considerations)

Annual growth rate in net income	Current year's net income		
	$48	$60	$72
	maximum bid price per acre*		
0	$ 569	$ 683	$ 797
2%	671	811	950
4%	810	985	1,159
6%	1,002	1,224	1,447
8%	1,271	1,560	1,849
10%	1,651	2,036	2,420

*These bid prices are generated by a computer program that has been provided with the following set of assumptions about other variables: a 9 percent after-tax rate of return, financing for 30 years at 9.5 percent interest, and a low income tax bracket. The effects of changing the values of these variables will be discussed later.

Table 2. Maximum bid price on land that earns $60, including inflation projections and present (after-tax) value of the land 30 years from now, to obtain an after-tax return of 9 percent

Income growth rate	Expected land value inflation rates			
	0%	3%	6%	9%
0%	$683	$ 844	*	*
2%	811	972	*	*
4%	985	1,146	$1,521	*
6%	*	1,386	1,761	$2,612
8%	*	*	2,096	2,947

*These combinations are not rational since th- two inflation measures are likely to be closely correlated. However, if expectations for escalating inflation rates become widespread, one should project a higher future land price increase than an income growth increase, therefore, pushing down the competitive rate of return below the current 3.0-3.5 percent.

The Minnesota Department of Agriculture is responsible for a farm loan program aimed at helping young farmers get started in farming. Almost all farm sales involved in this program are contract-for-deed sales in which interest rates are negotiated privately between the buyer and the seller. Of the some 200 sales in the three years prior to the publication of the proposed rule changes in sections 482 and 483 in the Federal Register on August 29, 1980, all but two were at interest rates from 6 to 8 percent.1/ These "low" rates (in comparison to Federal Land Bank or insurance company rates) prevailed for sales between non-family parties as well as in family sales. (About half the transactions were between family members.)

Therefore, one must conclude that the prevailing interest rate on land contracts was below 9 percent--at least on contracts involving low equity purchasers at the time the change in regulations was announced. (The net worth of the buyer must be under $75,000 in order to qualify for the Minnesota Family Farm Security Program.)

After announcement of the proposed rule changes last fall much confusion has existed plus the general belief that an interest rate of at least 9 percent is already required. Land brokers and farmers now tell me they are using the 9 percent rate "because IRS requires it". (In fact, some think that 10 percent is required in a "family" sale because of the confusion over section 482.) Therefore, loans approved under the Farm Security Program in recent months have frequently carried interest rates of 9 percent, despite the fact that earlier intentions had been to establish lower interest rates.2/

Therefore, it appears that the announcement of last August has already resulted in an upward adjustment in the interest rate set on farm land contracts in the midwest. Consequently, some negative aspects of this proposal have already been realized by beginning farmers in Minnesota. An increase of 2 percentage points in the interest on a $200,000 farm loan (the average loan under the Farm Security Program is $195,000) means an additional annual payment of $3,030 per year on a 20 year payment plan--a total additional outlay of $60,000 over the period. Such an increase in cash flow requirements has changed the status of some potential farm purchases from feasible to not feasible, and it could result in the future failure of others.

To use an actual example, one farm sale arrangement had been under consideration at a 6 percent interest rate. Subsequent to the announced rule change it was submitted to the Farm Security Board with the stipulation that finalization of the loan be delayed until July when, hopefully, the current confusion over the "required" rate will be cleared up.3/ If they could still use 6 percent, they wanted that rate to be used. And the sale price would stay the same--at $2,400 per crop acre. They felt that if this were changed to accommodate the new "required" rate while holding the cash flow the same, this would trigger a gift situation on the farm sale.

1/ Seetin, Mark W., Minnesota Commissioner of Agriculture, in letter to the Commissioner of Internal Revenue, October 24, 1980.

2/ Marzolf, Wayne, Director of Minnesota Farm Security Program, conversation on April 23, 1981.

3/ Ibid.

The data in table 1 illustrates the magnitude of the impact that the final decision which congress and/or IRS makes on this issue would have upon the future cash flows from an acre of land. Table 1 shows projected cash flows under 6 and 9 percent loans from land that earns $85 in the year of purchase, with earnings increasing at an annual rate of 7 percent per year. A down payment of 10 percent is assumed. The first column shows projections of cash flows under a typical (6 percent) 15 year contract-for-deed based on a 30 year amortization schedule with a balloon payment refinanced after 15 years. Note that even with this low interest rate this farm purchase must be subsidized out of other income (nonfarm earnings, livestock earnings, earnings from other land or gifts for the first 10 years).

The second column shows what happens to cash flows with everything the same except that the interest rate is now set at 9 percent. This jump in interest costs causes per acre losses to be $53 more during each of the next 15 years. And, it now takes 4 additional years (from the 11th to the 15th) before this land becomes self-financing.

There can be little doubt that such a change in cash flow requirements will have a significant impact upon the ability of this beginning farmer--and others like him--to finance farm purchases and to become securely established in farming. It will hasten the development of financial arrangements that facilitate the use of equity capital via limited partnerships, corporations, trust funds or shared appreciation mortgages. It will block entry into farming for some individuals. It may force the exit of others.

It has been argued that the lower interest rates observed in contract-for-deed mortgages are simply tax managmement devices used by land sellers with the land selling at a higher price than it would under a conventional loan. As an economist, I have often pointed out that there should be a trade-off between interest rates and land prices. And, this is the reason that IRS is concerned about the interest rates reported on these contracts--they lose pontential revenues if there is, in fact, a trade-off in which the seller ends up taking a larger proportion of his payments as capital gains income rather than as interest.

The reality of the farm market place, however, shows very little evidence that such a trade-off is in fact taking place. I don't find it. Land brokers and professional farm managers report very little evidence of it. And, finally, our annual department surveys of land prices show no evidence of higher prices being paid for land bought under contract-for-deed than under conventional mortgages. In fact, the opposite has been true in recent years. The average of farms selling under contract-for-deed reported in the 1980 survey was $1,290 compared to $1,470 for those sold under conventional mortgages. For "good quality land" the figures were $1,677 for contract sales versus $1,933 for mortgage sales.*

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* Landwehr, James and Philip Raup, "The Minnesota Rural Real Estate Market In 1980," Minnesota Agricultural Economist, No. 624, January 1981, Agricultural Extension Service, University of Minnesota.

Consequently, I conclude that most land buyers and sellers do not practice the theoretical trade-offs that economists and tax specialists talk about. Rather, there are some disadvantages to the buyer and/or advantages to the seller which result in the lower observed market-place interest on these contracts without seeing a compensating increase in the land price. Three observations on this:

(1) The earlier menthioned "rigidity" of the contract with regard to limited prepayment options, locked in interest rates, and the inability to borrow against would be disadvantages to the buyer--especially if inflation/ interest rates decline. (There appears to be a correlation between length of contract and interest rate charged. The longer contracts have earned lower interest rates.)

(2) The seller is able to spread his capital gains over a period of years.

(3) The longer term expectations of rural people relative to future inflation rates is still around the 5 percent area. (They apparently have more faith in the future ability of government to control inflation than does government itself.)

If these are the expectations of the parties when establishing a fair land price and fixing an interest rate--who has the wisdom to refute this expectation?

Relative to future inflation rates--and, consequently, future interest rates--there is a wide divergence of opinion among professionals as well as among lay people. Some expect even higher inflation rates in the coming decade. Some expect deflation. If lower inflation rates occur during the next 10-15 years--and, historically speaking, high rates have been followed by low rates (see graph 3), buyers who locked in high interest rates will be in financial trouble.

If government (IRS) persuades all land traders to accept their current long term inflation forecasts--can government also be held responsible if current land purchasers default on future loan payments--and subsequently lose their farms back to the sellers if we do in fact come into a period of significantly lower inflation rates—thus wiping out the inflationary increases in cash flows that are now bid into land prices as well as the inflation premiums now included in interest rates.

In closing I am reminded of a question that a grey-haired lady asked me during a meeting on land prices and financing alternatives at Owatonna on March 11, 1981. She wanted to know why, after working hard all their lives they could not now sell their farm "without having IRS tell us how much we can sell it for and how much interest we are supposed to charge".

This is just one specific example of the widespread growing disenchantment I find between peole and "government". A recent survey conducted by a large regional farm cooperative--Land O'Lakes, Inc., Minneapolis, Minnesota[4/] -- of a representative sample of its 250,000 farm families found that their major

4/ Family Farm Issues Of The 80's, Agricultural Structure/Farm Policies Project conducted by Land O'Lakes, Inc. in the interest of its farmer members, February 1981.

conern was inflation (listed by 84 percent of respondents). Three of the other four major problems they identified as impacting their farming operations were:

taxes and tax rules - 43 percent of respondents listed
high land prices - 30 percent of respondents listed
too much government - 30 percent of respondents listed

These results give very strong evidence as to the importance rural America places upon the very issues under consideration by this committee.

In conclusion, a few recommendations:

(1) The "required" minimum interest rate on contracts should be at some fraction of Federal Land Bank interest rates--perhaps two-thirds.

(2) Those requirements should be based on some moving average (3-5 years) and be either self-adjusting or be announced annually.

(3) The minimum interest rate suggested under section 482 should be the same as that required under section 483. (This would help eliminate confusion and the appearance that there is some "special punishment" intended for related entities who appear to violate the "arms length" specification.)

(4) The four major concerns of rural America identified above can all best be handled by congressional actions that will help bring inflation under control.

Relative to (4), it is a sad commentary on government when, at the same time states such as Iowa, Louisiana, Minnesota, North Dakota, Oklahoma and Texas are spending tax dollars to lower the effective interest rates on contracts, the Federal government is taking action that will increase these same interest rates. Legislation similar to the Minnesota Family Farm Security Act is under consideration in a dozen other states. In fact, similar legislation has recently been introduced at the national level. Called the "Beginning Farmers Assistance Act" (HR 2977), its purpose is to make available $250 million in loan guarantees to those states which offer special loan programs to beginning farmers. The use of tax dollars in two different programs that are at cross purposes with each other is not prudent fiscal management.

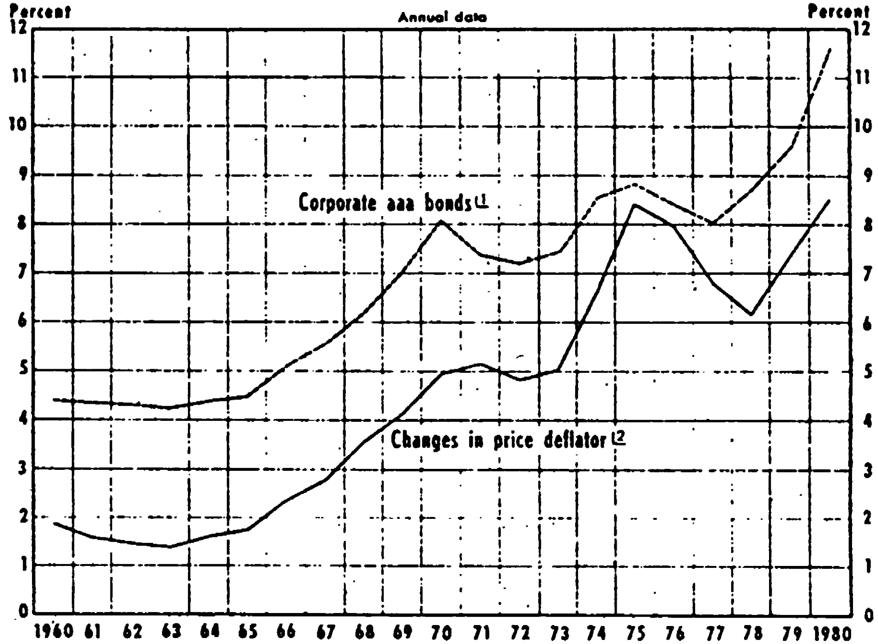
Finally, those who are responsible for the decision on the appropriate interest rate to suggest on land contracts might consider the word of admonition in the last verse in the 22nd chapter of Proverbs--"He who oppresses the poor to increase his own wealth, or gives to the rich will only come to want". (Prov. 22.16)

- Government hopes to increase its wealth from the larger tax take.
- Beginning farmers are usually relatively poor, these are the ones who will have to pay more interest as the required rate is increased
- Current land owners are the relatively rich because of recent inflation levels--these are the ones who will get the higher interest payments

GRAPH 1.

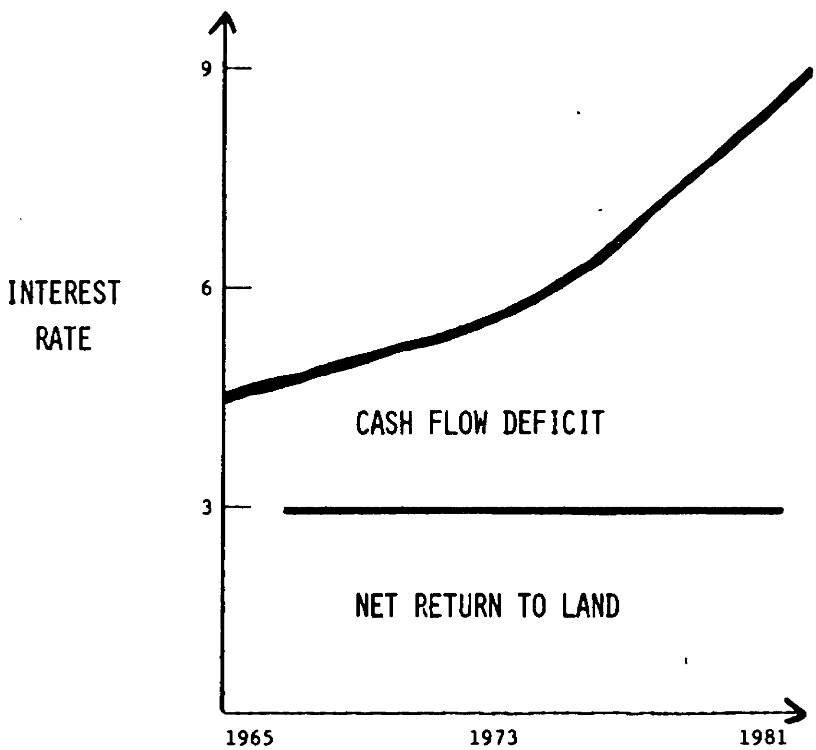
Chart 2

Long Term Bond Yields and Price Changes



1 Annually averaged Moody's Seasoned Aaa bond yields
2 Rate of change of three-year moving average of GNP deflator placed on last year
Note: 1980 data are averages of first two quarters

GRAPH 2. The impact of an increasing inflation rate and interest rate on the cash flow deficit inherent in a farm land purchase.



GRAPH 3.

Steve Leuthold
Funds, Inc.
Special Consultant, Piper, Jaffray & Hopwood, Inc.

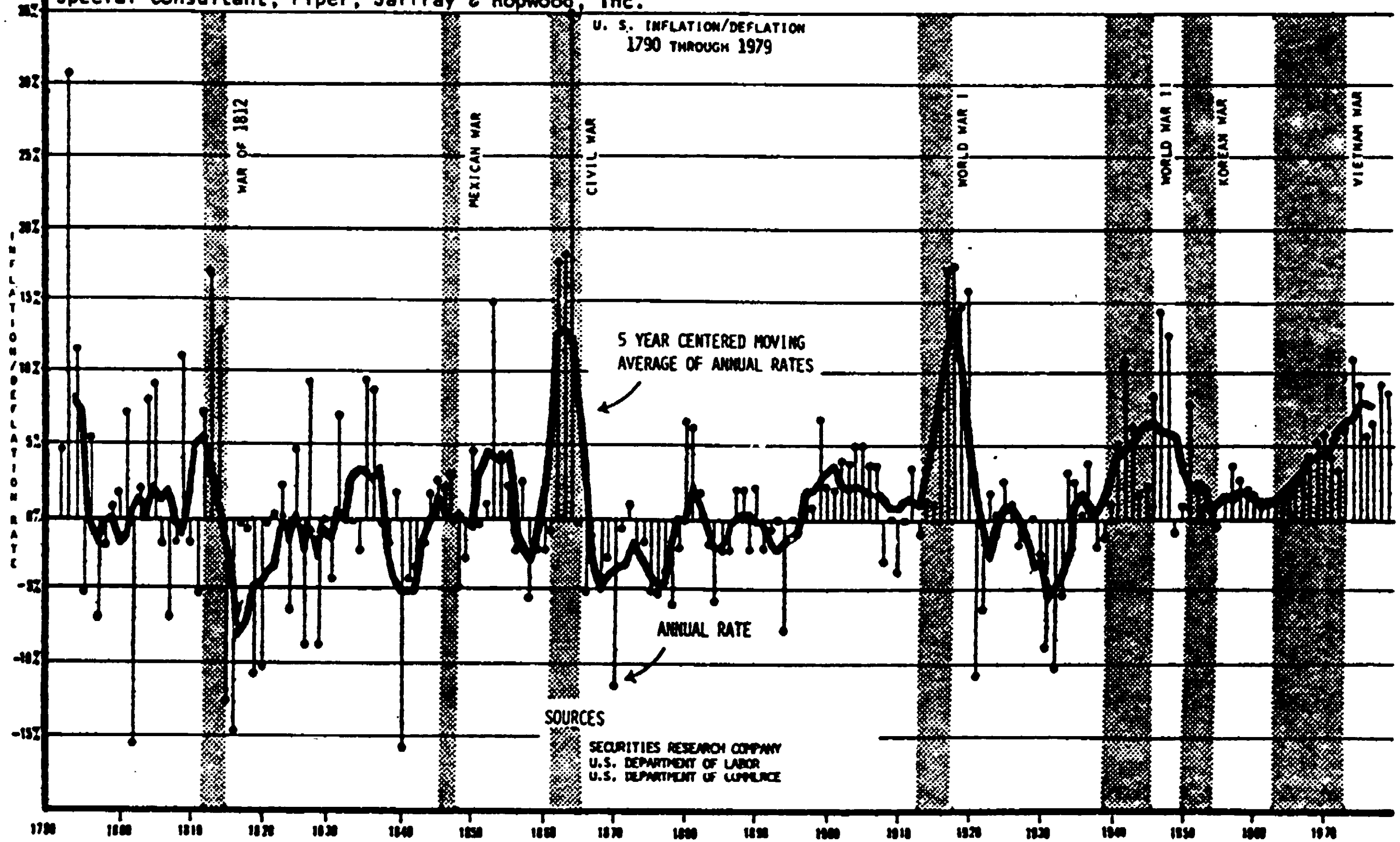


Table 1. 30-year net cash flows per acre on $2,400 land expected to net $85 the first year and 7 percent more each year thereafter.

Down payment	$240
Contract length	15 years
Payment terms	amortized on 30-year basis
Balloon payments	after 15 years
Refinance terms expected	30 years at 9 percent

End Of Year	6% Interest On Contract	9% Interest On Contract
0	-240.00	-240.00
1	-71.48	-124.15
2	-65.60	-118.28
3	-59.32	-111.99
4	-52.59	-105.26
5	-45.39	-98.06
6	-37.69	-90.36
7	-29.45	-82.12
8	-20.64	-73.31
9	-11.20	-63.87
10	-1.11	-53.78
11	9.69	-42.98
12	21.25	-31.43
13	33.62	-19.07
14	46.85	-5.84
15	61.01	8.31
16	85.20	68.74
17	101.44	84.98
18	118.82	102.36
19	137.41	120.95
20	157.31	140.85
21	178.60	162.13
22	201.38	184.91
23	225.75	209.28
24	251.83	235.36
25	279.73	263.26
26	309.59	293.11
27	341.54	325.06
28	375.72	359.24
29	412.29	395.81
30	451.43	434.94

Senator GRASSLEY. Now I would like to call a panel consisting of Dean Kleckner, president of the Iowa Farm Bureau Federation, representing the American Farm Bureau Federation, Mrs. Helen Timmerman, chairman of the tax committee, the National Association of Wheat Growers and Mr. Kent Jones, commissioner of agriculture, the State of North Dakota.

In way of apology, but also admitting that I did not plan ahead adequately and you have seen the chart that is spelled out plan ahead with going down the side of the paper the last letters of the words plan ahead. In that vein, we are running short of time, but not so much time that you won't be given what we should have limited everybody to—the 5 minutes per person.

We would like to then have you summarize your statement and use your 5 minutes of time. You all know that your statement will be printed in total in the record if that is the way you wish to have it done. I would ask then, that we would start—say did I miss somebody?

Dean, would you please start?

STATEMENT OF DEAN KLECKNER, PRESIDENT, IOWA FARM BUREAU FEDERATION

Mr. KLECKNER. Thank you, Mr. Chairman. I am Dean Kleckner, president of Iowa Farm Bureau Federation, representing the American Farm Bureau. I am a farmer from Iowa.

Mr. Chairman, I will attempt to summarize our statement to some degree. I recognize the lights up there. I know what they mean.

We do appreciate the opportunity to be here to talk about these two areas of imputed interest rates and special use valuation for farmland. We commend you for your examination of the IRS regulatory practices.

Imputed interest rates and special use valuation have generated much discussion among our members. This tax policy has significant effect on the economic well-being of Farm Bureau member families who now number over 3 million member families in 48 States and Puerto Rico.

Now, concerning imputed interest, as we have heard today, under current law a portion of each deferred payment is required to be treated as ordinary interest income. We testified before IRS in January of this year regarding the proposed regulations that would increase these interest rates and this is part of what we said as we testified to IRS.

We are concerned that the proposed regulations discriminate against related party transactions. That has been pointed out earlier this afternoon. We don't think it is clear yet whether family farms are affected by section 482.

Mr. Chairman, you tried to get the IRS Commissioner to explain and I am not sure exactly how he answered you and I listened.

So, we don't really know yet whether family farms are affected. If the purpose of the rules is to prevent sweetheart deals between financially related entities such as parent corporations and their subsidiaries, we think the proposed regulation should be clarified to reflect that purpose.

We don't think that we ought to arbitrarily apply the increased interest to family farms and other small businesses. That position unfairly hampers and may prevent, in some cases, the transfer of family businesses from one generation to another.

Transactions should not be suspect simply because they occur between related parties. We are concerned, though, that a pattern is being established which reflects this thought. An example that we know of is an IRS proposed regulation on the deductibility of normal business expenses for a taxpayer who rents a dwelling to a family member as compared to somebody who is not a member of the family.

We list here a number of bills that the Congress has introduced designed to prohibit the IRS from doing this. That signifies Congress' interest in another bill H.R. 837 providing that regulatory increases in the interest rate shall not apply to farms and other small business.

The Farm Bureau opposes the efforts of the IRS to increase imputed interest rates. The rules are vague at best, and offer no guidance as to whether family farms are affected.

Furthermore, the discriminatory application of the rate regarding related/unrelated party transactions appear likely.

To increase the interest rates on a type of sales arrangement, frequently used in the intergenerational transfer of farming operations between family members will serve to prohibit some transfers entirely.

Lower interest rates and a loan or installment sales transaction between family members is not an effort to avoid income taxes. It is a traditionally recognized method of continuing family businesses. I think the previous witnesses pointed that out for their States. It is certainly true in Iowa and much of the Midwest that I am familiar with.

It is presumptuous of the IRS to attempt to substitute its business judgment through the proposed regulations for that of a farmer. By removing a farmers or business owners flexibility to set interest rates, the IRS assumes that legitimate transfers are efforts to avoid income taxes.

We reject this notion and therefore, oppose proposed regulatory increases in sections 482 and 483.

I see I am not going to get through. That concludes my statement.

Senator GRASSLEY. You have another minute until the red light comes on.

Mr. KLECKNER. I can't go much faster. You wouldn't understand it, Mr. Chairman.

The special use valuation, we have a section on that, lists our policy. I would like to point out down there just two of those areas.

I think the fourth paragraph under our policy explains it. We believe both crop share and cash rentals should qualify in determining the special use valuation of farmland under section 2032(A).

In the next one, we encourage a reasonable and flexible intrepretation by the Internal Revenue Service of the material participation requirements for this special use valuation.

I think I best go on to the next to the last page under some previous testimony.

We think the proposed regulations present a double bind to farmers and their families. First, a restrictive definition to material participation can discourage a decedent to be—I guess we are all decedents to be—and our heirs from engaging a nonfamily farm management specialist or firm to operate the farm.

Now, Mr. Chairman, I would like to go on to the last paragraph, but my time is up.

We believe, the Farm Bureau believes, that the Subcommittee of the Internal Revenue Service examination of regulations on imputed interest rates and special use valuation is justifiable.

All too often the role of the IRS is adversarial to the interest of taxpayers. The controversy and confusion surrounding the regulatory procedures with regard to these tax issues, reflect a need for the IRS to reexamine its role. Such reexamination is timely, given President Reagan's emphasis on regulatory reform.

The Farm Bureau supports a program for economic recovery outlined by the President. We hope that the regulatory procedures of the Internal Revenue Service will be modified to reflect more clearly the intent of Congress and the needs of the taxpayers.

Mr. Chairman, I would like to have the whole testimony in the record if I could and we thank you for consideration of the Farm Bureau's comments.

Senator GRASSLEY. Your whole statement will be included.

Now, Mrs. Timmermann.

STATEMENT OF HELEN TIMMERMANN, CHAIRMAN, TAX COMMITTEE, NATIONAL ASSOCIATION OF WHEAT GROWERS

Mrs. TIMMERMANN. Mr. Chairman and members of the committee, the National Association of Wheat Growers appreciates this opportunity to present its views on the Internal Revenue Service regulations for special use valuation of farmland for estate tax purposes.

I am Helen Timmermann of Pendleton, Oreg., wheat farmer and chairman of the National Association of Wheat Growers Committee on Taxation.

A special use valuation of agricultural lands for estate tax purposes was included in the Tax Reform Act of 1976. Section 2032(A)(e)(7) calls for a valuation procedure for valuing farm real property used for farming purposes based on the net rental returned to the lessor.

If you follow the procedure of 2032(A)(e)(7)(i) and subtract the annual real estate taxes from the annual gross cash rental, you arrive at the annual net return to the lessor.

This net return is then divided by the average annual effective interest rate for all new Federal Land Bank loans to provide the farm use valuation.

The appraisal procedure set forth in the IRS regulation, section 20.2032(A)-4 follows the procedure I just outlined, but only for one rental arrangement of farmland, a pure cash rent and excludes all others by definition.

In many areas of the country, such as dryland, summer fallow, crop rotation areas, few leases are written for cash rental, whereas all leases are convertible to cash.

The in-kind crop share rent converted to its cash equivalent is the cash rental of this land and becomes the net return to the owner when the annual real estate taxes are removed, just as the cash payment becomes the net return to the owner when the annual real estate taxes are removed.

Some leases, both cash and crop share, provide for certain shared expenses. Shared expenses must be subtracted as well as the real estate taxes to obtain the net rental return to the lessor.

It seems to me what is called for in the IRS code 2032(A)(e)(7) is the net annual rent; that is, the annual return to the asset to capitalize over the interest rate determined in the code to arrive at the use valuation.

The State of Oregon has developed a farm use appraisal method that determines the annual net rent for all agricultural lands regardless of leases.

Exhibits A–1 and A–2 are lease summary conversion sheets used for both cash and crop share to determine annual net rental to owner, which is then used to determine farm use valuation using the effective rate of interest charged in Oregon by the Federal Land Bank as an average over the past 5 years plus a component for the local tax rate.

Also included is exhibit A–3, pages 1 and 2, farm use information sheets, comparing crop share rent to cash rent.

Yield information may be obtained at the county USDA ASCS office. Local average and monthly average prices are available in every State on the major commodities from the USDA Economics and Statistics Service.

In exhibit B, when we look at the four farms, identical except for type of lease, we can see that under the current regulation only farm A is allowed valuation based on capitalization of the net rent return to the land. This results in extreme discrimination in valuation.

Farm B is allowed valuation under 2032(A)(e)(7) but not on net return. Farms C and D are disallowed under 2032(A)(e)(7) and would be forced to use 2032(A)(e)(8).

However, paragraph 8 also uses comparable sales which distorts the valuation away from the actual use valuation.

In my prepared statement, I list the regulations that prevent a fair and equitable valuation. It is interesting to note that proposed IRS regulations in volume 45 of the Federal Register, page 31042 issued on July 19, 1978, recognized the need for converting crop share to cash. This provision was then disallowed in the final regulations.

The goal stated in the summary in the Federal Register to provide "the method of valuing certain farm real property according to its actual use" cannot be attained while these arbitrary and discriminatory regulations remain.

Thank you.

Senator GRASSLEY. Thank you. Stay there please for possible questions.

Mr. Jones?

STATEMENT OF KENT JONES, COMMISSIONER OF AGRICULTURE, STATE OF NORTH DAKOTA

Mr. JONES. Mr. Chairman, thank you for the opportunity to be here today. We have heard much rhetoric this afternoon about the demise of our farms. We know for example the number of farms has gone from 6.8 million down to 2.3 million. We are losing 30,000 farms each year now.

Ironically, this country was founded on the belief that each citizen is entitled to the right to have his own piece of land. The Federal Government still stands by that right, but its policies, such as the one you are considering here today, are making that an impossible dream.

North Dakota is having the same problem. We are losing our farms about the same percentage, I would imagine. We have gone from 85,000 to 40,000. The future of North Dakota's agricultural way of life is most seriously threatened by the inability of young people to take the place of farmers who are retiring.

Because North Dakota wants to have a healthy system of family farms and rural communities, we are fighting back and doing something on a State level.

The North Dakota Department of Agriculture has been researching the problems facing beginning farmers and has developed a number of programs to deal with the problems.

For example, our State, through the Bank of North Dakota has developed a beginning farmer loan program to provide low-cost financing for young farmers. The going rate is currently about 2 percent below the rate they can get elsewhere.

Our State legislature has instituted State income tax incentives for landowners to sell or rent farmland to beginning farmers.

A key feature of this program is a provision which exempts all principal and interest payments on an installment sale of a farm to a beginning farmer. The installment sale provision, or the contract for deed as it is commonly called in North Dakota, of our State beginning farmer program is why I felt compelled to travel here today to attend this hearing.

North Dakota is trying to provide the lowest rate of interest possible when a farm is sold to a beginning farmer. The IRS regulations under consideration, today, will offset a major portion of those benefits to young farmers which North Dakota has plugged in.

This past December my office sponsored a series of meetings. Out of those meetings came many of the same things we have heard today, with such statements as, What right does the Government have to tell me that I have to charge my son or daughter or a long time tenant 9-percent interest when I sell my farm on a contract for deed? They can hardly afford the present 6 percent.

Installment sales of farms are a common way of transferring a farm from one generation to the next. In many instances such transfers are being made so that they can have the lowest rate of interest allowed because a retiring farmer wants to be sure that the new generation, be they offspring or long time renter, on the farm has the best chance possible for making it on that farm.

Increasing allowable rates of interest on such farm transfers will reduce the chance that such a new farm will survive.

Despite all these problems, many North Dakota young people want to farm. American agriculture would be better served by tax policies at the Federal level similar to the ones we have put into place to help beginning farmers in North Dakota, rather than additional tax obstacles making the transfer of family farms more difficult.

Now, we have all heard how hallowed the family farm is today. Everybody has referred to it. In addition to that it has done an amazing job of productivity. Unfortunately our institutions do not self-preserve.

We can control our destiny and that of American agriculture only if we set out to do so. I would hope that you would control the destiny of the family farm in the proper manner by doing everything in your power to make sure that the imputed interest rates on installment sales be left at the present level and not be increased as the IRS has proposed.

Federal tax laws seem designed to deliberately drive farmers and their families off of the land. The IRS regulation under consideration here today is as blatant an example as has come along in quite some time.

I want to thank you, Mr. Chairman and members of the committee for this opportunity to visit with you and I would hope that the entire testimony as presented to you, will be recorded.

Senator GRASSLEY. As long as that is your desire it will be printed in the record in total.

Mr. JONES. Thank you, sir.

Senator GRASSLEY. Now, I have questions of Mr. Kleckner and Mrs. Timmermann I feel silly calling you Mr. Kleckner. We have known each other so long, Dean, but I appreciate your coming out here and expressing your feelings to us.

I would like to ask both Dean and Mrs. Timmerman—you recommend permitting use of crop share rents in the 2032(A) formulas valuation method. What guidelines would you offer for converting crop share to cash amounts? Mrs. Timmerman, would you like to be first?

Mrs. TIMMERMANN. The guidelines should include the net rental return—whether cash, crop share, or other rental system—before the property taxes are removed, so that any kind of rental situation could be valued equitably.

As I stated earlier, the State of Oregon uses conversion sheets that convert crop share to cash, and I do not see why the same procedure could not be followed in other States. Oregon only removes the shared production expenses, not any individual expenses.

Senator GRASSLEY. OK. Dean?

Mr. KLECKNER. Mr. Chairman, I am not exactly sure if there would be any formula that you could work out that would be appropriate in every case.

It certainly can be done. All we ask is that you be reasonable. I guess I find it hard to believe that there are sections of the country where there isn't some cash rent and some crop share, albeit tipped one way or other in different sections of the country, where they could make valid comparisons.

The IRS, as I recall reading the regulations, lists 7 or 8 criteria. If you follow those it would make it nearly impossible. The topography of the land is one and the drainage and the buildings on the farm; you almost would have to have a clone of a farm to qualify under their rigs. It is not even reasonable.

All we would ask is that they make some reasonable assumptions and you could, I think, with some good judgment convert the crop share to a given figure and then use the formula.

Senator GRASSLEY. I want to assure you, Dean, because you made the point of whether we are going to push for broad based clarification of paragraph 482.

I think that the only question I would have about this general problem was the one that I had presented to the Commissioner. I guess I would ask you to comment if you have any particular understanding of the law that I don't have and tell me if it would be in opposition to the Commissioner.

They made the point to me that they interpret that Congress intended that they do, not making differentiation between the small family and small businesses and the major corporations. I think they are more or less saying that it is Congress responsibility to give that differentiation or direction to them.

Do you have any reading of the law that would be any different than that? I don't even want it to be implied that I agree with them. I am just accepting their judgment momentarily and sometimes you don't admit that Congress doesn't always spell out what it is intended in the past.

Do any of you have any comments on that point?

Mr. JONES. Well, this is a little different point, I guess, but I heard it over and over today and it certaily dovetails with how we felt in North Dakota with our struggling to have a beginning farmers program.

As soon as you raise that 6- to 9-percent minimum you are affecting it. I guess that doesn't matter what size farm, but it certainly is applicable on a beginning farm.

Senator GRASSLEY. Well, along that very line, when the interest rate was lower it wasn't so much of a problem. When you get the higher interest rates, primarily with the prospect that they could go much higher, then it really begins to impact upon some of the smaller concerns that do not have the ability to get capital independent of the family.

Mr. JONES. I guess what kind of bothers us is if we make all this effort in the State of North Dakota and back these loans by the State, pay the additional 2 percent by ourselves for the State pays it, and then lose it on the other end of the fence, that doesn't make an awful lot of sense.

Senator GRASSLEY. No. Dean?

Mr. KLECKNER. Mr. Chairman, I think you were right on target with your comments to those two gentlemen who led off the program.

I don't know what in law—you asked that point and I am not an attorney either—but it seems to me that in this case and other cases dealing with, for example, investment credit, all any person with any commonsense that worked for the Internal Revenue Service would have to do would be to read what Congress was saying in the testimony and interpret that, but they are not. They are interpreting it in a very worst form possible from the taxpayer's point of view.

They are a bureaucracy, in my opinion, that is big and wants to grow bigger and they put different meanings on words. I don't frankly see how Congress can spell out everything and every absolute detail to prevent these things from happening. I guess you have to slap them down when they overstep their bounds. A personal opinion, Mr. Chairman, a good way of slapping them down would be to occasionally fire the top man and those underneath and they would get the message. A change in administration is a change in the top man, too.

Senator GRASSLEY. Well, I hope that that was what the last election was all about.

Mr. KLECKNER. Mr. Chairman, I have a paragraph that was not in the prepared testimony that I would like to get in the record. Could I——

Senator GRASSLEY. You can just submit it to us or you can read it. If it is a short paragraph it might be faster to read it.

Mr. KLECKNER. Could I read it right now, because it is something——

Senator GRASSLEY. Yes, go ahead.

Mr. KLECKNER. OK. The proposed regulations seem to concentrate solely, this concerns the material participation, on whether or not the decedent qualified for material participation whereas section 2032(A) clearly states as one of the qualifications for special use valuation that "the decedent or a member of his family materially participated in the farmer business operations in 5 of the 8 years before the decedent's death."

I think you or someone flagged that with the Treasury man Mr. Chapoton and he indicated that they were going to allow that and make it retroactive. Then he came back later and said that, as one of his staff pointed out, that is a part of the regulations now so we really don't need to do anything. That would be my interpretation too. That is part of the arrangement, but that's not what they have been doing in our State, for example.

There are cases of certain internal IRS districts apparently not doing what the other one is doing. A right hand not knowing what their left has been doing because in Iowa, they have at this point interpreted it that the decedent had to be materially participating and not if a member of his family was. That would not be allowed or not qualify.

Senator GRASSLEY. We will check on that and follow with it. I have no other questions. Is there anybody from the minority staffs that have any questions?

Then I guess we will say thank you very much.

Mr. KLECKNER. Thank you, Mr. Chairman.

Mr. JONES. Thank you, Mr. Chairman.

Mrs. TIMMERMANN. Thank you, Mr. Chairman.

[The prepared statements of the preceding panel follow:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
OF THE SENATE FINANCE COMMITTEE
WITH REGARD TO REGULATIONS ON IMPUTED INTEREST RATES
AND ESTATE TAX VALUATION

Presented by
Dean Kleckner, President, Iowa Farm Bureau Federation
and Member, AFBF Board of Directors

April 27, 1981

Farm Bureau appreciates the opportunity to offer comments on Internal Revenue Service regulations concerning proposed increases in imputed interest rates and the special use valuation of farmland for estate tax purposes. We commend the Subcommittee for its examination of IRS regulatory practices with reference to these two issues. Imputed interest rates and special use valuation have generated much discussion among our members. Tax policy has a significant effect upon the economic well-being of Farm Bureau member families who now number over three million in 48 states and Puerto Rico.

I. Imputed Interest Rates (IRC 482 and 483)

Under current law, a portion of each deferred payment in an installment sales contract is required to be treated as ordinary interest income. Proposed regulations issued by the IRS last August would increase the rate that is imputed on this unstated interest from seven percent to ten percent for installment sales and from seven percent to twelve percent on loan transactions occurring between financially related entities.

In testimony to the IRS on January 8, 1981 regarding the proposed regulations increasing imputed interest rates, Farm Bureau expressed concern that the proposed regulations may require a higher imputed interest rate on transactions occurring between related parties.

> "We are concerned that ...the proposed regulations... discriminate against related party transactions, such as loans between a farmer and his or her children. Section 482 of the Internal Revenue Code speaks in terms 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....' It is unclear whether family farms are affected by Section 482 and the proposed regulations. For instance, would a transaction by one shareholder (farmer) to another (child) in a family farming corporation be subject to the safe-haven rule...?

"If the purpose of the rules is to prevent 'sweetheart deals' between financially related entities such as parent corporations and their subsidiaries, the proposed regulations should be clarified to reflect this purpose. To arbitrarily apply the increased rate to family farms and other small businesses is an injustice. Such a position unfairly hampers and may prevent, in some cases, the transfer of family businesses from one generation to the next.

"Transactions should not be suspect simply because they occur between related parties. However, we are concerned that a pattern has emerged which reflects this thought. For instance, other regulations recently proposed by the Internal Revenue Service would place a restriction upon the deductibility of normal business expenses for a taxpayer who rents a dwelling to a family member."

The debate over the proposed interest rate increases has continued to grow and has given rise to legislation designed to prohibit the proposed regulatory increases (S. 164, H.R. 953, H.R. 1448, and H.R. 2495). Another bill, H.R. 837, provides that regulatory increases in the interest rates shall not apply to farms and other small businesses. The introduction of this legislation reflects Congressional concern that the IRS has overstepped the bounds of reasonableness in proposing these increases.

Farm Bureau opposes the efforts of the IRS to increase imputed interest rates. The rules are vague, at best, and offer no guidance as to whether family farms are affected. Futhermore, the discriminatory application of the rates regarding related/unrelated party transactions appears likely. To increase the interest rates on a type of sales arrangement frequently used in the intergenerational transfer of farming operations between family members will serve to prohibit some transfers entirely. Lower interest rates in a loan or installment sales transaction between family members is not an effort to avoid income taxes. Such practice is a traditionally recognized method of continuing family businesses. It is presumptuous of the IRS to attempt to substitute its business judgment through the proposed regulations for that of a farmer. By removing a farmer's or business owner's flexibility to set interest rates, the IRS assumes that legitimate transfers are efforts to avoid income taxes. Farm Bureau rejects this notion and therefore opposes the proposed regulatory increases in Section 482 and Section 483 of the Internal Revenue Code.

II. Special Use Valuation of Real Property for Estate Tax Purposes (IRC 2032A)

Farm Bureau has a long involvement in the federal estate and gift tax area because of the effect that these taxes have upon family farms and other family businesses. Farm Bureau was active in its support for estate tax relief in the Tax Reform Act of 1976 and the Revenue Act of 1978. The continuing interest of our membership is reflected in the following policy which was adopted by the voting delegates of the member State Farm Bureaus at the American Farm Bureau Federation's annual meeting in January, 1981.

Federal Estate and Gift Taxes

"We favor a phase-out of the federal estate tax. Until this phase-out is acomplished, we will continue to support legislation to reduce the impact of the federal estate tax on the orderly transfer of property and an exemption for property on which an estate tax has been paid within 15 years prior to the death of the second decedent.

"We favor indexing of the federal estate tax to compensate for inflation.

"We favor recognition of the equal contribution of the spouse to a farming enterprise in estate settlements.

"We believe both crop share and cash rentals should qualify in determining the special use valuation of farmland under Section 2032A of the Internal Revenue Code.

"We favor special use valuation of agricultural land for gift tax purposes similar to the special use valuation of such property for estate tax purposes under Section 2032A of the Internal Revenue Code.

"We encourage a reasonable and flexible interpretation by the Internal Revenue Service of the 'material participation requirements' for the special use valuation of farmland under Section 2032A of the Internal Revenue Code.

"We recommend an immediate increase in the estate tax exemption to $500,000 and an increase in the annual gift tax exclusion to $10,000 per year."

Farm Bureau is particularly pleased to see the Subcommittee's examination of IRS regulations related to Section 2032A. When the special use valuation of agricultural land for estate tax purposes was included in the Tax Reform Act of 1976, it promised to be quite helpful to farm and ranch families, particularly in areas of urban and suburban development. However, the provision has been much less of a benefit than originally envisioned. The final regulations published in July 1980, have construed Section 2032A so narrowly that some estates have foregone its use entirely. Two areas in particular have caused major concern to farmers. They are the material participation requirements and the definition of gross cash rentals for the special use valuation of farm real estate.

In testimony to the Internal Revenue Service on April 3, 1979, North Carolina Farm Bureau President John Sledge voiced the concerns of the American Farm Bureau Federation:

"Farm Bureau supports the Internal Revenue Service in its attempts to prevent abuses in the special use valuation of farm real estate. We are concerned, however, that the proposed regulations may work to the detriment of many farmers, ranchers, and their heirs because of the restrictive aspects of the proposed definition of material participation. The regulations should maintain the flexibility necessary to reflect the intent of Congress to encourage the preservation of family farms.

* * * * *

"The proposed regulations present a double bind to farmers and their families. First, the restrictive definition of 'material participation' can discourage a decedent-to-be and his or her heir from engaging a nonfamily farm management specialist or firm to operate the farm, although business or family considerations might dictate such services. To employ a non-family member could mean the loss of the special use valuation for the farm. Second, when an owner does participate in the operation of a farm, within the meaning of the proposed rules, the related income becomes earned income under Social Security. Thus, material participation requirements can force a farmer to make a choice between eligibility for social security benefits or eligibility for the special use valuation."

In January 1980, Doyle Rahjes, Vice President of the Kansas Farm Bureau, presented Farm Bureau's position at the Internal Revenue Service hearing on the definition of gross cash rentals for purposes of the special use valuation of farmland. The definition of gross cash rentals included in the proposed regulations published on July 19, 1978, permitted crop share rentals if no actual cash rentals of comparable real property were available in the locality. The option to substitute crop share figures for cash rent figures is essential in areas of the country where rental operations are conducted primarily under crop share arrangements, a traditionally recognized way of conducting business. Unfortunately, proposed regulations published in September 10, 1979, withdrew this option to farmers and ranchers. In areas of the country where crop share arrangements predominate, such as Kansas and Illinois, it has become impossible to take advantage of the special use valuation under 2032A(e)(7). This leaves the alternative of a more cumbersome valuation procedure under 2032A(e)(8). Mr. Rahjes emphasized the importance of crop shares to farmers and urged the Internal Revenue Service to reexamine its decision to eliminate the use of crop share rentals. In a hearing on March 4, 1980, before the Senate Finance Subcommittee on Taxation and Debt Management, Farm Bureau's position was offered again in support of legislation allowing the use of crop shares as well as cash rentals.

In hearings before the Subcommittee on Taxation and Debt Management on August 4, 1980, Farm Bureau reemphasized that the benefits of special use valuation can be realized by farm families only if reasonable guidelines for methods of valuation and requirements for material participation are presented. To date, the Internal Revenue Service has not offered workable guidelines. Therefore, Farm Bureau supports amendments to the Internal Revenue Code that would provide realistic requirements to qualify for special use valuation. In particular, provisions are needed that address the interaction of Social Security benefits and special use valuation, as well as accommodate questions of material participation or active management of surviving spouses, minor children, and other similarly situated individuals who inherit property from a decedent who qualified for special use valuation.

Farm Bureau believes that the Subcommittee's review of the Internal Revenue Service regulations on imputed interest rates and special use valuation is justifiable. All too often the role of the IRS is adversarial to the interests of taxpayers. The controversy and confusion surrounding the regulatory procedures with regard to these tax issues reflect a need for the IRS to reexamine its role. Such reexamination is timely, given President Reagan's emphasis on regulatory reform. Farm Bureau supports the program for economic recovery outlined by the President. We hope that the regulatory procedures of the Internal Revenue Service will be modified to reflect more clearly the intent of Congress and the needs of taxpayers.

Thank you for consideration of Farm Bureau's comments.

Statement of
Helen Timmerman, Chairman
National Association of Wheat Growers Committee on Taxation
before the
Senate Subcommittee on Oversight of the Internal Revenue Service
Senate Committee on Finance
on
Special Use Valuation of Farm Land for Estate Tax Computation
April 27, 1981

Mr. Chairman and members of the Committee:

The National Association of Wheat Growers appreciates this opportunity to present its views on Internal Revenue Service regulations for special use valuation of farm land for estate tax purposes. I am Helen Timmerman, a Pendleton, Oregon wheat farmer, and chairman of the National Association of Wheat Growers Committee on Taxation.

A special use valuation of agricultural lands for estate tax purposes was included in the Tax Reform Act of 1976. Section 2032A(e)(7) calls for a valuation procedure for valuing farm real property used for farming purposes, based on the net rental return to the lessor. If you follow the procedure of 2032A(e)(7)(i) and subtract the annual real estate taxes from the annual gross cash rental, you arrive at the annual net return to the lessor. This net return is then divided by the average annual effective interest rate for all new Federal Land Bank loans to provide the farm-use valuation.

The appraisal procedure set forth in the Internal Revenue Service regulation section 20.2032A-4 follows the procedure I just outlined, but only for one rental arrangement of farm land -- a pure cash rent, and excludes all others by definition.

In many areas of the country, such as dryland, summer fallow crop rotation areas, few leases are written for cash rental, whereas all leases are convertible to cash. The in-kind, crop share rent converted to its cash equivalent is the cash rental of this land and becomes the new return to the owner when annual real estate taxes are removed, just as the cash payment becomes the net return to the owner when the annual real estate taxes are removed. Some leases, both cash and crop share provide for certain shared expenses. Shared expenses must be subtracted, as well as the real estate taxes, to obtain the net return to the lessor.

It seems to me what is called for in the Internal Revenue Code 2032A (e) (7) is the net annual rent; i.e., the annual return to the asset, to capitalize over the interest rate determined in the code to arrive at the use valuation.

The State of Oregon has developed a farm use appraisal method that determines the annual net rent for all agricultural lands regardless of leases. Exhibit A1 and A2 are lease summary conversion sheets, used for both cash and crop share to determine annual net rental to owner, which is then used to determine farm use valuation using the average annual effective Federal Land Bank interest rate.

Also included is Exhibit A3, page 1 and 2, farm use information sheets.

Local yield and price data is readily available to convert crop-share rent to cash rent. Yield information may be obtained at the county USDA - ASCS office. Local average yearly prices are available in every state from the USDA Economics and Statistics Service.

In Exhibit B, when we look at the four farms, identical except for type of lease, we can see that under the current regulation only farm A is allowed valuation based on capitalization of the net rent return to the land. This results in extreme discrimination in valuation. Farm B is allowed valuation under 2032A (e) (7), but not on net return. Farms C and D are disallowed under 2032A (e) (7) and would be forced to use 2032A (e) (8) to obtain any use valuation. However, paragraph (8) also uses camparable sales, which distorts the valuation away from the actual use valuation available to Farm A.

Following are sections of regulations that prevent a fair and equitable valuation:

In 20.2032A (b) (1), the gross cash rent is not allowed to be diminished by any expenses associated with the farm operation or lease. This has the effect of preventing the valuation on the net return to the land.

Under 20.2032A-4 (b) (2) (iii) rents paid in crop shares may not be used, thus denying the valuation on the net return to the land.

It is interesting to note that proposed IRS regulations, in volume 45 of the Federal Register, page 31042 issued on July 19, 1978, recognize the need for converting crop share to cash. This provision was specifically disallowed by the final regulations, however, appearing as section 20.2032A-4 (b) (2) (iii).

The goal stated in the summary of the Federal Register, volume 45, page 50736 (July 19, 1978) to provide...."the method of valuing certain farm real property according to its actual use" cannot be attained while these arbitrary and discriminatory regulations remain. The regulations must provide a valuation method that is fair and equitable.

# # # # # # # # # #

_________AREA

_________DATE

_________TOTAL ACRES

_________TILLABLE

_________NON TILLABLE

_________CROP SHARE TERMS

Yield Ratio
to Land Class

I=135%
II=115%
III=100%
IV= 90%
V= 60%

DRYLAND

Ave. fertilizer application______lbs. per Acre.

Ave. cost of fertilizer per Ac.______x______%=______

Ave. rainfall per yr.______.

EXHIBIT A 1
Obtained from:
Umatilla County
Assessor's office,
Pendleton, Ore. H.J.

								Owner Operational Expense					LEASE TERMS IN %		
								%	1 %	50 %	50 %	50 %			
Land Class	Total Acres Leased	Acres Under Crop (50% Total)*	5 Yr. Ave Yield	Total Yield of Area	2 Yr. Ave Price	Dollar Value of Total Crop	Gross Income Per Ac	Manag-ement	Liab. Fire & Hail Insurance	Federal Crop Ins.	Fert-ilizer	Weed Control	Total Expense	Net Income Per Acre	Owner Net Income
I Dry															
I Irr															
II Dry															
II Irr															
III Dry															
III Irr															
IV Dry															
IV Irr															
V Dry															
V Irr															
TOTALS															

*50% used for summer-fallow-crop rotation
Annual would be 100%

EXHIBIT A 2

LEASE SUMMARY CONVERSION SHEET
FOR IRRIGATED LAND

______________ Area

______________ Date

______________ Total Acres

______________ Tillable

______________ Non-Tillable

______________ Crop Share Terms*

Yield ratio to land class

I = 1.35
II = 1.15
III = 1.00
IV = .90
V = .60

1	2	3	4	5	6	7		OWNER OPERATIONAL EXPENSE									
Land Class	Total Acres Leased	5 yr. ave. Yield	Total yield of Area	2 yr. ave. price	Dollar value of total crop	Gross Income	Owner's Share	Management	Insurance	Irr. Water Cost	Equipment Repair	Fencing	Other	Total Expense	Net Income	O.R.S. 307.320	Taxable Net Income
I																	
II																	
III																	
IV																	
V																	

* [illegible] entered here, as well as crop share and goes to column 7

LEASE SUMMARY CONVERSION SHEET
FOR IRRIGATED LAND

EXHIBIT A 2

_______ Area

_______ Date

_______ Total Acres

_______ Tillable

_______ Non-Tillable

_______ Crop Share Terms *

Yield ratio to land class

I = 1.35
II = 1.15
III = 1.00
IV = .90
V = .60

1	2	3	4	5	6	7		OWNER OPERATIONAL EXPENSE									
Land Class	Total Acres Leased	5 yr. ave. Yield	Total yield of Area	2 yr. ave. price	Dollar value of total crop	Gross Income	Owner's Share	Management	Insurance	Irr. Water Cost	Equipment Repair	Fencing	Other	Total Expense	Net Income	O.R.S. 307.320	Taxable Net Income
I																	
II																	
III																	
IV																	
V																	

[illegible] Acres as well as Crop share and goes to Column 7

FARM USE INFORMATION SHEET

EXHIBIT A3
Page 1

	1977	1978	2 Year Average
State Furnished Information			
1. Certified Interest Rate	9.18%	9.40%	
2. 2 Year Average Portland Price Per Bushel	$2.95	$3.28	
3. Deficiency Payments $.52 Per Bushel			
Local Information			
4. 1977 NCA (Normal Crop Acres) 307,000 Ac. Deficiency Payments On 236,637 Ac. 236,637 ÷ 307,000 = 77% X $.65 =	.50		
1978 NCA 293,406 Ac. Deficiency Payments on 107,392 Ac. 107,392 ÷ 293,406 = 37% X $.52 =		.19 +	.34
Total Price Per Bushel Portland			
5. Local Wheat Price Adjustment			
a. Freight	.18	.19	
b. Commission (Wheat)	.02	.02	
c. Handling	.06	.06	
d. Storage (3 Mo.)	.045	.045	
e. Wheat Commission Tax	.01	.01	
	.315	.325 -	.32
6. Total Price Per Bu. Adjusted To Local Area			3.30
7. Alfalfa Price Per Ton	$55	$43	$49
8. Fertilizer			
a. Anhydrous Ammonia (Full Service)	.1525	.1585	.1555
b. Sulphur	.20	.1616	.1800
c. Top Dressing	.22	.2188	.2194
d. Aqua Ammonia	.16	.1585	.1593
e. Application	2.50	2.50	2.50
f. Add 10% of Cost For Overlap			
9. Irrigation Water Charges			
a. Stanfield Irrigation District	10.50	13.00	11.75
b. Westland Irrigation District	10.00	10.50	10.25
c. West Extension Irrigation District	12.00	14.00	13.00
d. Hermiston Irrigation District	13.00	13.00	13.00
e. Other Irrigated	7.50	9.50	8.50
f. Supplemental Irrigation	-	7.60	7.50
g. Milton-Freewater and Hudson Bay Irrigation District	7.50	9.50	8.50
h. Creek Irrigation	9.50	9.50	9.50
10. Irrigation Expenses			
a. Equipment Repair	2.50	3.00	2.75
b. Fencing	1.00	1.50	1.25

1979-80

FARM USE INFORMATION SHEET

EXHIBIT A3
Page 2

	1977	1978	2 Year Average
11. Rangeland			
a. Fencing	.25	.25	.25
12. Insurance			
a. Federal Crop - Wheat	2.80	3.30	3.05
b. Federal Crop - Peas	7.70	7.70	7.70
c. Fire & Hail $.95 per $100			
d. Liability $.05 per $100			
Total $1.00 per $100 or 1%	1%	1%	1%

13. ORS 307.320

perennial

QUOTE: The value of any deciduous trees, shrubs, plants or crops, whether annual or perrenial, growing upon agricultural land devoted to agricultural purposes, shall be exempt from assessment and taxation and shall not be deemed real property under the provisions of ORS 307.010.

In recognizing this statute, consider the following percentages as income contributed to the deciduous trees or plants:

a.	Alfalfa	20%
b.	Rangeland & Pasture	10%
c.	Orchards (Trees)	55%

14. The following tables will be used in standardizing the possible production differences in various land classes. (The most comm class of tillable land in the county is Class III. The most common range and pasture land is Class VII.)

a. Tillable Land

Class I = 135%
Class II = 115%
Class III = 100% (Base)
Class IV = 90%
Class V = 60%

b. Rangeland & Pasture

Acre
AUM Ratio to
Land Class

III = .60
IV = .71
V = .81
VI = .88
VII = 1.00
VIII = 1.25

EXHIBIT B.

DISCRIMINATORY EFFECT OF CURRENT REGULATIONS

re: Farm Use Valuation on farms, identical except for type of lease

	Cash Rent Farms		Crop Share Rent Farms	
	A	B	C	D
1. Gross return to lessor:				
2. Cash Rent	$40,000	$50,000		
3. Crop share (cash equivalent value)			$40,000	$50,000
4. Less: Real estate taxes	$ 5,000	$ 5,000	$ 5,000	$ 5,000
5. Share of production exp.		$10,000		$10,000
6. Net return to Lessor (land)	$35,000	$35,000	$35,000	$35,000
7. Return used in valuation under 20.2032A-4(b)	$35,000	$45,000	Not Allowed	Not Allowed
8. Farm valuation under 20.2032A-4(b) using average annual effective interest rate, Spokane Federal Land Bank Dist. 1980 -- 9.31%	$375,939	$483,351	Depends on other criteria including sales.	
9. Return used in Oregon Farm Use Valuation Procedure	$35,000	$35,000	$35,000	$35,000
10. Farm valuation under Oregon Farm Use using the same average effective interest rate in No. 8 above - 9.31%	$375,939	$375,939	$375,939	$375,939
11. Ability to elect under 2032A(e)(7)(B)(ii)	yes	yes	no mandatory	no mandatory

Prepared by:
Dr. Clinton Reeder, PHD
Agricultural Economics

REMARKS PREPARED FOR THE U.S. SENATE FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE HEARING REGARDING THE PROPOSED REGULATIONS RELATING TO AN INCREASE IN IMPUTED INTEREST RATES ON INSTALLMENT SALES

April 27, 1981, 1:00 p.m.

Presented by Kent Jones, N.D. Commissioner of Agriculture

Mr. Chairman, thank you for the opportunity to comment on the effect that the proposed regulations increasing imputed interest rates will have on American agriculture and North Dakota agriculture, in particular.

In the mid-thirties, there were about 6.8 million farms and ranches in the United States. Today there are only about 2.3 million left, and given the present trends, we will continue to lose 30,000 farms and ranches per year in the future.

This country was founded on the belief that each citizen is entitled to the chance to own his own piece of land. The federal government still stands by that right -- but its policies, such as the one we are considering here today, are making that an impossible dream for many rural Americans.

Land prices have gone so high that they are no longer based on the ability to produce food but rather to provide a substantial return on investment a few years down the road. Less than sixty percent of the farm and ranch land in the United States today is owned by people who name farming and ranching as their major occupation. White and blue collar workers own over twenty percent of the land, with retired persons owning about seventeen percent. In addition, with land prices so high, the inheritance taxes on even a modest farm are often too much for the heirs to pay along with all the other expenses associated with starting in farming. Therefore, they often sell out.

What's wrong with this? Many things. Farmers are being forced off the land. Young farmers find it impossible to buy a farm, and rural businesses that live off the farmers lose their customers. The small rural towns that lived off these businesses stagnate. And a way of life vanishes.

North Dakota is probably the most agricultural state in the union. We are experiencing the same problems in agriculture as the rest of the country. In North Dakota, we had about 85,000 farms in 1935; today we have about 40,000 left. The high rate of interest that farmers are having to pay to borrow money for land, machinery, equipment, and operating expenses are ensuring that the trends of the past will continue by further reducing already-small profit margins. On top of all that, a large portion of our state is presently in the second year of a devastating drought.

The future of North Dakota's agricultural way of life is most seriously threatened by the inability of young people to take the place of farmers who are retiring. I have already mentioned a number of the obstacles that stand in the way of the family who wishes to start in farming. Exorbitantly priced land and credit, estate tax laws, and farm commodity prices that do not keep pace with escalating operating costs combine to effectively block new people from getting started in agriculture.

Because North Dakotans want to have a healthy system of family farms and rural communities, we are fighting back and doing something. The North Dakota Department of Agriculture has been researching the problems facing beginning farmers and has developed a number of programs to deal with the problems.

Our state, through the Bank of North Dakota, has developed a Beginning Farmer Loan Program to provide low-cost financing for young farmers. This program gives qualifying young farmers reductions in interest rates for the first years of the loan, because the people of North Dakota feel such a program is in the best interests of the entire state.

Our state legislature has instituted state income tax incentives for landowners to sell or rent farmland to beginning farmers. Under the tax incentive program, a landowner is able to exempt from state tax liability all the income received from selling or renting farmland to beginning farmers. A key feature of this program is a provision which exempts all principal and interest payments on an installment sale of a farm to a beginning farmer.

The installment sale provision -- contract for deed, as it is commonly called in North Dakota -- of our state beginning farmer program is why I felt compelled to travel all the way from North Dakota today to attend this hearing. North Dakota decided to provide such tax incentives on contract for deed sales of farms to provide the lowest rate of interest possible when a farm is sold to a beginning farmer. The IRS regulations under consideration today will offset a major portion of those benefits to our young farmers in North Dakota.

This past December, my office sponsored a series of meetings across the state of North Dakota. At those meetings we looked for ideas from the state's citizens that would increase the assistance available to young farmers. One of the chief concerns of people at these meetings was the IRS proposal to increase the minimum rate of interest on contract for deed sales of farms.

"What right does the government have to tell me that I have to charge my son or daughter or a long-time tenant 9% interest when I sell my farm on a contract for deed. They can hardly afford the present 6% minimum." -- was a statement often repeated by the participants at these meetings. To say that these people feel that government again is meddling in an area of private enterprise that it has no right to be involved in, is an understatement. North Dakotans are furious about the proposed changes.

Installment sales of farms are a common way of transfering a farm from one generation to the next. Such transfers will usually be made at the lowest rate of interest allowed, because the retiring farmer wants to be sure that the new generation on the farm has the best chance possible for making it on the farm. Increasing allowable rates of interest on such farm transfers will reduce the chance that such a new farm will survive.

I have mentioned all of the obstacles facing a young family starting in farming. Despite these obstacles and despite the fact that young farmers face extreme financial problems during their first year, in North Dakota we have countless numbers of young people who want to farm. American agriculture would be better served by tax policies at the federal level similar to the ones we have put into place to help beginning farmers in North Dakota, rather than additional tax obstacles making the transfer of a family farm more difficult.

Few American institutions are venerated as much as the family farm and the farm family. Each is endorsed on its own merits. Combined they are seen as the anchor to a viable rural community and a rural way of life. Every poll of public opinion yeilds an overwhelming vote of confidence in the family farm. No candidate for public office fails to have his rhetoric about family farms ready. Scholars and citizens, city folk and rural folk alike, join in the praise for the amazing productivity of the man on the land who nourishes us all so well.

Unfortunately, our institutions do not self-preserve. We can control our destiny and that of American agriculture only if we set out to do so. I would hope that you would control the destiny of the family farm in the proper manner by doing everything in your power to make sure that the imputed interest rate on installment sales be left at the present level and not be increased as the IRS has proposed. Federal tax laws seem designed to deliberately drive farmers and their families off the land. The IRS regulations under consideration here today are as blatant an example as has come along in quite some time.

I would like to thank you for the opportunity to represent North Dakotans at this hearing today, and hope that you will do whatever possible to see that these regulations do not go into effect. Thank you.

Senator GRASSLEY. The next panel consists of Bob Furleigh, a farmer from Clear Lake, Iowa, J. D. Luse, Duff Farm Management Service, Lebanon, Ind., Philip Ridenour, Cimarron, Kans., and David J. Hutton of Hutton, Kennedy & Neaton, Minneapolis, Minn.

Are all of you here?

OK. I guess I would like to have you proceed in the order that I introduced you. Mr. Furleigh, Mr. Luse, Mr. Ridenour, and Mr. Hutton. I would like to have you go in that order and I would also like to remind you, so you won't have to ask for permission to do so, your statements will be printed in the record if you submit them and that is your desire.

We would appreciate it if you would summarize. The blue light is when your time starts, the yellow light is when you have a minute left and the red light and the bell simultaneously signify that your time has expired.

Bob, would you proceed please?

STATEMENT OF ROBERT FURLEIGH, CLEAR LAKE, IOWA

Mr. FURLEIGH. Thank you, Mr. Chairman, for allowing me to appear. I do commend the subcommittee on your willingness to deal with these issues.

My name is Bob Furleigh, from Route 2, Clear Lake, Iowa. I am a genuine farmer. I raise cattle, hogs, field crops, vegetables. I am not sure if all the witnesses were requested to leave their shoes in the hallway or not. But, it apparently applies to some of the witnesses.

I farm in north central Iowa. I am here to describe the effect of the recent administrative regulation by the IRS. It has been referred to many times. I am not sure even if my testimony is necessary at this point, but I will try to summarize on this matter.

My father died this winter. We had a family-size farm. By the way, I think you have copies of my testimony, too. I would like to request that they be placed in the record.

Senator GRASSLEY. Yes, it will appear in the record.

Mr. FURLEIGH. It comes at a time when it is going to be tough to make this payment beyond what our plans were from having read Dr. Harrel's book and consulting with our attorneys, and assuming that we were eligible for the use tax or use valuation, under 2032(A).

But, at any rate, we suffered a shock after his death in finding that there was indeed a ruling that disallowed the use valuation where we were using cash rent with my father, prior to his death.

There has been a great deal of increase in cash rent in our part of the State, and I suspect, across the State of Iowa, and the States of Illinois and Iowa, both.

It was plain to me, that Congress, in enacting the 1976 Internal Revenue Code wanted to preserve the family farm or small business by providing for use valuation, to a limited extent, where a commitment is made by all the heirs of the family farm or small business to a continued operation of that farm by the family, for at least 15 years.

As you probably know better than I, there is an extended list of conditions or tests surrounding the use valuation, including the 15-year tax lien against the property, in case the farm is sold by the family or rented to someone else outside the family during the 25 years.

If it were not continued as a family farm, there would not only be a recapture of whatever estate tax might have been saved, but in case of a later sale, whatever gain might be experienced would be computed on the lower basis of the use valuation, because an obvious double penalty for early disposition. Dr. Harl, I was pleased to note, mentioned this as a technical factor he hoped the Senate could or the Congress could deal with.

As I understand it, 25 percent of the estate must be real estate. 50 percent must be farm or business property in general. The farm must have been operated and material participation by a decedent or a member of the family during 5 or the last 5 years prior to his death.

The farm or small business valuation cannot be reduced by more than $500,000.

Now, the use valuation provides for capitalizing at typical cash rent, as we have already heard. It doesn't usually make interest in our part of the State these days, farm land, so that utilizating the use valuation would normally result in a lower valuation for estate tax purposes.

I haven't tried to describe all the provision in precise legal terms or even list the conditions and procedure. I am only a farmer, not a lawyer. But, I do have a copy of the section 2032(A), the IRC, and it refers repeatedly to material participation by the decedent or members of the family and other places it says "and or."

Somehow or other we came up with a regulation that might as well forget the part with "or," I believe, because at least in my opinion, it falls back on the active participation of the decedent.

Again, I admit to being probably being the least qualified person in this room to read and understand legislation, but that is the way it looks to me.

I should say that our attorney even cautioned us against using this as an option, because he said:

> You must be sincere about continuing this, because of the penalties that occur should early recap, early disposition or change in operation bring about.

My wife said that I carried on a little too much in this testimony about establishing whether or not this farm in question was a family farm, Senator. So, I am not going to read this. I go through a period of 1971 ownership by the family and the family's participation. No one else farmed the farm during that 71-year period.

I just want to make the point that this is not a quick move by an outside investor to achieve a tax shelter here.

I respectfully propose, Mr. Chairman, that this ruling is not consistent with the intent of your legislation and that you try to eliminate its effects some way that applies to section 2032(A). Maybe it has already been dealt with. I trust your judgment in that respect.

Senator GRASSLEY. We hope that the statement of the Commissioner and the Secretary, take care of your problem. I suppose that we need to follow up and make sure that there is a common understanding of what they are doing, but that is the way I interpret it as I understood it. Is that fair to say?

If it does, then a lot of the problems with a lot of people will be taken care of.

Would you stay at the table until the panel is completed? I may have some questions I want to ask each one of you.

The next person is Mr. Luse. I hope that is pronounced right.

Mr. LUSE. Right.

Senator GRASSSLEY. Would you proceed?

STATEMENT OF JAY D. LUSE, DUFF FARM MANAGEMENT SERVICE, LEBANON, IND.

Mr. LUSE. Thank you, Senator. I am a farm appraiser in central Indiana. I am a member of the American Society of Farm Managers and Rural Appraisers and have experienced making appraisals under 2032(A).

In some parts of our country special use valuation appears to be achieving its goal of relieving some of the estate tax burden from the family farm.

Those areas in which it is working are those in which renting farms for cash is common, so adequate comparable rental data is available.

However, areas of the country in which farm land is not typically rented for cash are having difficulty utilizing 2032(A).

The first point I wish to make is that under 2032(A)4(b)(2), the special rules documentation required of the executor, the executor must identify to IRS actual comparable property for all special valued property, and cash rentals from that property, if it is to be valued under paragraph (e)(7).

If the executor does not, all of the special valuation property must be valued under paragraph (e)(8).

The words "or all special evalued property" were not in the proposed regs., but only appear in the final regulations.

Agents in the field sometimes interpret that phrase to mean every little bit of miscellaneous land on the farm.

They then require the executor to attempt to find cash rentals of small miscellaneous parts of the farm that are of little value, and for which there is no rental market. Finding none, the agents ask the executor to value the farm under paragraph (3)(8).

In this situation, the estate should be allowed to value under (e)(7), the bulk of the land for which cash rentals are available, use (e)(8) on the remaining qualified property and use the fair market value on the miscellaneous parts of the farm.

There shouldn't be any problem with allowing the estate to pay tax based on the fair market value of portions of the property and allowing election special use value on the balance, recognizing, of course, that the threshholds to qualify would have to be met.

The reason for this is that IRS is attempting to interpret paragraph (7), to be so restrictive that the estate is forced to go to paragraph 8.

Apparently IRS feels that paragraph 8 will not or should not provide the tax relief that paragraph (7) holds.

This committee needs to recognize the relationship between paragraph (7), and paragraph (8), and point out to the Treasury Department the need for the two paragraphs to contain some consistency.

IRS interprets the phrase in the law that says "the formula provided by subparagraph (a), shall not be used where it is established that there is no comparable land from which the average annual gross cash rental may be determined," to mean that the capitalization rate, based upon Federal Land Bank interest rates, as used in paragraph (7), would not apply in paragraph (8).

This is my second point. If you want paragraph (7), and paragraph (8), to have somewhat uniform impact upon farm estates in various parts of the Nation, then you need to see that the same Federal Land Bank interest rate is used as the capitalization rate in both paragraph (7), and paragraph (8), sections (a) and (b).

American agriculture includes many farm rental arrangements in various areas. There is considerable renting for cash in central Indiana, while next door, in central Illinois, nearly all rentals are share arrangements.

All of the various rental rental arrangements come down to the same thing, money. It matters not whether the land owner rents his land for cash or one-half of the crop and pays one-half of the seed fertilizer and chemicals or rents his range for dollars per animal unit. The owner converts all of that to money and so can any competent appraiser.

Since all rental arrangements reduce themselves to money, it is only fair and equitable to use the same capitalization rate to convert income into value under 2032(A).

If you want to treat all of the family farms in the Nation in the same way, then don't let the capitalization rate change in paragraph (7), to paragraph (8).

Thank you.

Senator GRASSLEY. Thank you very much.

Now, I would like to go to Mr. Ridenour. Before you start, I would like to say that Senator Dole, who is chairman of the full committee, had hoped to be here to welcome you, but he has been detained in the Agriculture Committee, and also, let me tell you that some informal sessions in regard to budget allocations as a member of the Senate Finance Committee.

He wants to express to you his regrets that he could not be here to welcome you.

[Senator Dole requests this statement appear in the record:]

PREPARED STATEMENT OF SENATOR BOB DOLE

INTRODUCTION OF PHILIP D. RIDENOUR, CIMARRON, KANS.

Mr. CHAIRMAN: I am pleased that Mr. Philip Ridenour of Cimarron, Kansas, is here today to testify before the Subcommittee on problems that have arisen in connection with the regulations governing special use valuation of farm property.

Mr. Ridenour is a partner in the law firm of Ridenour and Knobbe in Cimarron. He has had considerable experience in working with the special use valuation and the regulations designed to implement it, and I understand that he will indicate some of the particular problems of farm estates in Kansas, including the approach taken by local agents of the Internal Revenue Service. It is clear that estate tax practitioners have had considerable difficulty with the approach the Service has taken to implementing this law, and I appreciate the fact that Mr. Ridenour has taken the time to come to Washington to discuss these problems with us.

STATEMENT OF PHILIP D. RIDENOUR, CIMARRON, KANS.

Mr. RIDENOUR. Fine. Thank you, Senator Grassley.

Senator, I practice law in western Kansas. I might add, extreme western Kansas. My testimony today is going to draw on our experience in filing nine estate tax returns which have elected use value or protective use value elections.

I would like to take a look at some of the problems we have discovered in the local Kansas district.

Generally, it is our feeling, in our office, that the national office has drafted a number of restrictions through adoption of the regulations which make the election extremely difficult.

I suppose the best analogy I could come up with would be to analogize it, perhaps, to the marital deduction section. Qualification for use value under the regulations would be akin under the marital deduction section to proving that your priest, rabbi, or minister was properly ordained or that the justice of the peace had been elected by the requisite number of duly qualified electors.

Turning to the outline, my first point under national office problems deal with cash leases. You have heard a great deal of those today. To arrive at the cash rental value, the regulations currently require that only cash leases may be used. There aren't any in our area.

We can extrapolate, though, I think to anyone's satisfaction what the cash rental value is based on a crop share rental. Unlike what Secretary Chapoton said this morning, that is not a complicated problem at all.

In every county in Kansas, at least, the county agents have a history of production. Let's take almost any crop, wheat, corn, milo, and soy beans that our county produce; we have a 50-year average of the yields of those crops. In the case of soy beans, they have obviously not been grown that long in our part of the country, but nevertheless, there is a long average.

It is a very simple matter to rely upon the county agents' averages and elevators' averages on their records as to what the value of a bushel of one of these commodities has been for several years.

Point No. 2 deals with lease studies. The regulations prohibit areawide averages. There is an excellent study that has been compiled in the State of Kansas by Kansas State University dealing with average areawide rentals. It is an excellent study. It is very well done and under the regulations we are forbidden and prohibited from using that.

Points three and four on equity interest and present interest have been taken care of apparently by the Treasury's announcements this morning.

Paragraph 5 of my outline involves what is probably the silliest requirement of the use value regulations and that is the requirement that a corporation officer, director, stockholder, or employee must have an arrangement with the corporation regardless of the fact that he may be employed fulltime and solely employed and be the only material participator in the corporation. In the absence of some sort of provable formal arrangement, he is disqualified from electing use value, and there is deemed to be no material participation by the decedent or his family.

No. 6, I think though, is probably the most serious problem that we have observed and that is guidance from the national office. The 1976 reform act is now 4½ years behind us. To date we have no published rulings. We have only private rulings which under 6110(j)(3), we can't cite or rely on as precedent despite the fact the Internal Revenue Service agents are in fact citing them, relying on them and using them in their work as guidance.

Turning to the local problems that we have observed in the Kansas district, the Kansas agents to a man—I should say we have had five auditors, five different agents and at least those five to a man, believe the use value is unfair and gives the farmer an unfair advantage. They will freely admit this when asked if they are trying to disallow the use value election.

The first difficulty in Kansas deals with finding comparability of leased land. The regulations have perverted "comparable" to mean "identical." We have had problems with proving comparability when roads are hard surfaced as opposed to gravel. We have had difficulty with improvements depending on whether they had wood shingled roofs or tin roofs. On a 2,000 or 3,000 acre farm or ranch in western Kansas, the improvements are irrelevant to the valuation.

The second thing that we have had difficulty with is the agents will put nothing in writing. Everything has been oral at this point and we have had no written discussions with them.

No. 3, as my predecessor just mentioned, they have tried to push us out of (e)(7) and into (e)(8) with the result that we end up at fair market value, using a capitalization rate of 2 to 4 percent which the Kansas district uses.

No. 4, the expense of compliance far outweighs any advantage to the Service. We have come up with affadavits, certified copies and we have spent a great deal of time running around the country looking for cash leases which is sort of a silly endeavor, I think, for grown men to do.

No. 5, I have already pointed out the agents' attitudes.

In conclusion, it is our position that the use value provisions have not been observed on a national office level or the local office level as they have been enacted.

I think it is a very dangerous precedent we are setting allowing local agents, at least in the Kansas district, to run around the State and for that matter the country, establishing national tax policy.

Speaking as a trial tax lawyer, there is no question in my mind that we can litigate our way out of this mess. I think there ought to be a much more productive, simpler, and less expensive way of doing that and I think we need some help.

Thank you.

Senator GRASSLEY. Thank you, Mr. Ridenour. I would like to go now to Mr. Hutton.

STATEMENT OF DAVID J. HUTTON, HUTTON, KENNEDY & NEATON, MINNEAPOLIS, MINN.

Mr. HUTTON. Thank you, Mr. Chairman. I appreciate the opportunity to testify before this committee.

The IRS has recently issued three interpretative rulings, which I feel ignore the statutory language of section 2032(A) and the congressional intent of special use valuation.

In these rulings the national office has indicated and the revenue agents have followed, a policy whereby a portion of the real estate indebtedness is not allowed as a deduction when an estate makes the special use valuation election.

Let me illustrate, by example, the estate tax effect of the position taken by the Internal Revenue Service. If a decedent owned a 400 acre farm that was qualified for special use value which had a fair value of $2,000 an acre or $800,000 and a special use value of $800 an acre or $320,000, by the election of special use valuation the gross estate is reduced by $480,000.

In this example, the decedent also had a mortgage against the farm of $300,000. It is the position of the Internal Revenue Service, by its three revenue rulings, that because the gross estate farm was valued at 40 percent of its fair market value because of the special use election then only 40 percent of the mortgage indebtedness is allowed as a deduction. Therefore, instead of obtaining a $300,000 deduction for the mortgage indebtedness the deduction is limited to $120,000.

In summary, instead of having a $480,000 benefit by special use valuation, the estate was only reduced by $300,000.

Senator GRASSLEY. Let me interrupt you here. I think this is the first time that has been pointed out today.

Mr. HUTTON. That is correct.

Senator GRASSLEY. OK. I appreciate it. Go ahead.

Mr. HUTTON. There are two statutes and I refer to them in middle of the second page of my outline that are involved.

One of them is the special use statute which we have been discussing. The other one is section 2053; 2053 allows for the deduction in calculating estate tax for expense of administration, indebtedness that the decedent owed at the time of his death and they meet any ιaxes.

Under subpart 4—section 2053(a)(4)—provides for the deduction in calculating the estate tax for unpaid mortgages on or any indebtedness in respect of property where the value of the decedent's interest therein is included in the value of the gross estate.

Under section 2032(A), it starts out by providing that if you are a citizen of the United States and you make the election, then it says "for purposes of this chapter", the "value" of qualified real property shall be its "value" for the use under which it qualifies as qualified real property.

It seems very clear, in my reading of section 2032(A), that for purposes of chapter 11 which covers the entire estate tax laws, that value of qualified real property shall be at special use value if the election is made under section 2032(A).

I feel the Internal Revenue Service has no basis for reading into the term value under section 2053(a)(4), the term "fair market value" and that is in effect what they have done.

I have an estate where the Internal Revenue Service is presently proposing the disallowance of approximately $175,000 of a $330,000 mortgage indebtedness against the qualified property. This is resulting in a $36,000 tax deficiency which may require my clients to sell a portion of their farm to pay this additional tax liability.

If they sell a portion of the farm to pay this tax liability, this will result in an early disposition of the qualified and trigger a recapture and paying the higher estate tax.

It seems that the farming unit that carries a substantial amount of debt, has the greatest need for estate tax relief and is actually being penalized by the position taken by the Internal Revenue Service.

Back in my beginning example, an estate where the real estate had no indebtedness against it, the special use election would reduce the gross estate by $480,000. Because the estate had indebtedness against the real estate, the taxable estate was reduced by only $300,000.

Thank you for the time for appearing before your committee.

Senator GRASSLEY. Thank you. I have a couple of questions and/or comments of a couple of you.

First of all, I would like to thank all of you for your expertise as practitioners and telling us how you have been affected by it.

It is very important to us that we have people out there in the trenches working with these laws to testify to tell us whether there are shortcomings both in basic law as well as the administrational law.

I think most of the fault so far, as pointed out, has been with the interpretation and regulations in pursuit of the law than it has the basic law itself.

I think I would like to make a point that I know about Bob Furleigh's case that maybe was or was not included in his testimony, but it is my understanding that you made some basic plans for estate purposes based on Neil Harl's book and his interpretation of how the 1976 law should be interpreted.

He was very involved in that 1976 legislation and since that time has worked with individual Congressmen.

Then in August after your father's death, you found out that what you had planned was no longer the case.

Mr. Furleigh. That is right, Senator.

Senator GRASSLEY. Then, I would like to use you as an example of a classic family farming operation.

Your farm was bought by your father in 1948, 265 acres. I assume that that was before you were out of school so you helped contribute to the operation of that farm while you were still in school, probably in those days for little or no pay.

Then you have farmed the farm for quite a few years recently, at least, well beyond 8 years, as a matter of convenience to your father because he was in a nursing home. You cash rented that farm.

Knowing your background and your love for farming, I anticipate that you are going to be farming for at least 15 years after your father's death.

The whole purpose of special valuation, the whole purpose of the estate tax reform of 1976 and what we are anticipating in future estate tax reform is to keep a family farming operation like from your father to you and then maybe you will have sons who will want to farm, an institution of American society.

If you were to be hit with this higher estate tax and have to sell off part of your farm to pay the taxes, or even if you have to borrow heavily against it, then that might make your family farming operation less efficient than it previously was.

I ask you that partly as a question, but also go to great lengths to demonstrate how the cash rent that you paid your father in recent years of his life, may have precluded you from qualifying for special use. It seems to me your father's and your farming operation and your rental arrangements and the continuation of you farming that farm is a perfect example of what we want to accomplish through estate tax reform.

Does all of that apply to you?

Mr. FURLEIGH. Well, I think so. That is probably why I am here.

Senator GRASSLEY. OK, I guess I want to go to some lengths with that because I want that to be pointed out to people who do not understand the purpose of estate tax reform.

It is to preserve the very generation to generation of property so that we have the family running the farm. That is the most efficient food producing unit anywhere in the world, compared to the corporation farms of America or other nations or compared to the state farms and collective farms of other societies.

Mr. Ridenour, there was a point in your testimony where you started to say and I didn't get the point. Could you clarify this?

Mr. RIDENOUR. We have seen this problem in trying to qualify the estates we have filed for use value. The agents, and I shouldn't say all of the agents, I should say three in particular, have freely admitted that is exactly what they are trying to do—prohibit our estate from qualifying for use value. It has not been a problem having them admit that.

Senator GRASSLEY. OK.

Mr. RIDENOUR. I don't know what good that admission does, but they have willingly admitted that use value is unfair and that they are trying to push us out of use value. That is correct.

Senator GRASSLEY. OK. I wish I had time to ask some more questions, but I think I better dismiss you as a panel and hope and assume that you would all be available for any followup that my staff would need.

Is there anybody who would prefer not to be contacted in the future if your help would be needed?

Well, since there are no heads signalling no, we will assume that you will be available at any future time.

Thank you all very much.

[The prepared statements of the preceding panel follow:]

TESTIMONY OF BOB FURLEIGH
BEFORE THE SENATE COMMITTEE ON FINANCE,
SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

PUBLIC HEARING ON REGULATIONS CONCERNING IMPUTED INTEREST RATES AND ESTATE TAX LAW GOVERNING VALUATION OF FAMILY FARM AND OTHER SMALL BUSINESS PROPERTIES.

MONDAY APRIL 27, 1981

CONTENTION:

A recent administrative regulation by the I. R. S. denying use valuation because of cash rent paid within a family is likely contrary to the intent of Congress, if that intent was to fashion the use valuation to preserve the family farm or business and avoid artifically high estate taxes..

Evidence is offered that our farm is indeed a family farm and that the denial of use valuation will jeopardize the preservation of that farm intact.

My name is Bob Furleigh from Route 2, Clear Lake, Iowa. I am a farmer from north central Iowa and I'm here to describe the effect of a recent administrative regulation by the Internal Revenue Service regarding valuation of estates for Federal Estate Tax purposes.

My father, Bob Furleigh Sr., died in February of this year at the age of 87 and owning about 265 acres of farm and pasture land which had a Federal Land Bank martgage. There was not much cash in his estate, so there is no money in the estate to pay the Federal Estate Tax, the State Inheritance Taxes, or the Administrative costs.

This comes at a time when my lender is advising me to start aiming toward debt reduction because of the current high interest rates and my high debt load. He's offering this same advice to many farmers in our area this year.

Perhaps we farmers are not often very good estate planners, but we had worked some with our attorney and had a copy of Dr. Neil Harl's book on Farm Estate and Business Planning. We know there is a unified credit against Federal Estate Tax and we also knew there was a "use" valuation procedure which applied to family farms and small businesses. By utilizing the use valuation as described in Dr. Harl's book, we had assumed we might be able to borrow enough more money against the farm to pay the Federal Estate Taxes, State Inheritance Taxes and administrative and legal expense.

When we contacted our attorney after our father's death, we were shocked to discover that since our edition of Dr. Harl's book, there had been an administrative regulation from the I. R. S. which seemed to disqualify us from the use valuation approach because we had been paying cash rent for his farm. We found out at this time that this regulation was affecting or would affect many of our attorney's clients in the same way it was affecting us.

At this point we began inquiring as to the purpose of this administrative regulation and were told that it was to keep big city investors from swooping in to buy farmland for tax shelters, thereby not only avoiding taxes, but artificially inflating the price of farmland.

There has been a general increase in the use of cash rent for farmland in my area in the last 20 years and I'm pretty sure this is true for the entire states of Iowa and Illinois, however not probably the case now in our neighbor Kansas.

There are logical reasons for this trend. For retired farmers, it removes much of the management headaches and provides a constant dependable income. When my father considered retiring, we went to the local Social Security office where he was advised that if he rented his farm on crop or livestock share basis, they didn't want to get word of his doing any work on that farm after retirement. Since it was important to him to be able to help around the farm and also since he was already over 68 years of age and not wanting to jeopardise his social security benefits any further, he rented me his farm for cash rent.

It was explained to me that congress in enacting the 1976 Internal Revenue Code wanted to help preserve the family farm or small business by providing for "use" valuation to a limited extent where a commitment is made be all the heirs to the family farm or small business to a continued operation of that farm by the family for at least 15 years. As you probably know better than I, there is an extended list of conditions or tests surrounding the use valuation including a 15 year tax lein against the property in case the farm is sold by the family or rented to someone outside the family during that 15 years. If it were not continued as a family farm, there would not only be a recapture of whatever estate tax might have been saved, but in case of a later sale, whatever gain might be experienced would be computed on the lower basis of the use valuation. I think there is an obvious double penalty for early disposition.

As we understand it, 25% of the estate must be real estate, and 50% must be farm or business property in general. The farm must have been operated (material participation) by the decedant or a member of his family during 5 of the last 8 years prior to his death. The farm or small business valuation cannot be reduced by more than $ 500,000.00.

The use valuation provides for capitalizing a typical cash rent for similar property after having deducted the annual property tax. Since farmland doesn't usually "make interest" these days, dividing the net cash rent by an interest specified by the I. R. S. would usually result in a valuation lower than current market value at highest & best use.

I haven't tried to describe all the provisions in precise legal terms or even list all the conditions and procedure because I'm only a farmer, not a lawyer.

I have a copy of Section 2032 A of the I. R. C. in which it refers repeatedly to material participation by the decedant <u>or</u> members of the family. I am totally unable to see from this material why there should be an administrative regulation by which the use of cash rent within the family disqualifies the estate from use valuation. It's ironical that cash rentals for similar properties is often capitalized to determine the special use valuation. Again, I admit to being probably the least qualified person in this room to read and understand Legislation.

If, indeed, it was the purpose of congress to help preserve the family farm or business by instituting the use valuation of the farm or small business estate, this recent administrative regulation which came along almost 4 years after the legislation, in my opinion, runs counter to the desired effect. I refer to Treasury Regulation 20.2032 A-3(b)(1), 1980.

In the very matter of electing the use valuation, our attorney cautioned us strongly that we must be sincere about continuing the family farm since the penalties for not continuing after the election are too severe to otherwise take the chance.

Some law firms in out area won't even use the options under 2032 A because of the stringent conditions.

It's probably important to this testimony that it be established whether or not my fathers farm was a family farm and whether he was a family farmer or that big outside investor only recently arrived to shelter his income by taking advantage of the use valuation.

I can only testify about this farm covering the most recent seventy one years since my grandfather, Dick Furleigh, bought the original 200 acres of the farm in 1910. He lived and worked that farm from that time until soon before his death at 84 in 1947. No one outside the family farmed (materially participated) and he had no other occupation during that thirty seven year period.

My father, Bob Furleigh, came to work with his father in 1927 and had no other occupation and lived no where but on that farm from that time until he was unable to care for himself at age 85. He had added the additional acres in 1949.

My sister and I grew up in that same farm home which had been built by my grandfather in 1911 and in which three generations of our family lived at the time. If the cattle got through the fence we all helped get them back. We all knew it when a farm mortgage payment was met barely in time to save the farm from foreclosure in the 1930's.

My wife and I rented the farm from my parents in 1962 after having worked for them since 1958. We contunue farming this farm until this day.

Our mother preceeded dad in death in 1973.

There has never been anyone but our family farming that farm since 1910.

Except for the fact he lost his left leg and a few fingers at age 19, you couldn't find a more typical family farmer than my father.

I can tell you that when I was born in the northeast bedroom of that farm home, I had no prior knowledge of tax shelters or even of I. R. S. rulings.

I'll have to leave it to the subcommittee whether or not this is a family farm.

It's probably also important to this testimony to establish whether this ruling contributes toward carrying out the intent of congress in preserving the family farm in this case.

Our attorney prepared for us some very preliminary estimates of how being unable to utilize use valuation will affect our estate tax. It appears that it could make a difference of at least $ 82,000.00 in Fed. Estate Tax. I don't know how we'll be able to pay this additional amount besides the amounts we originally had hoped to borrow.

I respectfully propose, Senators, that this ruling is not consistant with the intent of your legislation and that you try to eliminate its effect some way as it applies to the Section 2032 A.

COMMENTS BY: Jay D. Luse
Duff Farm Management Service, Inc.
Lebanon, Indiana
Representative of the American Society
of Farm Managers and Rural Appraisers

TO: Senate Finance Committee
Oversight of IRS Sub-Committee

DATE: April 27, 1981

SUMMARY

Special use valuation of farms is working in those areas of the country in which farm land is commonly rented for cash. In many areas land is rented under other arrangements, and 2032A is not working effectively there.

Estates should be allowed to use the cash rent method of paragraph (7) when there is cash rent data available to document the valuation for the cropland and bulk of the property. They should not be required to attempt to locate rental information of miscellaneous portions of the farm that are more logically valued at fair market value.

Congress should instruct the Treasury Department to use the same Federal Land Bank interest rate as the capitalization rate in paragraph (8) as set forth in paragraph (7) in order to treat all of the nation's family farms equally. Use of any other rate will distort the relationship of income to special use value from one paragraph to the other.

COMMENTS BY: Jay D. Luse
Duff Farm Management Service, Inc.
Lebanon, Indiana
Representing the American Society of
Farm Managers and Rural Appraisers.

DATE: April 27, 1981

TO: Senate Finance Committee
Sub-Committee on Oversight of I.R.S.

TOPIC: Final Regulations on Section 20.2032A
Internal Revenue Code

By way of introduction, I am a farm appraiser in central Indiana, and part owner of Duff Farm Management Service, Inc. We are a seven man office providing professional farm management, farm appraisal, brokerage and consultation services to the public. I am a member of the American Society of Farm Managers and Rural Appraisers, and represent that organization here today. I have experience writing special use value appraisals.

I would like to compliment Mr. Hartley and his staff on at least two sections of the regulations under discussion. The first is the statement "retention of a professional farm manager will not by itself prevent satisfaction of the material participation requirement...". This is a fair and equitable statement that provides farm management clients the same treatment as other farm owners, and that is good. The second is the definition of comparable real property, which lists ten factors to be considered in determining comparability. That section is easily understood and accepted by competent appraisers in the field.

In some parts of our country special use valuation appears to be achieving its goal of relieving some of the estate tax burden from the family farm. Those areas in which it is working are those in which renting farms for cash is common and there is adequate comparable rental data available. Application of 2032A is not without problems even when the data is available. Considerable extra work is required of everybody connected with the estate except the decedent; and even he had to put forth the effort to materially participate before his death. However, areas of the country in which farmland is not typically rented for cash are apparently having difficulty in utilizing 2032A.

The first of the two points I wish to make today is that in the final regulations, under 20.2032A-4(b)(2) "*Special rules (i) Documentation required of xecutor*. The executor must identify to the Internal Revenue Service actual comparable property for all specially valued property and cash rentals from that property if the decedent's real property is valued under section 2032A(e)(7). If the executor does not identify such property and cash rentals, all specially valued real property must be valued under the rules of section 2032A(e)(8) if special use valuation has been elected." The words "for all specially valued property" apparently only appear in the final regulations. Agents in the field sometimes find it to their advantage to interpret "all specially valued property" to mean every little bit of miscellaneous land on the farm. They then require the executor to attempt to find cash rentals of such things as a four acre woods at the back of the farm; or a two acre old farmstead which includes a house with the roof falling in and an old obsolete barn. These parts of the farm are of little value and rentals of such property do not exist. The agents then ask the executor to value all qualifying real property under 2032A(e)(8). In this situation the estate should be allowed to value under (e)(7) the bulk of the land, which is typically crop land and perhaps pasture, for which cash rentals are available, use (e)(8) on the remaining qualified property, and use the fair market value on the other miscellaneous portions of the farm. There should be no problem with allowing the estate to pay tax based upon the fair market value of portions of the property, and allowing election of special use value on the bulk of the farm; recognizing that the thresholds to qualify for special use value would have to be met. I know that such partial elections have been made in some estates, but there is evidence that I.R.S. is attempting to interpret paragraph (7) to be so restrictive that the estate is forced to go to paragraph(8).

Paragraph(8) is a section of the law for which (to my knowledge) proposed regulations have not yet been published. Apparently the I.R.S. agents feel that paragraph(8) will not provide the tax relief that paragraph(7) holds. At this point in time operating under paragraph(8) almost puts the I.R.S. agent on his own to negotiate with the estate, since there are no regulations to guide either the agent or the executor.

Although we are discussing the final regulations as published here today, this committee should recognize the relationship between paragraph(7) and paragraph(8); and perhaps point out to the Treasury Department the need for the two paragraphs to contain some consistency. Apparently the I.R.S. interprets the wording in the law that says "the formula provided by subparagraph(A) shall not be used - (i) where it is established that there is no comparable land from which the average annual gross cash rental may be determined, or (ii) where the executor elects to have the value of the farm for farming purposes determined under paragraph(8)". The I.R.S. apparently interprets that to mean that neither the top nor bottom half of the formula is to be used. In other words - the capitalization rate taken from the Federal Land Bank interest data as used in paragraph(7) would not apply in (8). This is my second point: If you want paragraph(7) and paragraph(8) to be similar and therefore have somewhat uniform impact upon farm estates in various parts of the nation, then you need to see that the same Federal Land Bank interest rate is used as the capitalization rate in paragraph(8) sections A and B.

Agriculture is a big, wonderful and diverse industry. It has many farm rental arrangements that have evolved in various areas through the years. There is considerable renting for cash in central Indiana, while in central Illinois nearly all rentals are share arrangements. Wisconsin dairy farms use share arrangements, while Kentucky tobacco farms with their tobacco barns typically rent for cash. All of the various rental arrangements come down to the same thing: MONEY. It matters not whether the land owner rents his land for one-third of the crop and pays only real estate taxes, or receives one-half of the crop and pays one-half of the seed, fertilizer and chemicals; or rents his pasture for so many dollars per animal unit for the year; or rents his crop land for so many dollars per acre. The land owner converts all of that to money; and so can any competent appraiser. Since all rental arrangements reduce themselves to money, it is only fair and equitable to use the same capitalization rate to convert income into value in the Special Use Value section of the Tax Reform Act of 1976. Don't let the capitalization rate change from paragraph(7) to paragraph(8). Treat all of the family farms in the nation the same way.

Thank you Mr. Chairman for this opportunity to speak. I would like to offer any additional help that you might need from the members of the American Society of Farm Managers and Rural Appraisers. We have knowledgeable people in the areas of farm management and rural real estate valuation throughout the nation. We would be happy to provide information for anybody on the committee, or others who might need it.

SUMMARY OF COMMENTS ON §2032A USE VALUE

Philip Ridenour
Ridenour And Knobbe
Cimarron, Kansas 67835

General Comments

The regulations under §2032A contain numerous quirks, without basis in the statute or the legislative history, apparently intended to discourage election by farm estates of the provisions of §2032A valuation and to complicate perfection of the election. On the local level, (Kansas District) examiners erect road blocks to frustrate the use of §2032A. In short, the National Office and the local level take the position that §2032A affords the farm estate an "unfair" advantage over the estates of non-farmers, and therefore it is their "duty" to restrict the application of §2032A.

Specific Comments: National Office: Regulations

The following provisions set forth by the regulations which must be met in order to elect to value real estate pursuant to §2032A are unsupported by the statute and legislative history:

1. Cash Leases. Regulations require that only cash leases, not crop share leases, be used to determine annual cash rent.

2. Lease Studies. Regulations prohibit use of independently compiled "area-wide averages of rentals" such as those published by Kansas State University.

3. Equity Interest: Regulations require the decedent to own an "equity interest" in the farm, and cash renting to a son or daughter is not sufficient.

4. Present Interest: A "discretionary trust" for the benefit of children or others, where income is not required to be annually distributed, will not qualify under §2032A, even though set up in a farmer's will and even if only qualified heirs are named as beneficiaries.

5. Corporate Arrangements. Even if a decedent is the sole shareholder, officer, director, and employee of a farm corporation, his estate cannot elect §2032A valuation in the absence of a formal "arrangement" requiring material participation; actual material participation is insufficient in the absence of an "arrangement."

6. Guidance. To date, over 30 private letter rulings, which may not be cited or relied on as precedent, have been issued, and public published rulings have been issued only defining the average annual Federal Land Bank interest rates.

Specific Comments: Local Interpretation (Kansas District)

1. Comparable Real Estate. "Comparable" is interpreted to mean "identical": length of pasture grass; miles from town; nearest elevator; hard surfaced or gravel road near farm; house, sheds, barns, and improvements must be identical.

2. Oral Comments. Despite requests on nine use value and protective use value election returns handled by our office, agents have declined to document local requirements in writing.

3. Capitalization Rates. Local agents try to push use value election out of "(e)(7)" method into "(e)(8)" method, using a low capitalization rate designed to make use value coincide with fair market value.

4. Expense. Local agents require documentation of comparability, leases, and material participation through affidavits and certified copies, driving up expenses of electing without discernable benefit to the Service.

5. Attitudes. Several (3) local agents have expressed the opinion that use value is "unfair" and willingly admitted their reluctance to permit its use.

Conclusion

The National Office and local Kansas agents seem anxious to disallow use value elections, apparently based on subjective notions of "fairness," placing undue strain on the self-assessment system of federal estate taxation.

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STATEMENT OF TESTIMONY OF DAVID J. HUTTON
PREPARED FOR FINANCE COMMITTEE HEARING ON
IRS REGULATIONS ON IMPUTED INTEREST AND
SPECIAL USE VALUATION ON APRIL 27, 1981

Thank you Mr. Chairman, I appreciate the opportunity to testify before this Committee.

The IRS has issued interpretative rulings that I believe ignore the statutory language of Section 2032A and the Congressional intent of special use valuation of farm and closely held business real estate. Specifically, I am referring to three Technical Advice Memorandums: Letter Ruling 8052080, September 26, 1980, Letter Ruling 8102009, September 29, 1980 and Letter Ruling 8108179, November 28, 1980, wherein the National Office of the Internal Revenue Service has taken the position--and has directed its Field Agents to follow--that if an election is made under Section 2032A a portion of the real estate indebtedness is not deductible under Section 2053(a)(4) of the Code.

I am a practicing attorney in Minneapolis, Minnesota with a significant estate and business planning and probate practice with farmers in Southern Minnesota. I find it very disconcerting as an estate planner when interpretative rulings ignore rather than interpret the statute.

Let me illustrate by example the estate tax effect of the position taken by the Internal Revenue Service. Decedent owns a 400 acre farm qualified for special use valuation having a fair market value of $2,000 per acre, or $800,000, and a special use value of $800 per acre, or $320,000. The decedent has mortgage indebtedness against the real estate of $300,000. By making the special use valuation election, the gross estate is reduced by $480,000. The position of the Internal Revenue Service is that if the special use valuation election is made and the farm real estate special use value is 40% of its fair market value, the allowable deduction for mortgage indebtedness under Section 2053(a)(4) is 40% of the mortgage indebtedness. Therefore, in this example, the estate tax deduction for the mortgage indebtedness would be $120,000 rather than $300,000. Rather than having a reduction in the taxable estate of $480,000 by the special use valuation election the net reduction in the taxable estate is $300,000 ($480,000 less $180,000).

The Internal Revenue Service cites the following situation in support of its position. If two people own a piece of real estate as tenants in common and one person dies, one-half of the value of the real estate is included in the decedent's estate and only one-half of the mortgage indebtedness on the property is allowed as a deduction in determining the adjusted gross estate. The reason that only one-half of the value of the real estate was included in the gross estate is that the decedent owned only a one-half interest in the real estate and therefore logically only one-half of the mortgage indebtedness is allowed as a deduction. The Internal Revenue Service in our above example is taking the position that even though the entire interest in the real estate is included in the decedent's gross estate, that interest is special use valued at 40% of its fair market value; therefore, only 40% of the mortgage indebtedness is allowed as a deduction under Section 2053(a)(4) of the Internal Revenue Code. Such rationale is without logic.

The term "value" is used throughout the Code and in Sections 2032A and 2053(a)(4). Those sections read in part as follows:

"CODE SEC. 2053. EXPENSES, INDEBTEDNESS, AND TAXES.

(a) General Rule.--For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts--

(1) for funeral expenses,
(2) for administration expenses,
(3) for claims against the estate, and
(4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate,

as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered." (emphasis added)

"CODE SEC. 2032A. VALUATION OF CERTAIN FARM, ETC., REAL PROPERTY.

(a) Value Based on Use Under Which Property Qualifies.--

(1) General rule.--If--

(A) the decedent was (at the time of his death) a citizen or resident of the United States, and

(B) the executor elects the application of this section and files the agreement referred to in subsection (d)(2),

then, for purposes of this chapter, the value of qualified real property shall be its value for the use under which it qualifies, under subsection (b), as qualified real property." (emphasis added)

The statute is clear that for purposes of Chapter 11, Estate Tax, the "value" of qualified real property shall be its special use "value" if an election is made under Section 2032A. The Service has no basis for attaching a different definition to the word "value" under Section 2053(a)(4) for special use valued real estate than as contained in Section 2032A.

The definition of "adjusted value" as contained in Section 2032A certainly contemplates that land qualified for special use valuation may be subject to mortgages and encumbrances. Yet, there is nothing in the law or in the Committee Reports to indicate that Congress intended the denial of a deduction for a portion of mortgage or other indebtedness against property valued under Section 2032A.

I am presently representing an estate where the Examining Agent is denying approximately $175,000 of a $330,000 mortgage indebtedness against farm real estate that was specially valued under Section 2032A. This adjustment results in a tax deficiency of approximately $36,000. The return as filed showed no estate tax liability. The decedent had a large operating debt in addition to the mortgage indebtedness on the real estate. The tax relief of special use valuation has enabled the decedent's two sons to continue the decedent's farming business. The additional tax burden resulting from the denial of a deduction of a portion of the mortgage indebtedness may force the sons to sell some of the farm land, breaking up the operating unit. The sale of the real estate would cause the imposition of an additional estate tax because of the early disposition of the specially valued property. The result may be the breaking up of a farming unit that the decedent had struggled to create during the past forty years.

It seems that the farming unit that carries a substantial amount of indebtedness and has a greater need for estate tax relief is being penalized over the estate that carries little or no indebtedness against the farm real estate. The position of the Internal Revenue Service is contrary to the intents and purpose of Section 2032A as enacted by Congress.

I thank you for the opportunity to provide this written testimony regarding my concerns and respectfully request your Subcommittee take some action as appropriate to right this wrong.

Senator GRASSLEY. Now, the last panel consists of Mr. Bert Ely, president of Ely & Co. of Roanoke, Va., Mr. Howard Benedict, Hamden, Conn., representing the National Association of Realtors, and Mrs. Ruth E. Kobell, legislative assistant, National Farmers Union. She is accompanied by Ann Bornstein, National Farmers Organization and Susan McDowell, National Grange.

PANEL MEMBER. She had to leave for a prior appointment.

Senator GRASSLEY. Did she have some testimony she was going to submit?

PANEL MEMBER. We have a joint statement.

Senator GRASSLEY. OK, well, would you apologize to her and tell her that probably my first hearing as chairman of this subcommittee, I have learned that very early on we should probably try to restrict members to the time limits previously imposed on other witnesses. Would you apologize to her, please, for me personally?

I would like to proceed with the way we introduced the people. Mr. Bert Ely first.

STATEMENT OF MR. BERT ELY, PRESIDENT, ELY & CO., ROANOKE, VA.

Mr. ELY. Mr. Chairman, thank you very much.

I am active as a financial consultant and merger and acquisition specialist dealing with small- and medium-sized businesses.

I really cannot comment at all about the problems of farm transactions, but I am intimately familiar with the comparable problems that arise in trying to sell businesses. Therefore, my statement addresses just the proposed regulations issued under code section 483.

My basic position is that Congress needs to reexamine the premise underlying the 1964 enactment of section 483. That premise holds that the minimum interest rate in deferred payment transactions should "reflect the going rate of interest."

There are several sound reasons why, despite recent record high-interest rates, the required minimum interest rate should not be increased above the present 6-percent level.

Higher minimum rates will impede seller financed capital asset sales. A below-market interest rate in seller financed transactions is a time-proven device sellers use to openly avoid reducing a stated selling price.

Buyers who understand the psychology of sellers are willing, for other than tax reasons, to pay a relatively high price in exchange for a low-interest rate and a long repayment period on the deferred portion of the price

Higher minimum interest rates will circumscribe this important marketplace device. Higher rates will also impede seller financing of capital asset sales. This will cause a portion of this financing burden to be shifted onto our already overloaded financial institutions.

In addition, higher rates will slow the turnover of capital assets, hardly a desirable impediment at a time when our economy needs improved capital utilization.

Furthermore, increasing the minimum interest rate requirements hardly seems consistent with our new era of reducing the impact of Government regulation on economic activity.

For this reason alone, Congress needs to reexamine the validity of the "going rate" premise that undergirded the 1964 enactment of section 483.

In effect, we should not let policies of the 1960's shackle the 1980's.

Second, the revenue impact of this regulation is not the key issue today. The IRS is concerned that taxpayers are using low-interest rates to minimize taxes. That undoubtedly happens in some cases. Yet, as appendix B to my full statement illustrates, there can just as easily be situations where a higher minimum rate will result in lower total Federal revenues from a particular transaction.

Furthermore, Federal revenues will definitely decrease to the extent that higher rates delay or bar capital asset sales.

In effect, higher minimum interest rates could have the same type of depressing effect on asset sale activity as high capital gains tax rates have had.

Third, inflationary considerations dictate a permanent, low, that is 4- to 6-percent, minimum interest rate for deferred payment transactions.

Interest rates have increased in recent years solely because of inflation. Real after-tax interest rates, that is the stated rate less taxes and the inflation premium, have probably declined. Keeping the minimum rate in the 4- to 6-percent range, the level of real pretax interest rates in my opinion, will insure that the inflation premium in capital asset sales is taxed at no more than the capital gains rate.

Ideally, the inflation premium should not be taxed at all.

Fourth and finally, my recommendations, if the IRS is to continue to periodically adjust the minimum interest rate, are:

One, set the new section 483 minimum rate no higher than 7½ percent. My full statement sets out the reason for that.

Two, make any rate change prospective rather than retroactive to last September 29. The IRS today indicated they are going to do that.

Three, make future rate changes on a regular basis, tie them to a formula, and announce them in advance of the effective date.

Four, do not require the interest rate in installment sales contracts to float with subsequent adjustments in the minimum rate. I mention this because at one point in time, that idea was floated by the IRS as a possibility.

That concludes my statement. I, of course, would be most appreciative if my full statement be included in the record.

Thank you very much.

Senator GRASSLEY. It will be included entirely in the record. Mr. Benedict.

STATEMENT OF HOWARD M. BENEDICT, NEW HAVEN, CONN.

Mr. BENEDICT. Mr. Chairman, my name is Howard M. Benedict. I am a realtor from New Haven, Conn. I am a former chairman of the realtors legislative subcommittee on Federal taxation. I have been an active realtor for 33 years in the New Haven, Conn., area and I am active in residential, commercial, property management, and real estate development.

Today I am here representing the largest trade association in the United States, indeed, the largest in the world, the National Association of Realtors which has over 750,000 members.

Accompanying me today, is John Ams, director of tax programs in the Government affairs division of the association. We appreciate the opportunity to present our views in opposition to an increase in the imputed interest rates on deferred payment sales.

We thank the committee for scheduling this hearing to review this important matter. I have a formal written statement that I will submit for the record.

It has been a pleasure to get updated on some of the special tax problems that affect farms because since the time that I lived in Cedar Rapids, I have gotten a little stale on farm taxation.

However, today I represent a larger number of people I would like to speak about and that is the homeowners in the United States and productive growing businesses.

Of the 80 million households in the United States, 65.2 percent currently own homes. That is 52 million homeowners. Fifteen percent of those people move every year. This year that will amount to 8 million families trying to move in probably the most difficult economy we have had in very many years.

I would like to give an example of the problem that a homeowner would have in moving from Washington, D.C. to Denver if imputed interest rates were increased. If he lived in Washington, D.C. today, he would probably have bought his house in 1976. He would have owned the house for 5 years and if I compute his inflation at only half of what we had last year, that house for which he originally paid $60,000, in the form of $10,000 in cash and a $50,000 mortgage, will have increased in value today to $80,000, his mortgage would have been paid down $2,000 and he would have an equity of $32,500.

If he wanted to sell that house in order to move, he would find that the bank will only allow him to qualify on a mortgage loan having an interest rate of of 13.5 percent.

However, the family that wants to buy his house is going to find a rate at 15 to 16 percent. In New Haven, Conn., this morning, the rate to a homeowner is 16¼ points, 16.25 percent plus 2 points and that means that 80 to 90 percent of people will not qualify for that mortgage.

Therefore, what do they do? The seller is forced to carry back a second mortgage so that the buyer can qualify for a conventional mortgage, with a lower principal amount at a bank. The bank says we will be happy to allow you to have the $48,000 mortgage that is currently on the house, but we want our full interest. We want 15 percent. So, the seller has to carry back a portion of the purchase price, at a lower rate of interest, so that the buyer can qualify for a bank loan at the current high rates of interest. The total amount of interest that the buyer can pay at his income level is $900, which, when the bank loan payment is deducted, leaves only a 7.2-percent interest rate that the seller can charge.

If he carries that back, he then can transfer and move his family, where he then in Denver, has to requalify a second time with his income instead of a seller's income.

If the Treasury's proposal to increase to 9 to 10 percent the imputed interest rules, the public won't perceive it as a tax allocation. They will perceive that as a requirement that the rate be 9 percent. If the rate were 9 percent, most of the sales being manufactured by taking a lower contract rate will disappear and these families will not be able to move and you will find permanent renters and people forced to stay much longer than they want in a location they no longer like or a house they may have outgrown.

So, the new rules will artificially drive the rates up. Second, they will prevent families from absorbing the excessive bank interest into an averaged or a blended rate and this will be a problem for 9 million or 8 million families today.

It will severely limit commercial, industrial, and retail expansion where productive and efficient businesses have to move into a bigger facility so they can compete. They will be denied this opportunity because they have to sell their old facility to be able to buy a new one.

I am also concerned about the fact that the Treasury is terribly slow in updating their rates. It is 2 years now since our rates have been over 12 percent and they are just now getting to the point of raising it.

If the rates drop down and we wait 2 years, business will be in severe straits indeed.

Thank you very much, Mr. Chairman.

Senator GRASSLEY. From Cedar Rapids? I should have spruced up your introduction a little more. My farm is 15 miles northwest of Cedar Falls. My address is New Hartford so you might know approximately where I come from.

Before I introduce Ruth, I would like to recognize her for the benefit of those who don't know her as a person, with whom I have become acquainted. As a testifier before the House Committee on Aging where I was the ranking Republican member, she has consistently spoken in support of programs for the elderly and she has a comprehensive understanding of that area. Her organization has done an awful lot of work for the elderly.

I also heard her testify before the House Agriculture Committee, but now I am becoming acquainted in yet a third way. I am sure that your expertise in this area will be as great as it has been in those areas as well.

STATEMENT OF RUTH E. KOBELL, LEGISLATIVE ASSISTANT, NATIONAL FARMERS UNION

Mrs. KOBELL. Thank you, Senator, for those very kind words. I am delighted to be accompanied by Susan McDowell of the National Grange. Ann Bornstein needed to leave and asked me to convey her disappointment at not being able to appear here.

This testimony is on behalf of the National Grange, the National Farmers Union, and the National Farmers Organization. We represent thousands of farm families and ranchers throughout the United States.

In response to your request that those with the same general interest consolidate their testimony, we have come together today to express our concern over the proposed increase in the imputed interest rates on transactions covered by Internal Revenue Codes 482 and 483.

We are encouraged by the testimony you received earlier today with the announcement of the adjustment that the IRS proposes at least between the two sections.

I want to commend you for the very broad range of testimony that you brought to these subjects today and I think it will serve your committee well in your consideration of the legislation.

Certainly, we hope it was not the intent of IRS to damage the viability of the family farms. You have made the case, which I think is the important one, that family farmers are a national asset that we need to keep in place with younger people coming on to preserve our supply of food and fiber.

The sections on imputed interest rates were written to regulate transactions of large corporations and their subsidiaries and not to the transfer of family farms between parent and child.

The estate planning has become an increasingly complicated and problematic issue for farmers and ranchers who wish to keep their operation within the family or who wish to continue family agriculture tradition.

Federal inheritance and estate taxes has failed to take into account the realities of inflated land values and necessary but costly farm equipment and operating capital. It is one of the continuing challenges of farmers across our country.

Long-term deferred land contracts have become, for many, the only way to pass a family farm intact to younger generations. You have had experts address this issue today. I don't think I will even go into it because the hour is late.

The rising land prices currently form a formidable barrier to young people eager to begin building their own farm operations. The IRS proposal would significantly worsen their prospects for buying that first parcel of land on which a viable farm and future can be built.

Relating to rural America, I was interested in the previous witness, because last week a young woman out in Wisconsin said, "I am not a farmer, but my husband and I are trying to buy our home with a loan from his mother and if this went through it would make it very difficult for us."

The administration proposal to eliminate the Farmers Home Administration limited resource loans for farm ownership would compound the existing problems of trying to get into farming. If the proposal is adopted and the imputed interest rate increase is applied to family agriculture, no mechanism would then exist for young farmers to acquire the capital necessary to build a farming operation.

The availability of long-term, low-interest credit for land, machinery and farm operations is essential to a young person who wishes to start farming. We feel strongly that guaranteeing the availability of low-interest credit to young farmers, is, indeed, a proper role for Government.

This is especially important because of the competitive advantage large corporations and pension funds have in buying farmland.

Young people seeking to continue their family farming tradition are unable to compete with well financed, nonfarm interests to buy farmland unless the long-term, low-interest credit is available.

We are convinced the agricultural economy and the Nation's economic well-being, as a whole, are both served best by a pattern of diverse landownership and the prevention of the establishment of an agricultural economy controlled by only a few wealthy corporations.

We are encouraged by the extent and the depth of congressional interest in the future of small farmers and ranchers as demonstrated by the various legislative proposals to correct the inequities of the proposed IRS regulations and other areas of activity which your committee is addressing itself.

We thank you for calling this hearing and for listening to the concerns of our group and we hope the Congress will continue to look at the broad areas in which we need to act to help maintain our family farmers.

Thank you very much.

Senator GRASSLEY. Susan, did you have something you were going to add or were you in conjunction with her testimony?

Ms. MCDOWELL. Mr. Chairman, the National Grange collaborated with the National Farmers Union on the testimony so I don't have anything specific to add. I just reiterate Mrs. Kobell's plea to you to look at the whole, to continue to look at the whole issue of the Federal tax impact on family farms.

Senator GRASSLEY. OK. I have a question of Mr. Ely. By the way, I don't have very many questions, so we are about done.

On page 2 of your summary, at the top you talk about the going rate—that that ought to be reexamined. Then down in D, the last paragraph, you have recommendations if the IRS is to continue to periodically adjust the minimum interest rates. Is D complementary and a natural followup of your statement at the top?

Mr. ELY. Well, my hope is that Senator Melcher's bill, or something along its line will be put into effect. As I understand it, it would have the effect of freezing the regs that were in place last year and, in effect, lock in the section 483 rates at 6 and 7 percent.

But, if that doesn't happen and things are to continue on as before, then my point that is summarized in D is that if you relate the last time the minimum rates were raised from 4 to 6 percent to some of the marketplace interest rates that were in effect at that time, that you cannot justify going above 7½ percent at this time. In other words, the 9-percent rate is not justifiable.

Senator GRASSLEY. Well, then in regard to your suggestion for reexamining the validity of a going rate, really you are telling us then that we ought to just lock it in at 6 percent?

Mr. ELY. Yes.

Senator GRASSLEY. OK. Finally, I ask the realtors, Mr. Benedict or Mr. Ames, as a way of summary because I think that it ought to be emphasized, your main point is that the problems that we have brought out here as it deals generally with agriculture is a problem that affects the 97 percent of the people living in towns and the 15 percent of the people each year who sell houses and move have argued.

Mr. BENEDICT. Very definitely. They are perfectly willing to accept a lower contract rate than 9 percent and do all the time to be able to move. If you artificially run it up you are just going to stop those families from moving.

[The prepared statements of the preceding panel follow:]Offset

STATEMENT BY BERT ELY

to the

SENATE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

regarding

MINIMUM INTEREST RATES UNDER INTERNAL REVENUE CODE SEC. 483

I want to express my appreciation to Senator Grassley and the Subcommittee for holding a hearing to receive public comment regarding proposed IRS regulations (Sec. 1.483-1) that would significantly increase the required minimum and imputed interest rates for certain deferred payment transactions. While these comments will focus on just the proposed Sec. 483 regulations, they are relevant in many ways to the proposed Sec. 482 regulations also being reviewed by the Subcommittee.

As a mergers and acquisitions consultant for the last six years, I have worked with enough installment sales transactions to be quite familiar with this issue. While I do not purport to speak on behalf of the National Association of Merger and Acquisition Consultants, of which I am a member and director, I know that all of my brethren join me in opposing any increase in minimum interest rates required for installment sales transactions.

* * * * * * * * * *

Obviously, this interest rate issue is hardly one of the raging tax issues of the day, yet it is not unimportant; the consequences of the proposed regulation are far wider and deeper than appear on its surface. This statement will discuss some of these consequences in detail.

The minimum interest rate issue is not just a tax or revenue issue for its revenue consequences are nil, as will be discussed below. In actuality, this is primarily a <u>deregulation issue</u>. Thus, its regulatory impact must be carefully examined, just as the impact of many other Federal regulations are being reexamined today. This regulation's impact can be stated quite simply: it will hamper billions of dollars of asset sales each and every year.

In my opinion, the Congressional reasoning underlying the 1964 enactment of Code Section 483 is faulty and thus needs re-examination. Quite simply, I do not believe it is wise public policy for the IRS to be empowered to periodically set a minimum interest rate requirement in deferred payment transactions at or near a "going rate of interest".

Furthermore, increasing the minimum interest rate requirements hardly seems consistent with our new era of reducing the impact of government regulation upon economic activity. For this reason alone, Congress needs to re-examine the validity of the "going rate" premise that appears to have undergirded the 1964 enactment of Sec. 483.

If the 1964 reasoning in support of Sec. 483 is now invalid, as I will argue below, then there is no logical basis for increasing minimum interest rates. Therefore, Congress should rewrite Sec. 483 to provide a low, permanently-set statutory minimum interest rate in the 4-6% range.

In other words, in evaluating this proposed regulation, the Subcommittee should look beyond the current law, and its legislative history, to today's circumstances. The eighties should not be shackled by the sixties when, among other things, the rate of inflation was much lower.

* * * * * * * * * *

<u>A. - The reason why higher minimum interest rates will impede asset transfers</u>. Interest rates play a somewhat different role in deferred payment situations than they do in typical arms length loan transactions.

Normally, interest rates include an inflation factor and, hopefully, a true after-tax return on capital. However, in seller-financed installment sales of capital assets, such as farms and businesses, below-market interest rates frequently represent a form of indirect price discounting. In other words, interest rates in deferred payment situations do not always reflect the marketplace for borrowed funds.

Indirect price discounting, through the use of below-market interest rates, is a very effective way to close the gap between what a buyer is willing to pay for a property or business and what the seller wants for it. In effect, the buyer gives the seller the price he wants, but in exchange for the seller deferring receipt of a substantial portion of the purchase price for a long period of time at a low interest rate.

This discounting rationale reflects basic human psychology at work in the marketplace: a seller knows he has to come down from his asking price in order to sell, but he wants to do so without appearing to have come down as much as he really has, and without losing face. By the same measure, the buyer knows he has to go up in price, but does not want to increase the real cost of acquiring the asset by the amount of the price increase.

Each side usually understands this process, and accepts it. Neither presses too hard for a lower selling price in exchange for a true market interest rate. The IRS should not hinder this marketplace process through a higher interest rate floor that circumscribes the negotiating process and limits the effectiveness of this discounting mechanism.

To draw a parallel, many governments utilize this discounting psychology to promote foreign trade. Exports are encouraged and even subsidized through "favorable credit terms"; that is, long payback

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periods at low interest rates. A Wall Street Journal article, attached as Appendix A, describes the Xerox Corporation's recent use of low interest rates to sell copiers. This article clearly indicates that large, sophisticated marketers also appreciate the use of below-market rates as a price discounting tool. For the same reason, the Federal government should hold down the required minimum interest rate so as to not inhibit business and property transactions.

Higher minimum interest rates in Sec. 483 transactions will therefore limit the use of seller financing. In times of high interest rates, particularly, seller financing is an important "lubricant" to facilitate capital asset sales. If seller financing is impeded because of higher minimum rates, then additional financing burdens will be placed upon our already overloaded financial institutions such as the banks, savings and loans, and life insurance companies.

Additionally, it must be remembered that a low minimum interest rate is necessary in numerous situations due to the fact that many businesses, farms, and other properties do not generate enough income to pay a market rate of interest. This is particularly true when (1) the property or business being sold generates little, if any, income or (2) the purchase price primarily reflects potential rather than past or current income.

Below-market interest rates are, admittedly, a way for a seller to attempt to increase that portion of future payments under an installment sales contract which will be taxed at lower capital gains rates rather than at the higher regular income rates. Obviously, the IRS is concerned about possible revenue losses because of this shift of income to lower effective tax rates. As is discussed below, this is largely a needless concern.

B. - The minimum interest rate issue is difficult to assess on revenue grounds; furthermore, the revenue impact of minimum interest rates is not a particularly relevant consideration in this debate. The minimum interest rate should not be increased for revenue reasons as total government tax receipts may not be affected very much by a change in the minimum rate. The reason for this, quite simply, is that one taxpayer's interest income is another taxpayer's interest expense deduction. Generally speaking, total tax collections will vary only to the extent that there is a difference in the incremental, or marginal, tax rates of buyers and sellers.

Although I lack statistical data for deferred payment transactions taken as a whole, I doubt if the actual incremental tax rates of buyers and sellers differ significantly in most transactions. If that is true, then a minimum rate increase will have very little impact on Federal revenues while causing unnecessary problems for buyers and sellers negotiating deferred payment contracts.

I will even go so far as to suggest that total Federal tax revenues may decrease if the minimum interest rate goes up. I base this on the attached Appendix B which sets out the tax consequences, for both seller and buyer, in a $1 million installment sale. The appendix shows net Federal tax revenues from the transaction at 4%, 6%, and 9% interest rates. As you will note, raising the minimum rate to 9% would cause total taxes in that installment sales situation to decrease 4.3%. Decreasing the minimum rate to 4% would cause total tax payments to increase 3.5%.

One can support almost any conclusion about taxes, depending on the assumptions one makes. That aside, I question the implied assumption underlying this proposed change in regulations: that it is in the best interests of Federal revenues to raise the required minimum interest rate for deferred payment transactions.

Federal revenues will definitely decrease to the extent that higher rates delay or bar capital asset sales. In effect, higher minimum rates could have the same type of depressing effect on asset sales as high capital gains tax rates have had.

If seller financing is mandated to be contracted at "the going rate of interest," as called for in the House Report accompanying the Revenue Act of 1964, or even at interest rates close to the going rate, then there will be a substantial and undesirable reduction in the sale of large capital assets. This will occur because the price discounting feature possible with seller financing will largely be curtailed.

In looking at just the revenue aspects of this issue, the key question the Subcommittee should consider is: should Federal revenues be forced up in certain installment sales transactions while being forced down in other similar transactions? I do not think so. Furthermore, I do not think it will be possible to establish minimum interest rate regulations that will (1) maximize Federal revenues from all installment sales transactions while (2) limiting maneuvering to minimize taxes.

One additional point is in order here: unrelated and even related buyers and sellers seldom work in perfect harmony to minimize the total tax burden that will arise out of an installment sales transaction. For example, it may be very much in the seller's interest to set a very high selling price and a low interest rate. However, without a significant corresponding selling price reduction, that mix will shift much of the tax burden in the transaction to the buyer because his tax deductions will be held to a minimum. This will be particularly true if he is buying a non-depreciable asset such as farmland or corporate stock. Thus, the buyer frequently will resist giving the seller a high selling price and a low interest rate. Therefore, normal market place bargaining will keep the interest rate from going too low. That bargaining will, as an unintended consequence, prevent Federal revenues in the transaction from going as low as they possibly could, if the seller is in a higher tax bracket than the buyer.

C. -. Inflationary considerations dictate that Congress permanently and statutorily set a low (4% to 6%) required minimum interest rate for deferred payment transactions. The increase in market interest rates in recent years has resulted entirely from inflation. Real interest rates, particularly on an after-tax basis, most likely have declined. Thus, a very strong case can be made that minimum interest rates should not be raised because, in fact, real interest rates have not increased.

The simplest, and best solution, to the relationship between the impact of inflation on nominal interest rates and the minimum interest rate problem is to rewrite Section 483 so as to permanently set a statutory minimum interest rate. I think a rate in the 4% to 6% range, say 5%, should be adequate because that portion of a market interest rate above a 5% level is strictly an inflation premium and not a real return on capital.

Ideally, the inflation premium in interest income should not be taxed at all. At worst, the inflation premium should be taxed at capital gains rates. This now occurs when at least some of the difference between a market interest rate and its real rate is reflected in the selling price of an asset sold with below-market seller financing.

A relatively low rate will not maximize government revenues nor will it short-circuit all tax minimization efforts. Yet, given the discussion above, I doubt very much if it is wise public policy to try to draw a tighter circle than will be achieved if a minimum rate is set in the 4% to 6% range.

D. - Recommendations for the IRS if Congress is going to continue to allow the IRS to periodically adjust required minimum interest rates. If the IRS is going to periodically adjust the required minimum interest rate, then I offer the following recommendations regarding proposed changes in the rate and the process for making future rate changes:

1. Set the new Sec. 483 minimum rate at 7 1/2%. The proposed 9% rate is not justified by interest rate history, particularly the apparent relationship between the current 6% minimum rate and marketplace interest rates in 1975, when the minimum rate was increased from 4%. In fact, it would be difficult to justify a rate in excess of 8%.

Moody's annual averages for Baa Corporate bonds appear to be a reasonable reference point to use in relating marketplace interest rates to the minimum rate. The current 6% rate equals 57% of Moody's 10.61% Baa bond average for 1975. The 6% rate also equals 63% of Moody's 9.45% Baa bond average for the three year period, 1973 to 1975.

Applying these rate discount percentages to the present would indicate the following:

Time Period	Moody's Baa Bond Average	x	Discount Percentage	=	Indicated Minimum Rate
1980	13.67%		57%		7.79%
1978-1980	11.28%		63%		7.11%

The average of the two Indicated Minimum Rates is 7.45%, slightly less than the 7 1/2% figure I recommend.

2. Make July 1, 1981 the effective date for the change in the minimum rate. Uncertainty hobbles tax planning as well as selling a business or piece of property. For eight months, there has been uncertainty as to the interest rate floor for installment sales transactions. That uncertainty will continue at least another two months. Given that there is very little revenue effect from a change in the minimum rate, I believe a postponement in the effective date of the rate change, if there is to be a change, is only fair and proper.

3. If the minimum rate is to change periodically, it should change automatically and in advance of the effective date. As I mentioned previously, uncertainty greatly complicates tax planning. Therefore, a mechanism that periodically adjusts the minimum rate would be very desirable. The procedure for regularly adjusting the interest rate on tax underpayments is ample precedent for this adjustment concept.

I recommend that the minimum rate be adjusted just once every two or three years. Its point of reference should be Moody's Baa corporate bond average or some other marketplace indicator of interest rates on somewhat risky, medium term (i.e. five to ten year) bonds. For the reasons pointed out above, and as history seems to indicate, the minimum rate should be set at a substantial discount from the measure of marketplace interest rates used to adjust the minimum rate.

4. The interest rate on an installment sales contract should not be required to "float" with subsequent adjustments in the minimum rate. It is very desirable for both parties in an installment sales situation to be able, if they so desire, to set a fixed interest rate for the entire term of their contract. They would be denied that option if subsequent minimum rate changes forced interest rate adjustments in existing installment sale contracts. The Tax Code does not require interest rate increases on fixed income securities issued ten or twenty

years ago, when rates were much lower. The same "hands off" approach should hold true for future installment sales contracts.

* * * * * * * * * *

Again, I wish to thank the Subcommittee for inviting the public to submit statements on this issue.

Respectively submitted:
Bert Ely
Ely & Company, Inc.
P. O. Box 8505
Roanoke, Virginia 24014
703-982-2600

April 27, 1981

APPENDIX A

To Prop Sales, Xerox Gives Bargain Loans

1/7/81

By JEFFREY A. TANNENBAUM
Staff Reporter of THE WALL STREET JOURNAL

For months, some securities analysts have wondered when Xerox Corp.'s equipment orders, especially for outright purchases, would suddenly weaken and ravish the copier giant's near-term earnings.

But it hasn't happened. For the first nine months of 1980, Xerox earnings rose nearly 10% on a 23% rise in outright sales from the year-earlier period. Now some followers of the company have spotted the secret to Xerox's recent success: Increasingly, it's lending money to customers at bargain interest rates to encourage sales.

Customers have been able to get financing directly from Xerox since 1976, but only recently has the company appeared to push and promote its lending program, called XEEP (for Xerox Equipment Equity Program). XEEP, with corporate funds, finances about half of Xerox's U.S. sales.

Even competitors think the Xerox program is a good one. "To offset a high purchase price with low interest charges is very creative marketing," says a Savin executive.

"Creative Marketing"

"XEEP is a big reason that Xerox's sales have held up in the recessionary environment," says Sanford J. Garrett, an analyst who follows the office-equipment industry for Paine Webber Mitchell Hutchins Inc. Savin Corp., a Xerox competitor, agrees. "To offset a high purchase price with low interest charges is very creative marketing," says Abraham Ostrovsky, a Savin vice president. "It softens the blow to their customers."

Analysts say XEEP is an especially powerful competitive tool because most of Xerox's rivals lack the cash resources to match Xerox's offers. (Still, such competitors argue that they offer customers a better deal overall.) International Business Machines Corp., with a pile of cash even bigger than Xerox's, is an exception. It is offering loans at 19%, only a bit higher than Xerox's current average rate of 18%.

Xerox keeps many of the details of XEEP, as well as other marketing weapons, private. But Melvin Howard, the company's senior vice president for finance, acknowledges that customer borrowing is picking up. Customers apparently see Xerox loans as bargains, for the company tries to keep interest rates about two percentage points below what customers would have to pay a bank. (Banks' prime, or minimum, interest rate is hovering at 20%.)

Instead of using XEEP as a last-resort sales tool, Xerox salesmen routinely offer loans to customers. Customers owe Xerox about $600 million in loans from XEEP, compared with outstanding balances of $300 million at the beginning of 1980. Although the below-prime rate is fixed when a customer borrows, customers can prepay their three-to-five-year loans without penalty if they're later able to borrow at lower rates.

Cash Put to Better Use

Xerox won't say which customers have borrowed. One borrower is a New Jersey engineering and construction concern that requests anonymity. It bought $800,000 in Xerox gear last month with a three-year XEEP loan at 16%. "We could have paid cash," the company's financial vice president says, "but our cash is earning 18% to 20% in the money market."

Uniroyal Inc., the Middlebury, Conn., rubber and chemicals concern, used a 16% Xerox loan recently to buy $25,000 of word-processing equipment. "Some third-party lenders were offering 18% to 20% rates at the time," a Uniroyal manager says.

Xerox itself could earn a higher return on the funds it lends, but the company says the value of the loans as an inducement for purchasers more then offsets foregone higher interest plus administrative costs and occasional losses from deadbeats. "We think it's a good marketing strategy to make it easier for our customers to purchase machines," Mr. Howard says.

Mr. Garrett and other securities analysts think the practice is a good one, too. They figure that giving up the maximum possible return on money-market investments is worth it because continued customer buying cuts the risk of losses caused by cyclical downturns in sales.

Xerox reported $550 million in cash and marketable securities on its balance sheet last Sept. 30 but declines to provide a more recent figure. Analysts believe the company still has more than $500 million available for lending to customers, however.

APPENDIX B

APPENDIX TO TESTIMONY BY BERT ELY

IMPACT OF CHANGE IN INTEREST "TEST RATE" UPON

TOTAL FEDERAL TAX REVENUES, GIVEN CERTAIN ASSUMPTIONS

ASSUMPTIONS

BASIC PREMISE: This appendix reflects the price discounting theory set forth in the attached testimony: that as interest expense changes in a deferred payment situation, principal payments (purchase price) change inversely by the same amount so that total payments to the seller remain constant.

SELLER: Married taxpayer sells an incorporated business in which he has a cost basis of $1,000. He receives no downpayment, but contracts to receive $117,230.50 every six months for five years. Interest is to be at the IRS Test Rate; the balance of each payment is to represent a portion of the purchase price, which in turn is to be subject to capital gains tax. The taxpayer has deductions and exemptions each year of $13,400. All of the taxpayer's other income is assumed to be taxed at the taxpayer's incremental tax rate; that is, his other income, considered to be coming in on top of his income from selling the company, is excluded from this analysis. However, no Alternate Minimum Tax is due.

BUYER: Pays interest out of the earnings of the acquired company. Since earnings are well in excess of $100,000 per year, corporate taxes are reduced 46 cents for each dollar of interest paid to the seller.

INTEREST RATE AT CURRENT 6% TEST RATE

Seller's Taxes

Year	;	Principal payment	;	Taxable income from gain	+	Interest income	=	Adjusted gross income	-	Excess deductions/ exemptions	=	Taxable income	;	Amount of tax
1		$ 177,078		$ 70,760		$ 57,383		$128,143		$10,000		$118,143		$ 53,140
2		187,862		75,070		46,599		121,669		10,000		111,669		48,996
3		199,303		79,641		35,158		114,799		10,000		104,799		44,829
4		211,440		84,491		23,021		107,512		10,000		97,512		40,530
5		224,317		89,638		10,144		99,782		10,000		89,782		35,969
Totals		$1,000,000		$399,600		$172,305		$571,905		$50,000		$521,905		$223,464

Buyer's Taxes

Year	Interest expense	x Tax rate	= Tax Savings
1	$ 57,383	.46	$(26,390)
2	46,599	.46	(21,436)
3	35,158	.46	(16,173)
4	23,021	.46	(10,590)
5	10,144	.46	(4,666)
Totals	$172,305		$(79,255)

Net Federal income tax revenues $144,209

APPENDIX B - Page 2

INTEREST RATE AT PROPOSED 9% TEST RATE

Seller's Taxes

Year	; Principal payment	; Taxable income from gain	+ Interest income	= Adjusted gross income	- Excess deductions/ exemptions	= Taxable income	; Amount of tax
1	$154,373	$ 61,683	$ 80,088	$141,771	$10,000	$131,771	$ 61,861
2	168,579	67,359	65,882	133,241	10,000	123,241	56,402
3	184,093	73,558	50,368	123,926	10,000	113,926	50,441
4	201,034	80,327	33,427	113,754	10,000	103,754	44,213
5	219,533	87,718	14,928	102,646	10,000	92,646	37,659
Totals	$927,612	$370,645	$244,693	$615,338	$10,000	$565,338	$250,576

Buyer's Taxes

Year	Interest expense	x Tax rate	= Tax Savings
1	$ 80,088	.46	$ (36,840)
2	65,882	.46	(30,306)
3	50,368	.46	(23.169)
4	33.427	.46	(15.376)
5	14,928	.46	(6,867)
Totals	$244,693		$(112,558)

4.3% less than revenues at 6% rate - - - - Net Federal income tax revenues $ 138,018

INTEREST RATE AT FORMER 4% TEST RATE

Seller's Taxes

Year	; Principal payment	; Taxable income from gain	+ Interest income	= Adjusted gross income	- Excess deductions/ exemptions	= Taxable income	; Amount of tax
1	$ 194,263	$ 77,631	$ 40,198	$117,829	$10,000	$107,829	$ 46,617
2	202,111	80,768	32,350	113,118	10,000	103,118	43,838
3	210,277	84,031	24,184	108,215	10,000	98,215	40,945
4	218,772	87,426	15,689	103,115	10,000	93,115	37,936
5	227,610	90,957	6,851	97,808	10,000	87,808	34,805
Totals	$1,053,033	$420,813	$119,272	$540,085	$50,000	$490,085	$204,141

Buyer's Taxes

Year	Interest expense	x Rate	= Tax Savings
1	$ 40,198	.46	$(18,491)
2	32,350	.46	(14,881)
3	24,184	.46	(11,125)
4	15,689	.46	(7,217)
5	6,851	.46	(3,151)
Totals	$119,272		$(54,865)

3.5% more than revenues at 6% rate - - - - Net Federal income tax revenues $149,276

Statement of the
NATIONAL ASSOCIATION OF REALTORS®
THE WORLD'S LARGEST TRADE ASSOCIATION

TO THE: SENATE FINANCE SUBCOMMITTEE ON OVERSIGHT

ON: THE PROPOSED REGULATIONS UNDER SECTIONS 482 and 483 CONCERNING IMPUTED INTEREST RATES

BY: Howard Benedict

DATE: April 27, 1981

My name is Howard Benedict. I am a REALTOR® from Hamden, Connecticut and am a former Chairman of the REALTOR® Legislative Subcommittee on Federal Taxation. I am here representing over 750,000 members of the NATIONAL ASSOCIATION OF REALTORS®. Accompanying me today is John Ams, Director of Tax Programs in the Government Affairs Division of the Association. We appreciate the opportunity to present our views in opposition to any increase in imputed interest rates on deferred payment sales and thank the Committee for scheduling this hearing to review this important matter.

The Proposed Regulation

The Internal Revenue Service has issued proposed regulations that would provide an imputed interest rate of 10 percent on deferred payment sales if the sales contract does not itself provide for an interest rate of at least 9 percent. The rate at which interest is imputed under existing regulations is currently 6 percent. The proposed regulation also provides for an imputed interest rate of 12 percent on related party sales, unless at least 11 percent was agreed to by the parties to the transaction.

The NATIONAL ASSOCIATION OF REALTORS® is concerned that an increase in the imputed interest rate would adversely affect many segments of the real estate industry by increasing the required interest rate to levels in excess of current market rates and by causing a decline both in the number of properties offered for sale and in the number of qualified buyers. Consequently, we request that the rate at which interest will be imputed under sections 482 and 483 of the Internal Revenue Code not be raised. We also note, and appreciate, the Treasury Department's commitment to Senator John Melcher of Montana not to issue final regulations on this matter until at least July 1 in order to give Congress the opportunity to review this proposal and the issues raised thereby. For all of the following reasons the NATIONAL ASSOCIATION OF REALTORS® recommends that the regulation be withdrawn and that this Committee approve any necessary legislation to accomplish this result.

The Proposed Regulation Ignores Current Interest Levels

According to the Federal Register announcement in which the increased interest rate was proposed, such an increase was declared to be necessary in order to "more accurately reflect the market rates in effect" at the present time. Current evidence and long-standing history indicate, however, that an interest rate of 9 percent is in excess of market interest rates in many cases.

Many properties are sold upon retirement and the seller is in the position of not needing immediate cash for other purposes. The seller is thus able to finance the sale and to set the terms for such financing. The relevant determinant of interest rates on these sales has been, as a result of this situation, the return the seller could get were he to place the sales proceeds in a savings account or other interest earning investment. Thus, despite recent high mortgage interest rates, many contracts for sales of property, especially farmland, called for interest rates of between 7.5 and 9 percent because the seller could receive a return in that range if the sales proceeds were invested elsewhere. It is important to point out that these interest rates were set on sales between unrelated parties in arm's length transactions. The proposed regulations would disrupt this practice simply because higher interest rates may be prevalent on other investments in other sectors of the economy.

In addition, the Federal government operates a number of programs that make mortgage money available to finance property purchases, such as the Federal Land Bank and the Federal Farm Credit Administration. As a result, the rates charged in seller-financed sales must be competitive with the rates charged by the Federal government, and these rates are generally below the market interest rates that may be prevalent in other segments of the economy. It is the rate charged by the Federal government, consequently, that is the relevant criterion against which buyers and sellers of various properties must compare the interest rate that will be established in the contract. The proposed regulations ignore current interest rates with respect to sales of many types of property and, for this reason alone, we would recommend that the current regulations not be changed nor the existing imputed interest rates increased.

The Proposed Regulation Ignores Cash Flow

The interest rate charged in a seller financed sale is usually set in relation to the cash flow that may be expected from the property. For example, the rate of return on farmland from farming operations is generally between 3 and 5 percent. As a result, the expected cash flow available to service debt is of primary importance in negotiating sales terms and necessarily results in interest rates less than 9 percent on sales between related parties.

An interest rate of at least 9 percent on the purchase of a farm that would provide a cash flow of only 3 to 5 percent would result in much too low an economic return to make operations worthwhile. The result would be that the total number of farms nationwide, especially smaller farms such as family farms, would decrease. This is directly contrary to current public policy encouraging the development and growth of small farms. Alternatively, in order to make a purchase of a farm at a 9 percent interest rate economically viable, the buyer must try to increase his cash flow through higher prices for his farm products, thereby contributing to inflation, which is also contrary to current economic policy.

Similar situations currently exist in sales of industrial and commercial property as well. A 9 percent rate of interest would produce undue hardship on both buyers and sellers, causing serious problems unless the interest rate is adjusted to reflect the expected rate of return from the property. In fact, economic estimates indicate that an imputed interest rate of 9 percent would lead to a 20 percent decline in deferred payment sales involving seller-financing. These add to the reasons why we recommend that the Committee approve legislation that ensures that the proposed regulation be withdrawn or not be implemented.

The Proposed Regulation May Conflict With Usury Laws

The proposed increase in imputed interest rates, particularly with respect to related party transactions, may conflict with usury rates in some states. Usury rates in the states are usually set by statute and, in some cases, by the state constitution. Inasmuch as the proposed regulation does not take into account a possible downturn in interest rates throughout the economy, it is entirely possible that the rates prescribed in the proposed regulation may exceed the rate allowed in a particular state.

To illustrate, seller financed contract interest rates on the sale of property is controlled by state law in Minnesota. These allowable rates are announced monthly by the State Commission of Securities and rise and fall consonant with general economic conditions. The rate set by this procedure has in the past been, and may again in the future be, below the minimum rates proposed by these regulations. One result of this situation would be the elimination of all seller-financed property sales in that particular state. We would urge that the proposed regulations are seriously deficient in not taking state usury ceilings into account and that for this reason alone should not be implemented.

The Proposed Regulation Discriminates Against Families

The NATIONAL ASSOCIATION OF REALTORS® is also particularly concerned that the proposed regulation would impose a harsher, more stringent rule on sales between related parties by requiring a higher interest rate on such sales. Why should parents be forced to charge a son or daughter a higher interest rate than would be required if the identical property were sold at the identical price to an unrelated party? These regulations should not impose a higher, or lower, burden on family members than on others.

It is particularly unfortunate that this anti-family discrimination be proposed at a time when Congress has taken a strong stand against such action. The recent favorable revision of the installment sales rule was made applicable to related party transactions by the Congress, despite objections by the Treasury Department, specifically so as not to discriminate against related party sales. Further, the many objections in Congress to the proposed regulations under section 280A of the Code would not have arisen but for the so-called "family rental tax" that so blatantly discriminates against the rental of a property by one family member to another.

This Association supports amendment of the proposed regulation to provide that the same interest rate be imputed without regard to whether the parties to the transaction are related.

CONCLUSION

I appreciate the opportunity to testify on this important regulation. In summary, there are many valid reasons for not increasing the imputed interest rate on deferred payment sales. We hope this Committee will carefully review the implications of the proposed IRS changes and conclude that the changes are not necessary with respect to owner-financed sales of real estate. I will be happy to try and answer any questions the Committee may have.

STATEMENT BY

Susan K. McDowell, NATIONAL GRANGE
Ruth E. Kobell, NATIONAL FARMERS UNION
Ann Bornstein, NATIONAL FARMERS ORGANIZATION

Before the

SENATE FINANCE SUBCOMMITTEE ON OVERSIGHT
OF THE INTERNAL REVENUE SERVICE

April 27, 1981

RE: Regulations increasing imputed interest rates and interpreting estate tax law concerning valuation of family farm and other business properties.

(IRS regulations under sections 482, 483, and 2032A)

This testimony is presented on behalf of the members of the National Grange, the National Farmers Union, and the National Farmers Organization. We represent thousands of family farmers and ranchers throughout the United States.

In response to Senator Grassley's request for all those with the same general interest to consolidate their testimony, we have come together today to express to this subcommittee our deep concern over the imputed interest rate on transactions covered under Internal Revenue Code sections 482 and 483.

We have been listening to the response to these proposals from all corners of rural America, and farmers, ranchers, and small businessmen of very diverse backgrounds and situations all seem to be speaking with one voice. Their message is coming through loud and clear: the application of these interest rate increases to the sale of a farm, ranch, or business within a family will have a decided negative impact on the tradition of family-owned and family-operated businesses in this country.

Certainly it could not have been the intent of the IRS to damage the viability of the family farm. The sections on imputed interest rates were surely written to regulate the transactions of a large corporation and its subsidiaries, not the transfer of a family farm between a parent and child. Congress has increasingly expressed its support of efforts to preserve the family farm.

Unfortunately, no federal intent to protect the tradition of family ownership is clearly expressed in sections 482 and 483. The recent outpouring of protests and questions from the farm sector has not elicited any clarifying action from the Internal Revenue Service. Congress and the general public seem to agree that a "reasonable interpretation" of these sections exempts intra-family transfers from the proposed increases, but the IRS seems unwilling or unable to commit itself to such an exemption. We feel strongly that Congress should act quickly to keep the proposed increases in interest rates from being imputed on the intra-family transfers of small farms, ranches, and small businesses.

One quirk in the IRS proposal we find particularly distressing is the related parties provision of section 482. The prevailing interpretation of "related" has it applying to relation in the kinship sense, as well as in the financial sense. It is inconceivable to us why the IRS would require a parent to charge his or her child a higher interest rate than he or she would have to charge a perfect stranger. If this is not the intent of the IRS, we call on them to clarify this and alleviate the very understandable concerns of thousands of farmers, ranchers, and small businessmen throughout this country.

The proposed IRS regulations will significantly threaten the viability of the family farm, especially when the proposal is viewed in the larger context of federal tax provisions affecting family farms. The federal tax code has evolved incrementally over generations; it now appears that many of its provisions are working at cross-purposes. It has been said that analyzing the impact of any one federal tax proposal on the structure of agriculture is like trying to complete a crossword puzzle with several portions already inked in incorrectly; it would be much simpler if we could start at the beginning.

Even though we can't start at the beginning, we can attempt to analyze the impact of the changes proposed by the IRS. The proposed regulations would increase the imputed interest rate on loans between related parties to 12 percent (section 482), and would set imputed interest rates at 10 percent on deferred or installment payments (section 483). This is especially significant to farmers because long-term deferred contracts have become the most common method of transferring property within a family in many areas. Estate planning has become increasingly complicated and problematic for farmers and ranchers who wish to keep their operation within the family, who wish to continue the family agricultural tradition. Federal inheritance and estate tax laws fail to take into account the realities of inflated land values and necessary, but costly farm equipment and operating capital. Long-term deferred land contracts have become for many the only way to pass a family farm intact to the younger generation.

Long-term land contracts at a low interest rate benefit both the parent and child in a typical transaction. The below-market interest rates allow the young farmer to purchase the land he, in many cases, grew up on, worked on, contributed his time and his labor. A land contract often reflects these years of shared labor and commitment that went unrewarded in a monetary sense. Most beginning farmers are unable to purchase land at present high interest rates. In order to profit from a larger interest paid deduction, the buyer must already be in a high tax bracket. The farmers and ranchers we represent are typically not in a position to reap this interest paid deduction windfall, and see no reason the wealthy should receive this tax break, either.

The seller also benefits from the long-term transaction since it provides a dependable source of retirement income. If the seller is forced by the IRS to assume a higher interest rate, this will result in an increased taxable income fro him or her, at least a higher income on paper. The parent would have little choice in these inflationary times but to increase the price of the land.

Rising land prices currently form a formidable barrier to young people eager to begin building their own farm operation, and the IRS proposal would significantly worsen their prospects for buying that first parcel of land upon which a viable farm and future can be built.

A Reagan Administration proposal to eliminate the Farmers Home Administration (FmHA) "limited resource loans" for farm ownership would compound the existing problems. If the Administration's proposal is adopted and the imputed interest rate increase is applied to family agriculture, no mechanism would then exist for young farmers to acquire the capital necessary to build a farming operation.

The availability of long-term, low-interest credit for land, machinery, and farm operations is essential to a young person who wishes to start farming. We feel strongly that guaranteeing the availability of low-interest credit to young farmers is indeed a proper role of government. This is especially important because of the comparative advantage large corporations and pension funds have in buying farmland. Young people seeking to continue their family's farming tradition are unable to compete with well-financed nonfarm interests to buy farmland unless long-term, low-interest credit is available. We are convinced the agricultural economy and the nation's economic well-being as a whole, are both best served by a pattern of diverse land ownership and the prevention of the establishment of an agricultural economy controlled by only a few wealthy corporations.

We are encouraged by the extent and the depth of Congressional interest in the future of small farmers and ranchers, as demonstrated by the various legislative proposals to correct the inequities of the IRS regulations. We thank the Chairman for calling this hearing and listening to the concerns of the agricultural sector we represent. We are hopeful that Congress will act to insure that the proposed increases in imputed interest rates will not be allowed to endanger the strong and economically important tradition of the family farm in our country.

National Farmers Union

STATEMENT
OF

RUTH E. KOBELL
LEGISLATIVE ASSISTANT
NATIONAL FARMERS UNION

TO

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE
SENATE FINANCE COMMITTEE

REGARDING

REGULATIONS REGARDING IMPUTED INTEREST RATES

APRIL 27, 1981

Mr. Chairman:

National Farmers Union is happy to associate ourselves in a joint statement with the National Grange and the National Farmers Organization in opposition to the proposal by the Internal Revenue Service under IRS Code Sections 482 and 483 to increase imputed interest rates for tax purposes.

Proposed regulations under Section 482 would, in certain circumstances, allow the IRS to assume an interest rate of 12 percent on loans between related entities if interest is not charged at a rate between 11 and 13 percent. Proposed regulations under section 483 would allow the IRS to assume an interest rate of 10 percent if property is sold on an installment basis with a contract rate of less than 9 percent. This imputed interest rule has the effect of characterizing part of the sales price of property as interest taxable to the seller as ordinary income, rather than capital gain, and creating a corresponding interest paid deduction for the buyer.

Your hearing notice also indicated that you would review the final regulations under Section 2032 A of the IRS code adopted July 28, 1980, which specifies circumstances under which real property used for farming or in other family business use may be valued for estate tax purposes on the basis of the property's actual use. Generally, under the estate tax provisions, property is valued at its "highest or best" use. Section 2032 A was enacted in 1976 to reduce estate taxes on farm and business property to help heirs keep the farm or other business within the family.

Suite 600, 1012 14th Street, N.W., Washington, D.C. 20005 – Phone (202) 628-9774

Members of the Farmers Union have raised serious objections regarding the impact these changes would have in the ability of family farmers to continue in the production of an abundant supply of food and fiber for our nation and for export. As you know, Mr. Chairman, many young people who grow up on farms want to continue to operate that family farm but depression level farm prices which now stand at 63 percent of parity and high interest, energy and other operating costs are driving more and more of them from the land. As our joint statement points out, Section 482 would appear to particularly discriminate against the transfer of farms and small businesses among family members.

Section 483 would likewise impact on the contract of deed which is often used for farm purchases by beginning farmers.

Delegates to our National Farmers Union Convention held in Florida on March 1-4, 1981, adopted policy statements on the subject of this hearing and I am quoting from that policy statement as follows:

"<u>National Economic Policy</u>

"Farmers cannot isolate themselves from what is happening in the rest of the national economy. The demand for our farm products is severely reduced by economic stagnation and high unemployment. The costs which farmers must pay to produce and live are inflamed by high interest rates, energy prices, inflation, and low productivity in industry.

"The severe depression in our agricultural economy is a special problem requiring urgent attention to avert a worldwide food crisis as dangerous to world stability as the energy crisis. Positive measures to raise farm prices into balance with returns in other sectors on labor, investment, management, and risk must be initiated at once."

"<u>Estate and Gift Tax Policy</u>

"We urge the Congress to continue and further strengthen those provisions of the Tax Reform Act of 1976 that were favorable to family farmers, specifically, (1) the federal farm-use valuation provision embodied in Section 2032 A of the Internal Revenue Code (IRC) and (2) the 15-year installment payment provision for estate taxes found in Section 6166 of the IRC.

"In regard to these sections, we believe that the special lien and tax recapture features of these provisions cause great uncertainties by potentially keeping estates open for a long period of time with undue burdens and costs in estate administration, and by causing other potential liability problems for heirs when the estate is not so prolonged. Congress should amend these sections to avoid such problems."

"Capital Gains

"Profit and loss from the sale of real estate should be calculated on a graduated basis according to the length of time the asset is held, and 100 percent of the income should be taxed on property held less than one year, graduating to 50 percent taxable at the end of ten years; except that (a) if such gains are reinvested by the seller in other residential or income-producing real property within 18 months, they would be exempt from all income tax; and (b) each individual should be granted a one-time exemption from income tax on up to $100,000 of gain from the sale of real property used for residential, farming, or small business, or a combination of such purposes."

"Imputed Interest Rates

"We urge Congressional opposition to the proposed regulations by the Internal Revenue Service increasing the imputed interest rates, for tax purposes, set by Sections 482 and 483 of Internal Revenue Service regulations. Such an increase would interfere with state laws and other efforts which provide special tax incentives designed to encourage farmland transfer to beginning farmers. We believe that the present rule which imputes 7 percent interest if the rate is below 6 percent, should be left as it is."

A number of our state Farmers Union organizations and cooperatives have written in detail regarding the way these regulations would adversely affect farm families in their state and I am attaching these comments which I hope can be made part of the record of this Hearing.

Mr. Denis Rosen, a young farmer and member of the Board of Directors of the Wisconsin Farmers Union, testified at the hearing conducted by the Internal Revenue Service on January 8, 1981. He outlined in detail the debt load he and his wife carry in their effort to buy their dairy farm from his parents and operate it as an efficient and productive family farm enterprise. I believe it also will make an important contribution to the Record.

We appreciate this opportunity to present this information for the Record to substantiate our opposition to the increase in imputed interest rates.

Thank you.

FARMERS UNION
Milk Marketing Cooperative

April 20, 1981

Ms. Ruth E. Kobell
Legislative Assistant
National Farmers Union
Suite 600, 1012 14th St., NW
Washington, DC 20005

Dear Ruth:

This is in regards to your April 10 memorandum to FU presidents and editors welcoming contributions to NFU testimony on Imputed Interest Rates to be presented in Senate hearing on April 27.

Over 300 delegates representing the Farmers Union Milk Marketing Cooperative's 6,000 members at our Annual Member Meeting on February 7, 1981 passed the following resolution on IRS imputed interest rates:

> Because of the great economic hardship caused to family farmers by high interest rates, the Farmers Union Milk Marketing Cooperative requests of the IRS that land transfers between family farm members and between retiring and beginning farmers be exempted from the higher imputed interest rates set forth in the Federal Register, Friday, August 29, 1980 (Vol. 45, No. 170, 57739).

Sincerely,

Evelyn Cunico, Director
Member Organizations

EC/lz

3225 East Washington Avenue • Madison, Wisconsin 53704 • Phone (608) 244-3373

Minnesota Farmers Union
1717 University Avenue
St. Paul, Minnesota 55104
Phone: 612-646-4861

OCTOBER 28, 1980

COMMISSIONER,
INTERNAL REVENUE SERVICE
ATTENTION: CC: LR:T
WASHINGTON, D.C. 20224

DEAR COMMISSIONER:

THE PROPOSED RULE CHANGE FOR INTERNAL REVENUE CODE SECTION 483, WHICH WOULD IMPUTE FOR INCOME TAX PURPOSES AN INTEREST RATE OF 10% ON ANY CONTRACT FOR SALE OR EXCHANGE OF PROPERTY WILL FURTHER DISRUPT THE ABILITY TO TRANSFER FARM LAND WITHIN FARM FAMILIES. THESE RATES, IF ADOPTED, WILL BE TWICE THE IMPUTED INTEREST RATE OF ONLY FIVE YEARS AGO.

WE RECOGNIZE THAT INTEREST RATES ON THE WHOLE HAVE RISEN IN THE PAST FEW YEARS, HOWEVER, WE CAN ALSO SEE THE BURDEN THESE EXCESSIVE RATES HAVE HAD ON ALL SEGMENTS OF OUR ECONOMY, FROM THE FARMING TO THE HOUSING SECTOR. WE THEREFORE QUESTION THE PROPRIETY OF ADOPTING FEDERAL REGULATIONS WHICH WILL IN EFFECT ADOPT THESE EXCESSIVE RATES AS ACCEPTABLE AND BUILD THEM INTO OUR TAX SYSTEM; NOR DO WE FEEL THAT THIS IS THE PUBLIC POLICY WHICH THIS GOVERNMENT AS A WHOLE WISHES TO ADOPT. ON THE CONTRARY, MANY PROGRAMS THROUGH THE USDA AND OTHER GOVERNMENT AGENCIES ARE DESIGNED DIRECTLY TO ASSIST THESE SEGMENTS OF OUR ECONOMY. IT MAKES ABSOLUTELY NO SENSE FOR THE GOVERNMENT ON THE ONE HAND TO SPEND SIGNIFICANT SUMS OF MONEY TO STIMULATE AND FOSTER THE GROWTH AND EXPANSION OF YOUNG PEOPLE IN AGRICULTURE, AS WELL AS SMALL BUSINESS AND INDUSTRY, ON THE OTHER HAND TO PLACE RESTRICTIVE AND UNNECESSARY BURDENS ON OTHER METHODS THAT HELP ACHIEVE THIS SAME GOAL. IN A TIME WHEN OUR ECONOMY IS FACING SERIOUS PROBLEMS, IT IS ALL THE MORE IMPORTANT THAT CITIZENS AND GOVERNMENT WORK TOGETHER IN SOLVING THE ISSUES AFFECTING US ALL.

WE SINCERELY HOPE YOU WILL CONSIDER THE IMPACT THESE RATES COULD HAVE SHOULD THEY BE ADOPTED. UPON SPECIAL CONSIDERATION OF THESE ISSUES WE FEEL YOU WILL AGREE THAT THIS MOVE IS UNNECESSARY AND DETRIMENTAL. IF YOU WISH ANY FURTHER INFORMATION OR COMMUNICATION, WE WILL BE HAPPY TO COMPLY.

THANK YOU FOR YOUR CONSIDERATION IN THIS MATTER.

SINCERELY,

CY CARPENTER, PRESIDENT

NORTH DAKOTA Farmers Union

Box 651 — Jamestown, North Dakota 58401 — Phone: 252-2340

October 22, 1980

Commissioner of Internal Revenue
Attention: CC:LR:T (LR-221-78)
Washington, D. C. 20224

Re: Proposed Regulations Under Sections 482 and 483 of Internal Revenue Code

Dear Sir:

The North Dakota Farmers Union is a general farm organization representing 32,866 farm families in North Dakota and also is a state division of the National Farmers Union which represents 255,284 farm families throughout the United States.

It is our belief that the Commissioner's proposal, found at Vol. 45 F.R. 57739 to 57744, to amend the regulations to increase the levels of imputed interest rates by three per cent (3%) in the computation of interest on certain deferred payments under Internal Revenue Code Section 483 will certainly increase the costs of acquiring land for farmers and will materially hinder the intra-family transfer of land from one generation to another.

A common method of transferring real estate in North Dakota, and probably in many other states, is by means of long-term deferred payment contracts between the transferor and transferee. This is especially true in the case of intra-family transfers; for example, between a father who is gradually phasing out of the operation and management of the family farm and a son who at the same time is gradually phasing into the operation and management of that same family farm. This sort of contract has advantages to both parties because it can be a source of retirement income to the parents and it allows the selling parent to take advantage of Internal Revenue Code Section 453. It gives the son the opportunity to spread payments over a period of time while he is getting his feet on the ground. It is also common because of the intra-family ties for the parent to make the property available to the son at the least possible cost that can be tolerated without the transfer being considered a partial gift.

Recognizing the widespread use of this property transfer device and in order to encourage transfers to beginning farmers, a North Dakota statute enacted in 1979 affecting the state's income tax structure, provides for a reduction in an individual taxpayer's gross income by the amount of interest income received on a deferred payment contract for sale of agricultural land to a "beginning farmer" where the annual interest rate stated in the contract is not more than six percent. N.D.C.C. 57-38-01.2 Subsection 1.m. (1979 S.L. Chpt. 604, Section 1.) The Commissioner's proposed regulation raising the imputed interest rate would effectively destroy this legislation and render it useless because it would force sellers to ask more than six percent interest.

The proposal to increase the imputed interest rate on such transactions would have the effect of allocating a greater portion of the total payment in such a transaction to interest and a proportionately lesser amount to a return of capital. This would practically force selling farmers in the intra-family situation described above to increase the selling price of the transferred property so that the sale will not be considered a sham transaction and result in a total or partial gift. This would have the ironic effect of causing a farmer to transfer property to his own family members at a higher selling price and interest rate than to someone outside the family because in an intra-family transaction the seller has no way to show that the bargain or contract terms were arrived at through an arm's length transaction. Such a result would discriminate against intra-family transfers and would have an inflationary effect on the acquisition and production costs of the purchasing farmer.

Consequently, we believe consideration should be given to the reality of the situation in the case of farmers or small businessmen who are selling to family members on long-term deferred payment contracts by permitting the difference in the sales price and interest due to the new proposed imputed interest rate and the actual contractual rate to be automatically offset by the $3,000.00 per individual annual gift tax exclusion to the extent such exclusion is available. Families qualifying for this application of the annual gift tax exclusion should have to meet the same requirements as families involved with estates that qualify for the "special use" valuation under Section 2032A of the Internal Revenue Code. This would be in accordance with the already recognized trend shown in the recent enactment of Sections 2032A, 6166 and 6166A to give consideration to farmers and small businessmen that are making such intra-family transfers of family farms or family businesses.

Furthermore, this organization has long advocated that the same tax advantages should be available to individuals as are available to corporate forms of businesses. In North Dakota, where corporations, except for certain cooperative kinds of corporations, are prohibited from engaging in the business of agriculture, our proposal would be a viable alternative to making transfers of corporate stock between family members within the $3,000.00 annual gift tax exclusion.

Sincerely yours,

NORTH DAKOTA FARMERS UNION

Stanley M. Moore
President

SMM:jet

cc Senator Milton R. Young, Washington, D. C.
Senator Quentin N. Burdick, Washington, D. C.
Representative Mark Andrews, Washington, D. C.
Governor Arthur A. Link, Bismarck, North Dakota
Agriculture Commissioner Myron Just, Bismarck, North Dakota
Cy Carpenter, President, Minnesota Farmers Union
Ruth Kobell, National Farmers Union, Washington, D. C.

Wisconsin Farmers Union

TESTIMONY OF DENNIS ROSEN OF EMERALD, WIS.,

A DIRECTOR OF THE WISCONSIN FARMERS UNION,

on

PROPOSED CHANGES IN IMPUTED INTEREST RATE REGULATIONS,

presented at

A PUBLIC HEARING CONDUCTED BY THE INTERNAL REVENUE SERVICE

in

WASHINGTON, D.C., JANUARY 8, 1981

As a young, beginning farmer I appreciate this opportunity to testify on the proposed increases in imputed interest rates. My wife and I operate a 320-acre dairy farm in northwestern Wisconsin which we purchased from my parents under a land contract in 1978.

We are fortunate that we received substantial help from my parents in acquiring a farm, but at the same time I want to emphasize how financially risky farming can be even under such circumstances.

A little over a year ago, I presented testimony at a hearing on farm structure conducted by U.S. Secretary of Agriculture Bob Bergland. Much of the testimony at those meetings was on problems of transferring a family farm from one generation to the next.

Young farmers, including myself, spoke on how difficult it was to obtain sufficient low-cost credit for an adequate farming operation. Now, with these proposed changes in imputed interest rates the IRS would make it much more difficult for young persons to acquire farms, especially under transactions within the family as in our case.

Congress is committed to encouraging the family farm system in this country; yet, the IRS, in my opinion, would weaken this commitment by imposing higher interest rates on loans between related parties.

Now, I would like to explain the type of financing it has taken to purchase the farm and keep it operating. We bought the farm from my parents under land contract for $160,000 or at $500 an acre. We also purchased some of the machinery and 50 milk cows which were on the farm for $50,000. The interest rate on the real estate is 6% and it is 7% on the personal property. These low interest rates have given us a better opportunity to succeed than is available to most beginning farmers.

However, in the spring of 1978 I still had to take the equity that I had in my cattle and machinery and go to the local bank and get an operating loan of $12,000 to purchase fertilizer and seed. I refinanced this loan in the spring of 1979 and again in 1980. The interest rate in 1978 was 9½%. In 1979, it was 12½% and the current rate is 14.5%. However, the borrowed funds for operating expenses now total $33,000 instead of the $12,000 in 1978.

In 1979, I decided I had to remodel the dairy barn. I talked to my banker about remodeling and he suggested that I try the Farmers Home Administration. We were able to get a Farmers Home Administration emergency loan for $50,500 at 9% interest. The loan is amortized over 40 years and is being paid off by a $400 per month milk check assignment.

The Farmers Home Administration payment is about 5 percent of the milk check. My parents receive 25 percent of the milk check for payment on the land contract and chattel mortgage. The bank receives 10 percent for the operating loan. This makes a total deduction from the milk check of about 40 percent. The Wisconsin Farm Management Association doesn't like to see milk check assignments go above 33 percent.

However, we have other debt obligations and I feel that we still must make other improvements. We put up a 5,000 bushel grain bin in 1979 and the $3,600 loan was financed through the Agricultural Stabilization and Conservation Service. We have 7 years to repay at 7% interest.

Looking at our total indebtedness, we are making interest and principal payments on loans totaling about $297,000.

The Wisconsin Department of Agriculture, Trade & Consumer Protection has computed that a real estate loan of $163,000, which is comparable to ours of $160,000, financed over 20 years at 6%, would require an annual payment of about $14,000. This corresponds closely to the size of payment we are making. At a 12% rate, an annual payment of nearly $22,000 would be required. It is my understanding that under the proposed IRS regulations a 12% interest rate would be imputed on loans between related parties if a rate between 11 and 13 percent were not charged. In our case, if such a regulation were retroactive to April 1978, my parents very likely would have been unable to transfer the family farm to my wife, Debbie, and me.

Inflation is a two-edged sword. It is keeping many family farms operating because inflated land prices make it possible for the farmer to go to the bank and keep getting more credit. But it is also driving family farmers much deeper into debt and becoming a greater and greater obstacle for young persons, wishing to enter farming, to overcome.

Recently, the Wisconsin legislature has been studying means for reducing the interest burden on farm ownership loans to beginning farmers. North Dakota and other states already have such laws on the books. Adoption of the IRS amendments would contradict public policy established by these states to help young farmers get started. Adoption of the amendments would also be contrary to long-standing national policy to preserve family farm agriculture.

In my own community I know of several farms which have been sold to corporations or other non-farmers instead of being transferred to family members. Also, I have noticed that more young farmers are renting because they are not in a financial position to consider farm ownership. It would seem to me that it would make much more sense for the federal government to tackle tax write-offs which encourage corporations and other non-farmers to buy farms than to propose changes in

[illegible]

Iowa Farmers Union

6538 University Ave. • Des Moines, Iowa 50311 • Phone 279-

January 6, 1981

Commissioner
Internal Revenue Service
Attention: CC:LR:T (LR-221-78)
Washington, D. C. 20224

Subject: Proposed Regulations Under Sections 482 and 483 of Internal Revenue Code

Dear Sir:

This letter is to express views on the proposed regulations as identified above. We share concerns similar to those expressed by North Dakota Farmers Union, Minnesota Farmers Union, and the National Farmers Union. The Iowa Farmers Union is also an affiliate of the National Farmers Union as are the other state organizations mentioned.

The high interest rates that are presently being enforced by the Federal Reserve Board have caused great hardship to operating family farmers in our state. The tight money has raised farmers' costs of doing business, has put pressure on commodity prices, and now it appears that the policy can raise havoc with the transfer of family farms.

We have not had proper time to research all of the statutes which determine the exact application of the rule change. From reports in the press, it has been indicated that the IRS did not intend to impact family farm transfers, but instead were looking for large exchanges of property that were being carried out at below market interest rates. This is understandable considering the nature of some of these transfers.

Iowa has begun a new young farmer loan program that will be based on the sale of bonds through the Iowa Housing Finance Authority. Although the program does not presently involve the transfer of farms through the postamic deed (commonly known as contract for deed), it is our intention to extend the law to cover such exchanges of property. With the current high interest rates, a large proportion of land being sold in the state is being handled through contract sales.

Raising the interest rate on contract sales between farmers would have two adverse effects. One, it would institutionalize ridiculously high interest rates that would have an immediate effect on sale of land to beginning farmers. It would force farmers selling land on contract to raise land prices which would further worsen the existing land tenure pattern in the state.

Raising the interest rate on contract sales between farmers would have two adverse effects. One, it would institutionalize ridiculously high interest rates that would have an immediate effect on sale of land to beginning farmers. It would force farmers selling land on contract to raise land prices which would further worsen the existing land tenure pattern in the state.

Because of a weak data base on land tenure, the Iowa Farmers Union, along with other farm groups, has been doing a study on land ownership in Iowa. The study has been done in local Agricultural Stabilization and Conservation offices, and in county courthouses. Some of the information that we have discovered is relevant to this proceeding.

Our first discovery, which has already been mentioned, is that a great deal of land is being sold on contract. There was no question that many sellers were taking advantage of installment capital gains because many sales were conducted at the 29 percent down, six percent interest terms. But an interesting divergence was also observed between family farmers and non-farm investors.

In Taylor County (the first where the study was done), it was discovered that sale of land between farmers was taking place at the lower level of interest, but that the terms were usually very different. The main difference was that down payments were considerably less than the 29 percent maximum.

The six percent/29 percent down criterion became important in identifying non-farm investors because nearly all of the contracts contained these identical clauses. It was apparent that some large industrial concerns in Illinois were using the contract as a tax avoidance tool.

The other factor that was observed was that most sales involving non-farm investors were taking place at higher prices per acre. This occurred for land of the same class, and location on sales in many cases. The impact was to drive up land prices on sales between farmers because much land was owned by absentee landlords, who demanded the highest price possible.

It was clear that selling investors were trading off lower interest rates for capital gains rates on the principal. So, we understand that the present regulations are a two-edged sword that can both help and hurt family agriculture.

Because of a weak data base on land tenure, the Iowa Farmers Union, along with other farm groups, has been doing a study on land ownership in Iowa. The study has been done in local Agricultural Stabilization and Conservation offices, and in county courthouses. Some of the information that we have discovered is relevant to this proceeding.

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It was clear that selling investors were trading off lower interest rates for capital gains rates on the principal. So, we understand that the present regulations are a two-edged sword that can both help and hurt family agriculture.

We respectfully request that land transfers between family members and those between retiring farmers and beginning farmers be exempted from the higher levels. However, we see no problem with the new rules where non-farm investors are involved. We believe that the IRS has the flexibility to close loopholes while still accomplishing the social good of preserving family farms.

Thank you for your consideration.

Sincerely,

Peter T. Croghan

Peter T. Croghan
President

PTC:sbg

Senator GRASSLEY. Thank you for that broadening view of the problem because we do need to be reminded of that.

I thank everybody who participated, Members of Congress, members of the committee, members of the various panels and the administration for your expert testimony and your willingness to work with us, particularly your patience while we went through an extended hearing.

Any followups or extension of remarks that any of you have would be appreciated, but most importantly, your availability to me, committee members and staff for further usage as resource would be appreciated.

Committee meeting adjourned.

[Hearing adjourned at 4:48 p.m.]

[By direction of the chairman the following communications were made a part of the hearing record:]

LAW OFFICES,
BROWN AND HUSS,
Miles City, Mont., May 13, 1981.

Representative RON MARLENEE,
House of Representatives, Washington, D.C.

DEAR REPRESENTATIVE MARLENEE: I am writing you in regard to the final regulations under Sections 482 and 483 of the Internal Revenue Code.

This is in regard to raising the imputed interest rate from 6 and 7 percent, respectively, to 9 and 10 percent, respectively.

We noted in a tax works that comments were to be submitted by May 11, 1981, to the following:

Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

We received this notice today so it is impossible to have our comments in by May 11, 1981. For this reason I am writing your office and I hope that our comments will be forwarded to the proper committee and you will do what you can in this regard.

This whole doctrine of imputed interest has raised havoc with the sale of ranches or small businesses to family members and even to third party buyers.

As you know, the livestock business is a peculiar business in that it gives a very small rate of return for the investment. This is also true in many small businesses in this area which are single proprietorships. The owners work many long hours for a very small return. When the owner wants to retire, the Internal Revenue Service now plans to tell him that he must charge 9 percent interest or be severely penalized under an installment sale. This imposition can make it impossible for a child to buy the family ranch and often times it would result in a sacrifice sale to a third party because of the high interest.

We realize that prime rate is around 17 percent at this time. However, ranches and small business transactions have never been near the prime rate and they have always sold from around 5 to 7 percent on the unpaid balance. This is the only way they can attract buyers to pay for the same. From the buyer's viewpoint, he cannot afford the overhead of 9 percent interest and still pay off a ranch or small business.

For example: if a ranch is sold for $300,000.00 deferred balance, at 6 percent over 20 years, then the annual amortized payment would be $26,157.00. If the interest was 9 percent, then the annual payment would be $32,865.00. This amounts to an extra payment by the Buyer of $134,160.00 over the full term of the contract, which is a 45 percent increase on the original $300,000.00 purchase price. In many cases this could mean that the owner cannot sell at a fair price.

In my 32 years in the practice of law in this area I have never had a case where there was an abuse of the interest rate or an attempt to avoid taxes by reducing the interest rate to an unreasonably low amount. I think the damage done by the Internal Revenue Service attempting to set interest rates far outweighs any additional tax revenue that they would receive.

I hope your office will do everything possible to let people sell their family business in the open market place without having the Internal Revenue Service interfering with the free market. If we do not stop them, then we are going to have another barrier on people trying to hold the family farm or family business together for their children.

Yours very truly,

BRUCE M. BROWN.

April 27 Record (1)

STATEMENT OF
AMERICAN BANKERS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT OF
THE INTERNAL REVENUE SERVICE
COMMITTEE ON FINANCE
UNITED STATES SENATE

MAY 11, 1981

The American Bankers Association (ABA) is a trade association composed of more than 13,100 banks - over 90% of the nation's full service banks. Approximately 4,000 of these banks are authorized to serve their customers as trustees and executors. ABA members have had long and important involvement with the federal estate and gift tax laws and have had many dealings with the Internal Revenue Service in the administrative and enforcement areas of these laws. We appreciate the opportunity to present our views on matters dealing with administration of the special use valuation law under section 2032A.

To begin with, we agree with the farm groups and others that many amendments are needed to section 2032A in order to improve its effectiveness and to make it more workable.

However, in view of the Subcommittee's present interest in learning about the administration of section 2032A by the Internal Revenue Service, we are limiting our comments to those areas pertaining to the implementation of the law.

We have consulted with many of our member banks and attorneys in farm states and we have concluded that the Internal Revenue Service is not administering the provisions of section 2032A uniformly throughout the country. There appears to be no agreement within the district offices as to what constitutes "material participation" or what is meant by "comparable land."

Examples of inconsisitent application of the "comparable land" provision abound. For instance, in at least one state the Service will not accept state school land leases--probably the best source of cash leases--even where it can be shown that the lease is reflective of market rental and not a subsidized, below market, rent. The IRS district office answered that they needed specific approval from Washington to accept school land leases. When the approval was finally obtained from Washington, the district office stated they would only agree that the lease qualified as "comparable" for the year in which the lease auction took place. The district office in that state is requiring separate leases for each of the five years involved. This is not the rule in other district offices.

In another instance a district office would not accept bushel leases as being equivalent to cash leases. Under a bushel lease arrangement the tenant simply agrees to deliver a fixed number of bushels per acre rather than a cash amount. Such bushel leases can be easily converted to cash by multiplying the agreed bushels times the market price at the date fixed in the lease or on the date of delivery.

Other examples of IRS's unreasonable denials include cases where cash rental land was deemed comparable in every way except one was irrigated and the other was not; where one had buildings and the other did not. As IRS is currently administering the law, for all practical purposes, "comparable" means "identical."

A major material participation problem in at least one state involves cases where the owner turned the land over to a farm manager or a member of the family to manage, but continued actual material participation. The district office presented the owners' signed statements when they had applied for social security, stating that they were no longer materially participating. These statements were signed prior to 1976 and before section 2032A was passed into law and material participation became an estate tax issue. The executors acknowledged that prior self-employment tax was owing, but the district office said the signed statement was conclusive proof there was no material participation, despite the fact that the facts clearly showed otherwise.

In that same state, the material participation problem has spilled over into the Service's administration of sections 6166 and 6166A which deal with installment payment of estate taxes over 15 and 10 years. These sections require that the decedent's interest be operated as a business, coupled with material participation if operated as a sole proprietorship. Again, the district office used the signed social security statement as conclusive evidence the decedent did not materially participate, although the facts clearly demonstrated that there was actual material participation by the decedent.

While our Association may disagree with the Internal Revenue Service as to many of their interpretations of the law and regulations, we feel the Service at a minimum should apply its interpretations consistently and uniformly. This is not being done presently, so far as we can ascertain.

We would also like to comment on specific provisions of the regulations issued under section 2032A which we do not believe are necessary or justified under the statute.

Section 2032A (a)(1)(b) requires that a written agreement be filed which is to be signed by each person in being who has an interest (whether or not in possession) in the special use of real property. The regulations interpret this requirement in a literal manner and also require the agreement to be filed with the estate tax return although that is not a requirement of the statute. In addition, the regulations require the consent agreement include designation of an agent for the parties to the consent agreement in their dealings with the Internal Revenue Service, and also require that trustees of trusts holding any interest in the property join in executing the consent agreement. Neither of these requirements are statutory. Treas. Regs. section 20.2032A-8(a)(3) and (c).

The regulations should be amended to delete these requirements. The regulations should adopt a "reasonable efforts" or "good faith" rule to cover the case where the consent of one or more persons is not obtained before the consent agreement is required to be filed. In some cases it is not possible to determine the necessary parties to the consent agreement before the return due date. Apparently, a good faith "mistake" in ascertaining the necessary parties means the use of section 2032A is invalidated. If the Treasury Department declines to amend its regulations, then section 2032A should be so amended.

It is our understanding that the Treasury Department continues to take the position that under section 2032A(e)(7) crop share leases cannot be converted to cash rental leases. While we will acknowledge that this position is possible under a literal reading of the law, it is our firm conviction that the law may also be interpreted to allow for crop share leases, and we do not believe that Congress could have intended otherwise. It makes little sense to require "cash rental" leases when under the trade or business ("qualified use") provision of 2032A (b)(2) a sole proprietor can only qualify for the special use of value law with "crop share" leases. Are we to assume Congress intended to permit qualification under the law only for land owners who are "farming" their land, rather than leasing it, at their death? Obviously, the Treasury Department wishes to so restrict the law, which we submit is without justification in view of the legislative history.

It is our further understanding that the Treasury Department has indicated its willingness to permit the conversion of crop share to cash rental shares if Congress will amend the law changing the denominator of the valuation formula under section 2032A(e)(7) - a proposal developed by the previous administration. We question the method of arriving at the denominator in the Treasury proposal and are unaware of any calculations prepared by Treasury showing the effect of such a change in the formula. However, we have conducted our own informal survey of nine farm states and find that the formula change proposed would result in special use valuations exceeding "market values" in at least two states with a decided trend in the same direction for the remaining states. We therefore oppose and urge rejection of the Treasury proposal, and also recommend amendment of the law to permit conversion of crop share leases into cash rent leases if Treasury will not amend the regulations.

We agree with the Treasury Department, as we understand their position, that discretionary income trusts should qualify for the "present interest" rule, so long as directed income trusts will continue to qualify, even though ultimate beneficiaries are unknown such as will be the case where the income beneficiary has a general power of appointment.

We are pleased to read in Treasury's statement that a passive rental by a decedent to a member of the decedent's family should not disqualify the property from special use valuation. We agree.

On the other hand, we fail to understand why Treasury believes it is necessary to narrow the definition of "family member." We are inclined to favor adding a "former spouse" to the definition to cover the case where the children of that marriage are too young to materially participate.

The Treasury, in its statement, suggested that "it may be appropriate to reexamine the availability of section 2032A where there is no use for the land other than farming in order to avoid many of the problems encountered with the statute." We have no idea what kind of problems they are speaking of unless they mean they wish to restrict the availability of the special valuation use provision to farms lying adjacent to development land. We would remind the Subcommittee that the legislative history (see for example General Explanation of the Tax Reform Act of 1976 by the Staff of the Joint Committee on Taxation, December 29, 1976) states that one of the purposes of 2032A was to eliminate speculative valuations of real property which do not bear a reasonable relation to its earning capacity. Moreover, in some states land usage results in significant differences in valuation for farming purposes, such as ranch and cattle grazing land versus crop land. Under prior law, it was not unknown for the Internal Revenue Service to maintain that grazing land should be valued as crop land as being the highest and best use. Is the Treasury suggesting we should return to these unfair practices?

In conclusion, while in general we support many of the proposals contained in the bills before the Senate Finance Committee to amend 2032A, most notably S.395 and S.858, our major concern, as stated in our testimony before the Estate and Gift Tax Subcommittee, with section 2032A has been and continues to be the valuation distinction that it creates between farms and other closely-held businesses. We believe such a distinction is unwarranted. That distinction would be broadened rather than narrowed through the removal of the $500,000 limitation on the decrease in value resulting from section 2032A. In 1976 and again in 1980 we suggested a means of creating the same type of estate tax relief for farms and other closely-held businesses. This would be accomplished by granting a partial forgiveness for estate tax deferred on the installment basis under section 6166. Not only would it simplify the law, but it would also provide for more uniform treatment in its implementation. ABA continues to believe that such an approach is the more desirable and the appropriate course of action.

The ABA appreciates having this opportunity to submit its comments for the record.

April 27 Recess

KRAHMER LAW OFFICES
204 LAKE AVENUE
FAIRMONT, MINNESOTA 56031
(507) 235-6631

BRUCE A. KRAHMER, ATTY.
FRED C. KRAHMER, ATTY.

FRED F. KRAHMER (1900-1964)

TRUMAN OFFICE:
TRUMAN, MN 56088
(507) 776-2811

May 8, 1981

TO THE SENATE FINANCE COMMITTEE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE RE: HEARINGS ON FINAL REGS UNDER SECTION 2032A:

Please, with my apology for not having in better form, are the following items which relate to the above matter:

1. Copy of letter of August 8, 1980, to Senator David Durenberger.
2. Copy of letter of October 2, 1980, from Senator Dave Durenberger.
3. Copy of letter of October 8, 1980, to The Honorable Rudy Boschwitz.
4. Copy of Internal Revenue Service National Office Technical Advise Memorandum dated October 31, 1980.
5. Copy of Memorandum of November 1, 1979, regarding the Louis Boehne Estate.
6. Copy of letter of November 21, 1980, to Roger Wachter of the Internal Revenue Service to which is attached an Affidavit.
7. Copy of letter of November 21, 1980, to Senator Rudy Boschwitz.
8. Copy of letter of November 21, 1980, to Senator Dave Durenberger.
9. Copy of Memorandum of December 29, 1980, regarding the Louis Boehne Estate.
10. Copy of letter of March 9, 1981, to Senator Durenberger.
11. Copy of letter of March 24, 1981, to Senator Durenberger.

The attached give a very comprehensive and detailed explanation of the unfairness and problems that will be and have been created by the cash rent disallowance even though the cash rent is to a member of the family. The attached correspondence explains in detail the reasoning and feelings regarding all of this.

Respectfully submitted,

Fred C. Krahmer
204 Lake Avenue
Fairmont, MN 56031
Phone (507) 235-6631

FCK:el

KRAHMER LAW OFFICES
[illegible] LAKE AVENUE
FAIRMONT, MINNESOTA 56031
(507) [illegible]

BRUCE A. KRAHMER, ATTY.
FRED C. KRAHMER, ATTY.

FRED P. KRAHMER ([illegible])

TRUMAN OFFICE:
TRUMAN, MN [illegible]
(507) 776-[illegible]

August 8, 1980

Senator Dave Durenberger
Senate Office Building
Washington, D.C. 20510

Dear Senator Durenberger:

Your previous interest in the problems that farmers have been experiencing with Internal Revenue Code Section 2032A, "Use Value", has been most appreciated, particularly as it related to the partial election. The Internal Revenue Service has now issued regulations interpreting Section 2032A and I understand that these regulations do allow partial elections.

However, these regulations contain a provision that perhaps is more troublesome and more burdensome and will create more problems for farmers than their former position on partial elections.

The new regulations provide that in order to qualify for the 2032A Use Value Election, it is not only necessary that a member of the family be actively farming the farm, but the Internal Revenue Service is taking the position that the decedent himself must have had some "at risk" interest in the farm. In other words, they are interpreting this to be some sort of a share rent interest that the decedent farmer must have had in his property. What this means is that a decedent who owns farmland and who is cash renting this farmland to his son and this son is actively farming the farm that this decedent's heirs will not be able to use the 2032A Use Value Election.

First, in my reading of the Internal Revenue Code, I cannot find anything that would so indicate that that should be a requirement.

Second, my previous discussions with the auditors have indicated to me that they felt that this would not be a problem and, in fact, were extremely surprised, and are still surprised, that this has been included in the regulations.

Third, I have not read the Committee Reports regarding Section 2032A, but it would seem to me that the purpose of Section 2032A was to provide a means for the farmer to be able to pass his farm onto his qualified heirs who are going to continue

Senator Dave Durenberger
August 8, 1980
Page 2

to actively farm the farm without the terrible burden of the Federal Estate Tax. It makes little sense to distinquish between that operation where the decedent was share renting his farm to his son and that where the decedent is cash renting his farm to the son. The purpose in either event should be to further the ease of passing this property onto the next generation, and the criteria for doing this should be met by having some member of the family actively farming the farm, and should not be further clouded by some sort of a requirement that there be a share rent arrangement between the owner and the qualified heir.

Fourth, the Internal Revenue Service has recently proposed also that it is necessary for us to have actual cash rent leases for which to make comparables in coming up with the numbers to value the property under Section 2032A. I have no objection with that although (because people do like their privacy) it is sometimes difficult to obtain the numbers. But, the Internal Revenue Service has also ruled that share rent leases cannot be used in determining the 2032A Use Value. Now, it strikes me that they have in a sense in the long run made it even more difficult for Section 2032A because they are saying that share rent leases must be used in order to qualify for Section 2032A, and in the long run there are going to, therefore, be fewer and fewer cash rent leases, and, therefore, fewer and fewer comparables with which to use to make the election under Section 2032A.

Here in southern Minnesota, and I would assume elsewhere in great numbers throughout the country, the situation of father cash renting to son who is farming the farm is used with a great deal of regularity. In fact, the share rent lease between father and son is the exception. Part of this arose, I believe, because of a position that the Social Security Department has taken in the past. They have stated that if father is farming the farm and desires to retire and still continue to live on the farm and rent the farm to son, in order for father to draw Social Security, they require that he cash rent the farm to the son. They feel that if he is share renting the farm to the son that he is still participating and, therefore, having earnings which will disqualify him from Social Security payments. Of course, this is an improper interpretation by the Social Security Department and we have argued with them about it at times, but, as a practical matter, we have advised our clients at times to make the cash rent lease to avoid the argument with the Social Security Department. Now, we are being caught in the backwash of that, in that the IRS is now saying that the share rent lease should have been used.

All of us here in southern Minnesota, and I am sure elsewhere in the country, would appreciate any efforts that you might have, if you feel in any way agreeable with this, to attempt to have these regulations changed, and if that is not possible, to clarify the matter by an amendment to the bill. As I indicated previously, unless I am not seeing the situation at all, I cannot for the life of me see any difference between the situation where farmer decedent cash rents his farm to son who is actively farming and decedent farmer who share rents his farm to the son who is actively farming.

Senator Dave Durenberger
August 8, 1980
Page 3

Very truly yours,

Fred C. Krahmer

FCK:el

United States Senate

COMMITTEE ON FINANCE

WASHINGTON, D.C. 20510

OCT [illegible]
KRAHMER L. O.

October 2, 1980

Mr. Fred C. Krahmer
Krahmer Law Offices
204 Lake Avenue
Fairmont, Minnesota 56031

Dear Fred:

Thank you for your letter expressing your concern about estate taxes, more specifically the regulations interpreting Section 2032A.

Your letter came across my desk today and I apologize for the delay in my response to you. A well-meaning staff member laid your letter aside.

I have co-sponsored S. 1984 which eliminates the material use provisions. Congress' intent is to allow the farmer to pass his farm on to his family more easily and S. 1984 makes this clear. Unfortunately, due to election year procedural difficulties, this and other good legislation is not being considered.

I appreciate your support of my efforts to ease both the burden and the technicalities of estate tax law. Let's stay in touch on this.

Sincerely,

Dave

Dave Durenberger
United States Senator

DD:wlg

OCT 8 1980

The Honorable Rudy Boschwitz
United States Senator
210 Bremer Building
419 N. Robert Street
St. Paul, Minnesota 55101

COPY

RECEIVED

OCT 14 1980

DIS...
INT. REV. S...

Dear Senator Boschwitz:

This is in further response to your communication of September 2, 1980, by which you forwarded correspondence from Mr. Fred C. Krahmer of Fairmont, Minnesota. Mr. Krahmer wrote to you concerning the definition of "qualified use" contained in final Treasury regulations under section 2032A of the Internal Revenue Code of 1954.

Section 2032A was added to the Code by section 2003 (a) of the Tax Reform Act of 1976. The report of the Conference Committee on that Act (at pages 609 and 610) summarizes the intent of the provision as follows:

> Under present law, the value of the property included in the gross estate of the decedent is its fair market value at the date of the decedent's death . . . . One of the most important factors in determining fair market value is the "highest and best" use to which property can be put.
>
> [The Act] provides that if certain conditions are met, the executor may elect to value qualified real property on the basis of such property's value in its current use rather than on the basis of its highest and best use.

Only that real property which is used in a "qualified use" is eligible for this special lower valuation. Section 2032A (b) (1) establishes this requirement. The requisite use must exist on the date of the decedent's death and for 5 years of the 8 year period preceding the death. Section 2032A (b) (2) defines qualified use as use in a trade or business. The report of the Conference Committee, previously cited (at page 528) elaborates on the meaning of qualified use as follows:

> Real property may qualify for special use valuation if it is located in the United States and if it is devoted to either (1) use as a farm for farming purposes or (2) use in a trade or business other than farming. In the case of either of these qualifying uses, the Congress intended that there must be a trade or business use. The mere passive rental of property will not qualify.

The final Treasury regulations about which Mr. Krahmer wrote adopt a definition of qualified use consistent with the statute and the legislative history. Regulation § 20.2032A-3 (b) (1) states as follows:

> Under section 2032A, the term trade or business applies only to an active business . . . . The mere passive rental of property will not qualify. The decedent must own an equity interest in the farming operation.

Absent an equity interest, the decedent can only be said to be passively leasing property. If the decedent owns an equity interest in the farm operation (i.e., receives a return on the land that is contingent on farm earnings), however, he is engaged in the trade or business of farming and is thereby using the property in a qualified use.

We appreciate your interest and that of Mr. Krahmer in this matter. As requested, the enclosure to your communication is returned herewith.

Sincerely yours,

(Signed) Robert A. Bley

Robert A. Bley
Director
Legislation and Regulations Division

Enclosure:
As stated

cc: Mr. John Dudycha, Estate Tax Group Manager, Internal Revenue Service, P.O. Box 3556, St. Paul, Minnesota 55165

Index No. 2032.40-

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

OCT 31 1980

District Director
St. Paul, Minnesota

COPY

Taxpayer's Name: [redacted]

Taxpayer's Address: [redacted]

Taxpayer's ID No.: [redacted]

Date of Death: [redacted]

Taxpayer Conference held: August 7, 1980

Issue:

Was the real property in question being used for a qualified use on the date of the decedent's death?

Facts:

The decedent owned a 230 acre farm in Minnesota at the time of her death. From 1968 until her death in 1978, the decedent leased her farm to a partnership for cash rent. The decedent reported this rental income on schedule E of her form 1040 for each year of the lease. The partnership to whom she leased the property consisted of five of the decedent's sons. The partnership materially participated in the production and management of the farm from 1968 until the decedent's death in 1978.

The decedent died testate on June 5, 1978. Her will directed that her representative pay debts, funeral expenses, expenses of administration and all inheritance or estate taxes. The residue of decedent's estate was left as follows: (a) 5% to The Society for the Propogation of the Faith, (b) 5% to The Jesuit Seminary Guild of Milwaukee Province, and (c) 90% to the decedent's children, share and share alike. At the time of her death, decedent had nine children.

District Director
St. Paul, Minnesota

The decedent's 230 acre farm was part of the residuary estate that was subject to probate. During the course of administration, the estate sold the 230 acre farm to two of the decedent's children for $345,000. Although the court has not yet entered the decree of distribution, it is expected that the decedent's children and the religious organizations will share in the proceeds of the sale.

The executor elected to value the property as provided by Internal Revenue Code section 2032A. The appraisal attached to the estate tax return valued the property at $356,000 as the fair market value on the date of death. The "special use" value of the farm as computed under section 2032A(e)(7) was listed to be $203,659.94.

In reporting the property under schedule A of the estate tax return, the executor valued 90% of the property at the special use value (90% of $203,659.94 = $183.293.95) and 10% at fair market value (10% of 356,500 = $35,650).

Applicable Law and Discussion:

Section 2032A provides that if certain conditions are met, an executor may elect to value farm or business property under a special use valuation, rather than at its fair market value based upon the property's highest and best use. For the special use valuation to apply, several requirements must be met.

Section 2032A(b) of the Code provides as follows:

> (b) Qualified real property.
>
> (1) IN GENERAL - For purposes of this section the term "qualified real property" means real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and which, on the date of the decedent's death, was being used for a qualified use, but only if-
>
> (A) 50 percent or more of the adjusted value of the gross estate consists of the adjusted value of real or personal property which-
>
> (i) on the date of the decedent's death was being used for a qualified use, and
>
> (ii) was acquired from or passed from the decedent to a qualified heir of the decedent.

District Director
St. Paul, Minnesota

(B) 25 percent or more of the adjusted value of the gross estate consists of the adjusted value of real property which meets the requirements of subparagraphs (A)(ii) and (C),

(C) during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which-

(i) such real property was owned by the decedent or a member of the decedent's family and used for a qualified use, and

(ii) there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business, and

(D) such real property is designated in the agreement referred to in subsection (d)(2).

(2) QUALIFIED USE.-For purposes of this section, the term "qualified use" means the devotion of the property to any of the following:

(A) use as a farm for farming purposes, or

(B) use in a trade or business other than the trade or business of farming.

Section 20.2032A-3(b)(1) of the Estate Tax Regulations provides that real property valued under section 2032A must pass from the decedent to a qualified heir or be acquired from the decedent by a qualified heir. The regulation provides that the real property may be owned directly or indirectly but all specially valued property must be used in a trade or business. The regulation goes on to state that ". . .[U]nder section 2032A, the term trade or business applies only to an active business such as manufacturing, mercantile, or service enterprise or to the raising of agricultural or horticultural commodities, as distinguished from passive investment activities. The mere passive rental of property will not qualify." At a minimum the decedent must in some way be at risk in the farming operation before he is engaged in a trade or business.

District Director
St. Paul, Minnesota

This "active business" component of qualified use is determined independently of any personal involvement in the business operation by the decedent or members of his family. Material participation and qualified use are separate criteria. Personal involvement determines whether the material participation requirements of section 2032A(b)(1)(C)(ii) and (c)(7)(B) are satisfied, not whether the property is used in a qualified use.

The decedent in this case net leased her property to a partnership in which she had no interest. Accordingly, the decedent did not use the property in a trade or business, but rather, used the property for passive investment activities.

Since the regulations require that, at the minimum, the decedent must in some way be at risk in the farming operation, the decedent fails to meet the requirement that she was using the property for a qualified use at date of death.

Because the decedent was not using the property for a qualified use on the date of death, the estate does not qualify for a special use valuation under section 2032A. However, the question has been raised as to whether all beneficiaries of the farm property must be "qualified heirs" in order for the estate to qualify for special valuation. Section 20.2032A-8(a)(2) of the Estate Tax Regulations explains that if joint or undivided interests such as tenancies in common or joint tenancies are received from the decedent by qualified heirs, an election with respect to one need not include any other heir's interest so long as the percentage tests are met. However, if sucessive interests such as life estates and remainders are received from the decedent, an election is available only when all of the heirs' interests are included. It is unneccessary to consider the related question as to whether the real property for which special use valuation was elected was acquired from or passed from the decedent to a qualified heir of the decedent.

Conclusion:

Because the decedent was net leasing the property to her sons and was not in an equity position with relation to the operation of the farm, the property was not being used for a qualified use on the date of the decedent's death.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

-END-

COPY

KRAHMER & KRAHMER

Memorandum

November 1, 1979
(Date)

FROM: Bruce A. Krahmer

Re: Louis Boehne Estate

File: 77328

SUBJECT:

___ Book
___ Bruce
___ Fred
___ Glenn
___ Steve
___ Wilberta
___ Helen
___ Arlys
___ Jo
___ Eileen
___ Janet
___ Mary Pat
___ Sharon
X File 7732

Roger Wachter, the IRS estate tax auditor, called me and we talked on the phone for approximately 45 minutes regarding the issue of special use value. With regard to the discussion in this case, as well as previous discussions with auditors and information available to us, it appears the IRS is being very hard nosed in attempting to minimize the number of estates which can qualify for special use value. It is not the opinion of the specific auditors involved, but the general departmental policy which seems to be involved.

Mr. Wachter indicated that he had conferred with counsel in Washington, DC, that had drafted the statute with regard to the intent of the language about special use value. We qualify for the 50% and 25% tests under 2032A only if we take all of the property involved. It is the IRS counsel's position that 2032A(b)(1)(D) is broad enough that unless we elect with regard to the specific parcel, it does not qualify under the preceding subparagraphs as part of the property for the 50% and 25% tests. I pursued the concept which I had expressed in my letter to Mr. Wachter, but hit a brick wall in this respect. Mr. Wachter does not feel it is within his authority to make such a decision. He indicated they could request a technical advice ruling from the national office, but considering his previous discussion with them, it would probably not be favorable to us. If they did request such technical advice, they would be bound by it, including their appellate division. Our only recourse, as a practical matter, would be to go to Federal District Court on the issue.

A Revenue Ruling would probably take about a year, and probably their department would not allow the file to lie dormant for that long. It probably will be several months at the minimum before final regulations are issued pertaining to the Statutes involved. Whether or not the final regulations will address themselves to the issue is highly unclear at this point.

Memorandum re Louis Boehne Estate
November 1, 1979
Page 2

Mr. Wachter indicated that departmental policy appears to be negative towards these items. They apparently feel that Congress went too far in the concept, and are trying to minimize the tax effect of the laws involved. Mr. Wachter indicated that previously the IRS had issued rulings to the effect that if there is no cash rental comparable land available in the area, then they could look to share rental for comparable values. They have now rescinded that concept, and take the position that if there is no comparable cash rental transactions involved in the local area, that the property cannot possibly qualify for the special use values.

As the matter was left, it is up to me to do some further research and consideration regarding additional authority for my interpretation, or to consider the possibility of special use on the entire parcel, etc.. I also will be getting more information to him regarding comparable rental transactions. Their oldest information on comparable rentals goes back only to 1975, and again as a matter of departmental policy they must have some comparable citations for their file, even if they do not disagree with the numbers we have put on the Tax Return itself.

Mr. Wachter indicated it did not appear there were any other issues involved on this Estate Tax Return.

November 1, 1979.

Bruce A. Krahmer

cc: Vernon Boehne

Note: Reminder made for 12/1/79 if I haven't gotten back to the auditor prior to that time.

KRAHMER LAW OFFICES
904 LAKE AVENUE
FAIRMONT, MINNESOTA 56031
(507) 235-6631

BRUCE A. KRAHMER ATTY.
FRED C. KRAHMER ATTY.

FRED P. KRAHMER (1909-1964)

TRUMAN OFFICE:
TRUMAN, MN 56088
(507) 776-2211

COPY

November 21, 1980

Mr. Roger C. Wachter
Internal Revenue Service
Department of the Treasury
316 N. Robert Street
St. Paul, MN 55101

Re: Estate of Louis F. Boehne
Our File No. 77328-A
Date of Death: November 11, 1977

Dear Mr. Wachter:

With regard to this estate, enclosed herewith is an Affidavit by Mr. Boehne, summarizing and clarifying some of the additional facts pertaining to the issue of Special Use Value and use for qualified use at date of death. It is our position that this property, as elected, does qualify for the qualified use, and we therefore qualify for the Special Use Election. We do not have full access to all of the committee reports and other documents which you have, but it is our understanding and interpretation of the Internal Revenue Code, that the general purpose of Section 2032A was intended to be applicable to help the family farm carry on in spite of highly inflated selling prices of farm property. The citizens of Minnesota live in the real world and are unable to consult their tax attorneys under each transaction, and we anticipate that Congress was aware of this when they passed some of these laws. We presume that the Boehne family, to the extent that Vernon is carrying on the farm operation, is the type of family that Congress intended to benefit. During all of the times in question, this farm was in fact being operated by the family, Vernon Boehne, the son who now owns the entire farm. It was being used for a qualified use, but we understand that you interpret this as not qualifying because the qualifying use was by Vernon, not by Louis Boehne on November 11, 1977.

In interpreting Section 2032A(b), (1), it is my understanding that our differences in interpretation of the law would relate to the portions of the statute quoted hereafter which I have underlined:

Section 2032A -

"(b) Qualified Real Property -

(1) In General. - For purposes of this section, the term, "qualified real property" means real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent to a qualified heir of the decedent and which, <u>on the date of the decedent's death</u>, <u>was being used for a qualified use</u>, but only if -

(A) 50 percent or more of the adjusted value of the gross estate estate consists of the adjusted value of real or personal property which -

(i) on the date of the decedent's death, was being used for a qualified use, and
(ii) was acquired from or passed from the decedent to a qualified heir of the decedent.
(B) 25 percent or more of the adjusted value of the gross estate consists of the adjusted value of real property which meets the requirements of subparagraphs (A)(ii) and (C).
(C) during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which-
(i) such real property was owned by the decedent or a member of the decedent's family and used for a qualified use, and
(ii) there was material participation by the decedent or a member of the decedent's family in the operation of the farm or other business, and
(D) such real property is designated in the agreement referred to in subsection (d)(2)."

Looking at that section in its entirety, it appeared that Congress provided that the decedent did not have to be actively involved at all times, but that five out of eight years was enough for holding the property, and that there must be material participation by the decedent or by a member of his family. I interpret the law, in particular the portions that I have underlined, as requiring that the property be used for a qualified use at the date of death, but not specifying that the qualified use be specifically by the decedent, but only that it be a qualified use by the decedent, or a member of his family, as appears to be the general context of the entire Section 2032A. We believe that this is the correct and proper interpretation of the Code, and if the regulations or interpretations of the regulations are different, they are the ones which are erroneous.

Until the new regulations were issued in July of 1980, none of the auditors we had been working with on examinations of this type had ever raised the issue or indicated a possible concern on this particular point. Enclosed is a photo copy of an article from the September 20, 1980 issue of the Minnesota Farmer, which indicated that the father could safely rent the farm to his son on a cash rent basis. This was published after the new regulations had been issued, and is similar to other articles that have been published in previous times, and is not inconsistent with what the IRS auditors had believed the rules were. Reflecting on the overall situation of the law, it is obvious that Congress intended this law to be applicable to the small farmer, and in fact restricted the benefits to a maximum reduction of $500,000. In the instant case we are asking for the special use value to be applied to approximately 41% of the 146 acre farm for a reduction in the state tax value of approximately $79,462, and a reduction of Federal Estate Taxes of approximately $25,400.

KRAHMER & KRAHMER

Page 2
Mr. Roger C. Wachter
Internal Revenue Service
November 21, 1980

We do not believe that Congress, at the time they passed the law, or even now, expects such small taxpayers as Mr. Boehne, in his old age, to have a fleet of Washington lawyers to interpret the law and keep him fully versed on every small bit of fine print that may be applicable. Congress intended this law to apply to the little guy, and they intended that it apply to the Boehnes, and as written, it does apply to the Boehnes. We request that you reconsider your interpretation of the regulations, and the facts as they exist in this case, and adjust your proposed audit report accordingly.

With respect to any increases in taxes which may result as a result of adjustments from this audit, election is hereby requested to avail the estate of the benefits of Sec. 6166 of the Internal Revenue Code to the maximum extent applicable.

Very truly yours,

KRAHMER LAW OFFICE

By:

BAK:mpn

Enclosures

COPY

STATE OF MINNESOTA)
ss
COUNTY OF MARTIN)

AFFIDAVIT

I, VERNON W. BOEHNE, being first duly sworn do hereby declare that I am making this affidavit in support of a deduction under Section 2032A of the Internal Revenue Code for Special Use Value of certain farm property in the Estate of my father, Louis F. Boehne, who died November 11, 1977, a resident of Martin County, Minnesota. The issue involved to which this affidavit is directed relates to an issue whether or not the subject property was being used for "qualified use" at the proper times, as required by the Internal Revenue Code. There appears to be no issue as to whether proper percentages, etc. apply, but only a question of proper use at proper times.

My father owned 146.5 farm, including his farm building site which were approximately seventy years old at the time of his death, having a value of $265,000 total. The estate also included personal property of approximately $71,000, making a $336,000 total estate. My mother is deceased and my father was not survived by a surviving spouse. Besides myself, my father had two daughters, neither of whom live in Minnesota near my father's home.

Since 1950 I have worked with my father in operating the property, as well as other property of my own. Since 1965 I was renting my father's farm under a 1965 written share rent lease, under which he received one/half of all of the crops, and paid for one/half of the spraying, trucking, fertilizer, seed, and other expenses, but under which my father was not required to perform any physical labor. We carried on under that lease extended from time to time orally through the 1976 crop season, and were planning to operate the 1977 crop season that way. In October of 1976 my father paid $694.00 for his share of fertilizer applied in the fall of that year. In March of 1977 he paid another $249.00 for his share of fertilizer applied at that time. In April of 1977, he suffered from a light stroke, and was hospitalized. Four days later, while in the hospital, he suffered a severe stroke and was completely incapacitated, being unable to walk, talk, or even feed himself. In late April or early May of 1977 he no longer required hospital care, but was unable to care for himself. He was transferred from the Fairmont Community Hospital, to the east wing of the hospital, which essentially is a nursing home type of facility. Applications were made for other nursing homes as well, inasmuch as it appeared that he would require nursing care for an extended period of time, perhaps for the rest of his lifetime. When he was transferred to the nursing home, small amounts of communication were possible, he could nod his head, for example, but he could not speak, and was unable to participate in any business decisions.

Myself and my two sisters met and discussed my father's overall financial situation, including the need for additional cash flow to cover the additional expenses, and also the potential concern of the family that I was the only family member at home who would have to take care of my father's affairs, but I was also the tenant with whom he was negotiating and dealing. This appears to be an inappropriate situation, and by agreement between myself and my two sisters, without ever having any conference with my father, who was unable to participate in such matters, a written farm lease on my father's farm was worked out for 1977, for $9,520 rent for the one season, being $793 payable monthly each month, starting June 1, 1977. It was further agreed that I would reimburse my father for the fall fertilizer he had previously paid for, being an amount of $943.

During the 1977 season I proceeded to operate my father's farm as in the past, paying all of the expenses myself, and paying a monthly rent as had been agreed, so cash flow was available to pay the nursing home bills. On November 11, 1977, my father died, never having been discharged from the nursing home facility. I had not ever advised him, and to the best of my knowledge no one had been able to advise him that he was no longer share renting the farm to me, but was receiving cash rent.

In calendar year 1977, according to information from my father's income tax return, he had received $10,920. from the sale of his share of corn and beans, and $4,760 from cash rent. He had paid $249 of fertilizer, for which he had not yet been reimbursed, $1,230 for taxes for the 1976 season paid in 1977, and miscellaneous other small farm expenses. He also had depreciation on his farm buildings and miscellaneous old farm equipment. As shown on the inventory of the estate, at the time of his death, my father still had 1,100 bushels of 1974 corn on hand valued at $3,491, and 1,200 bushels of 1976 beans valued at $3,276, which had been grown under the share rent lease, and also $4,400 of old farm machinery on hand. At the time of his death, the 1977 crop had been fully harvested, so that even if my father had had a share rent arrangement that year, there was no risk of production remaining at the moment of his death, his share of the production would have been in the bins, or sold, if he had been on share rent.

My father's will provided that I should have an option to buy out my sisters at a price not to exceed $1,600 per acre, and this was worked out between me and my sisters and accomplished. When the estate tax return was originally filed, the matter of Special Use Value under Section 2032A, was considered, and an election was made to claim the special use value only on my share of the farm. My sisters did not want to claim special use value since they were disposing of their property and would have had the recapture tax, and would have had a further problem of substantially increased income taxes resulting from a lower basis if the special use value had been used on their share of the farm. Substantial delays resulted in the estate tax audit when it was first reviewed because the Internal Revenue Service was taking the position, subsequently dropped, that we, if we elected special use value, had to elect it on all of the farm property, or none of it. We only wanted to elect it on my share.

In July of 1980 when the IRS dropped the issue of all or none, they raised a new issue and stated that I did not qualify for special use value because I was cash renting from my father at date of death.

After my father's death, I reimbursed his estate $943 for 1977 fertilizer he had paid in anticipation of being a share rent landlord, and also $3,966 being the balance of the 1977 cash rent which I owed, in accordance with the agreement I had worked out between myself and my sisters, but which my father had never participated in and did not know about.

Further affiant saith not.

Dated this 20th day of November, 1980.

Vernon W. Boehne
Vernon W. Boehne

Subscribed and sworn to before me
this 21st day of November, 1980

Arlys M. Halverson
, Notary Public

ARLYS M. HALVERSON
NOTARY PUBLIC - MINNESOTA
MARTIN COUNTY
My Commission Expires May 27, 1987

COPY

November 21, 1980

Senator Rudy Boschwitz,
Senate Office Building
Washington, D.C. 20510

Attention: Lillian Saunder

Dear Madam:

You have had several recent conversations with my partner, Fred C. Krahmer, regarding Section 2032A Special Use Values. As my partner has indicated to you, the problems are not remote and isolated, but are and will continue to be occurring quite frequently here in Southern Minnesota. Enclosed is a specific example of another farm problem which my partner has not brought to your attention. My letter directed to Roger Wachter, IRS Auditor, as well as Mr. Boehne's affidavit should be fairly self explanatory. We have this issue after having gone through previous issues with the auditor of having to elect 100% or none, which they have subsequently conceded, and also with the issue of having to find specific comparable cash rent leases, including a cash rent lease which includes the farm building site if we wish that portion to qualify. That issue has become immaterial in the instant case, but again it is alot of red tape attempting to circumvent the intent which Congress had when it passed the law.

We believe the present interpretation of the law prohibiting cash rent at date of death was not Congress' intention, and we hope that you can do something to clarify this by correcting the law.

I am also enclosing herewith a copy of Internal Revenue Service Technical Advice Memorandum dated October 31, 1980 index No. 2032.40-00, which I received from Mr. Wachter on November 20th as an indication of the Revenue Service's position. As shown on the last page, the Revenue Service's position is that we cannot qualify for special use value if the decedent at the moment of death was cash renting to his son.

We hope that some corrected legislation can be forthcoming. In the instant case of the Boehne Estate, Mr. Wachter is under orders to get this matter completed at his level of the audit stage, by the end of December, 1980. Corrective legislation two years in the future will not do this particular family, and many other families, much good. We hope that something will be forthcoming yet this session of congress.

Very truly yours,

KRAHMER LAW OFFICE

By:

BAK:mpn
Enc.

KRAHMER LAW OFFICES
904 LAKE AVENUE
FAIRMONT, MINNESOTA 56031
(507) 235-6631

BRUCE A. KRAHMER ATTY.
FRED C. KRAHMER ATTY.

FRED P. KRAHMER (1900-1964)

TRUMAN OFFICE:
TRUMAN, MN 56088
(507) 776-2311

November 21, 1980

COPY

Senator Dave Durenberger,
Senate Office Building
Washington, D. C. 20510

Dear Mr. Durenberger:

I am writing to you to request assistance in our present problems involving Section 2032A of the Internal Revenue Code, as it relates particularly to the Louis F. Boehne family, and to other southern Minnesota farm families. I talked to you briefly about the problems of Section 2032A at Sylvania Park this summer, but did not follow up in writing with my concerns at that time because the IRS was in the process of issuing new regulations which we believed were solving the problems we were then experiencing. However, these new regulations which eliminated the problem of electing 100% of the farm or none have now created a new problem of providing that cash rent from father to son at date of death does not qualify for special use valuation.

Enclosed herewith are several items pertaining to the Louis F. Boehne Estate which I believe is a typical example of the type of problems we now have and will continue to have. I believe my partner, Fred C. Krahmer, has also contacted you with regard to similar clients, other than the one I am writing about. We would hope that some corrected legislation can be done to cure this new problem about cash renting from father to son, under this relief legislation. We do not believe that Congress intended that a farmer should be prohibited from retiring in order to take advantage of this relief legislation. That is essentially the position of the IRS. We hope that action can occur in the near future. In the Boehne Estate the statute of limitations will be running out shortly. The auditor is delaying his audit report shortly, but must complete it before the end of December, 1980.

We would appreciate any action that can be done on this, and would also appreciate any advice you may have on the probabilities of corrective legislation.

Very truly yours,

KRAHMER LAW OFFICE

By:

BAK:mpn
Enc.

KRAHMER & KRAHMER

*M E M O R A N D U M

COPY

December 29, 1980

Re: Louis Boehne Estate

Subject: Section 2032A - Special Use Values and Cash Rents

This morning I received a telephone call from Roger Wachter, Internal Revenue Service Auditor, on this file. He indicated that if we are willing to enter into an agreed stipulation on the case at this time, he will accept Loren Aistrope's appraisal of the market value of the property, even though he feels that it was conservative for selling prices at the time, and that he will also accept our calculations for cash rental value, even though again based on their statistics, he feels my numbers are conservative. If the value of the farm was adjusted to $2,000.00 per acre, instead of approximately $1,800.00 as shown on the original return, the estate taxes would be about $33,000.00, instead of $25,000.00. The only disputed item would be the legal issue of whether cash rent qualifies for special use value. If we agree with these adjustments we would then have to pay the tax, and file a claim for refund or sue for a refund for the $25,000.00 plus dollars.

Alternatively, we can continue to dispute the claim, in which case, Mr. Wachter will have to review with his supervisors or other adjustments would have to be made in his report regarding values, etc. We would then have the opportunity, however, of litigating the question of cash rents in the tax court and getting the issue decided before we have to pay the tax. If we pay the tax and sue for a refund, the lawsuit if tried, would be in the Federal District Court, a completely different court system from the tax court.

My preliminary concept is that the District Court would be more favorable to us than the tax court would be, which we feel probably would be much more sympathetic to the Internal Revenue Service's interpretation of the law.

On this date, December 29th, 1980, I personally talked with Tom Hagedorn about the matter while he was in Fairmont. He indicated he expected a correction to be made with regard to this cash rental problem in an omnibus tax bill which he would anticipate will not be passed until about May of 1981. In the meantime we need to come up with a delay or holding tactic if we wish to not be paying the tax now.

This afternoon I talked to Lillian Saunders in Senator Boschwitz' office by telephone in Washington. She indicated that their amendment regarding this matter passed both the House and the Senate in their tax bills in December, but that the conference committee threw it out the last night. I understand the reason it was thrown out was not because they disliked this particular amendment, but that it is part of the compromise on pay raises for congress, all amendments to the particular bill were thrown out in order to get anything passed at all.

KRAHMER & KRAHMER

M E M O R A N D U M

RE: Louis F. Boehne Estate
Page 2 December 29, 1980

She indicated that they also expect something to be passed by Congress to correct this problem for the benefit of the farmers. She indicated that they had requested the IRS to delay action on issues of this matter since it appeared apparent that Congress will do something, with both Houses having been in agreement in principal on making such a correction. She indicated that she understood that the IRS had actively opposed the amendment, but ultimately dropped the opposition when it appeared to be a hopeless cause. Whether the IRS will delay actions as they had re quested, she did not know. She will make a specific inquiry with the IRS regarding the possibility of such delays and get back to me within the next day or so.

The status of my phone conversation with Mr. Wachter was that I was going to confer with Mr. Boehne regarding our decision of alternatives of paying the tax and writing it up on a settled basis, or disputing it at the audit level and taking the issue to tax court. I suppose another alternative is to drop the issue all together, but it would appear that we can see the light at the end of the tunnel with Congress on our side.

My recommendation is that to the extent that we cannot delay further, we enter into a settled agreement with regard to the IRS on the facts and pay the taxes, if necessary, followed by a claim for refund or lawsuit depending on what congress does. I am requesting that Mr. Boehne advise me of his thoughts on this so that I can report back to Mr. Wachter.

Bruce A. Krahmer

BAKmpn

cc: Vernon Boehne
R. F. D.
Ceylong, MN. 56121

Internal Revenue S /ice

Department the Treasury

Washington, DC 20224

Person to Contact:
L. A. Dunn

Telephone Number:
(202) 566-6512

Refer Reply to:
T:I:EG:1-KGA

Date:

9 MAR 1981

The Honorable Dave Durenberger
c/o Mrs. Julia M. Cherry
100 North 6th Street
Suite 550, East
Minneapolis, MN 55403

Dear Senator Durenberger:

This is in response to your communication dated February 6, 1981, by which you forwarded correspondence from Mr. Bruce A. Krahmer of Fairmont, Minnesota. Mr. Krahmer wrote to you concerning the definition of "qualified use" contained in the final treasury regulations under section 2032A of the Internal Revenue Code.

Section 2032A was added to the Code by the Tax Reform Act of 1976. Section 2032A provides that if certain conditions are met, the executor may elect to value qualified real property on the basis of such property's value at its current use rather than its fair market value.

Only property that is used for a qualified use is eligible for special use valuation. 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. The legislative history (H.R. Rep. 94-1380) indicates that the trade or business in which the qualified property is used must be the owner's trade or business.

The Estate Tax Regulations in section 20.2032A-3(b)(1) adopt a position consistent with this legislative history. The regulation states that "under section 2032A, the term trade or business applies only to an active business such as a manufacturing, mercantile or service enterprise, or to the raising of agricultural or horticultural commodities as distinguished from passive investment activities. The mere passive rental of property will not qualify. The decedent must own an equity interest in the farm operation." Therefore, property which is leased by the decedent for an amount of rent that is not contingent upon production, even if the lease is to a member of the decedent's family, is not normally considered to be used in a qualified use since the mere passive rental of property is not a trade or business use. At a minimum, the decedent must in some way be at risk (i.e., have an "equity interest") in the farming operation before he or she can be considered to be engaged in a trade or business. See General Explanation of

The Honorable Dave Durenberger

the Tax Reform Act of 1976 prepared by the Joint Committee on Taxation, page 538.

The "active business" and "at risk" requirements of a qualified use are determined independently of any personal involvement in the business operation by the decedent or members of his family. That involvement addresses another statutory requirement that the decedent or a member of his family materially participate in the operation of the farm business for certain specified periods. Activities of family members are by statute considered only for purposes of satisfying the material participation requirements. Therefore, even though the decedent's son operated the farm before his father died, the qualified use test is not satisfied unless Louis Boehne, the owner of the property, had an equity interest in the farming operation.

We appreciate your interest and that of Mr. Krahmer in this matter.

Sincerely yours,

Raymond G. Veltri
Chief, Estate and Gift
Tax Branch

COPY

March 24, 1981

The Honorable Dave Durenberger
United States Senator
Committee on Finance
Washington, DC 20510

Re: Louis F. Boehne Estate
Our File 77328

Dear Senator Durenberger:

Thank you for forwarding the correspondence on March 17th that you received from the IRS about the Louis Boehne Estate.

I feel that you can be of further assistance to the Boehne family, and to many other farm families in Minnesota and throughout the country if you will assist Senator Boschwitz and Representative Hagedorn and other members of the Congress to get the law clarified and changed on the point at issue regarding Section 2032A.

The IRS stated to you that their position is that the estate cannot qualify because the decedent was cash renting the farm, even though it was cash rented to his son who is actively operating it. Section 2032A was added as a relief provision to help family farming operations to be passed from one generation to another. Under the interpretation which is being applied to it, this can effectively be accomplished only if the father dies before reaching retirement time. The present interpretation is preventing fathers from shifting from an active participation to a passive participation in the farming operation, letting the younger generation take the risk. Although it is supposed to be theoretically possible, they have to walk a tight rope, under the IRS interpretation, on a share rent basis, being certain that they have enough participation to qualify under Section 2032A to qualify for special use when they die, but not having so much participation that they are "materially participating" for purposes of social security earnings tests, whereby until age 72 they would lose their monthly social security checks.

We hope that you will pursue the matter, rather than just drop the matter after having forwarded the correspondence to me, so that this inequity in interpretation which the IRS has applied can be corrected.

Very truly yours,
KRAHMER LAW OFFICES

Bruce A. Krahmer

BAK:ah

cc: Vernon Boehne
Enc.: Copy of correspondence

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