

THE MATERIAL PARTICIPATION STANDARD: AN ANALYSIS OF ITS RELEVANCE IN TAX PLANNING FOR FARMERS

INTRODUCTION

In the minds of certain administrators and legislative draftsmen, there exists a carefully chiseled concept which has far reaching ramifications in the areas of social security law and estate taxation. This concept is broadly described as "material participation" in the social security regulations and the tax code. One who is found to be materially participating in his farming operation or other business venture opens the door to a special status in the law. A host of obligations and benefits follows this elusive status. And elusive it is, for the minds of the tax administrators and the legislative draftsmen are not freely accessible to the tax and business planner. We must therefore seek to glean glimpses of their creation in more indirect ways.

Thus, it is the purpose of this comment to describe some of the various scenarios where the idea of material participation plays a part in our law, with particular emphasis on its application to federal estate taxation of farming operations. The astute business planner will be trying either to avoid this special status and its attendant obligations, or to court its protective sanctum and qualify for several benefits. In either case, it is important to have an accurate idea of what material participation means. Therefore, this comment is also designed to define the concept of material participation.

DESCRIBING THE SCENARIOS

Before delving into an analysis of what it means to be a material participant, it is helpful to take a brief look at three situations in which this concept plays an important role. The first area deals with liability under the self-employment tax provisions.¹ These are the pivotal provisions for understanding material participation since the other code sections which use this term rely, at least in part, on the definition which the courts and the Internal Revenue Service (IRS) have developed over the years in the self-employment tax context.² The other two scenarios involve relatively recent additions to the law of federal estate taxation: the valuation

1. I.R.C. §§ 1401-1402.

2. See I.R.C. §§ 2040(c)(7), 2032A(e)(6).

of jointly held interests³ and the special use valuation provisions for farms and closely held businesses.⁴

SELF-EMPLOYMENT INCOME

The self-employed person becomes liable for self-employment tax under sections 1401 and 1402 of the Internal Revenue Code.⁵ The taxes imposed by these sections are meant to provide a fund for those whose income is subject to changes due to advancing age, disability and death.⁶ For example, to be eligible for the benefits of social security, a self-employed person must contribute to this fund.⁷ The subject of the tax is the "net earnings from self-employment" as defined in the regulations.⁸ These earnings include net earnings derived by an individual from any trade or business carried on by such individual or by any partnership of which he is a member.⁹

Specifically excluded from self-employment income is rental income.¹⁰ An exception from this general exclusion of rental income has been created for farm rental income where the owner materially participates in the management or production of agricultural commodities.¹¹ Since the rental income in these instances depends upon the activity of the landowner, the income is taxed under section 1402(a)¹² and the material participant is later able to

3. I.R.C. § 2040(c).

4. I.R.C. § 2032A.

5. I.R.C. §§ 1401-1402; Normand, *Special Use Valuation of Farmland for Estate Tax Purposes: Arrangements for Material Participation*, 30 BAYLOR L. REV. 245, 250 (1978).

6. Note, *Material Participation and the Valuation of Farm Land for Estate Tax Purposes Under the Tax Reform Act of 1976*, 66 KENTUCKY L.J. 848, 863 (1977-78) [hereinafter cited as *Valuation of Farm Land*].

7. *Id.*

8. Treas. Reg. §§ 1.1401-1(a), 1.1402(a)-1 (1963).

9. I.R.C. § 1402(a).

10. I.R.C. § 1402(a)(1). The theory behind this exclusion is that self-employment income should represent income from personal activity rather than from the passive receipt of income from rental property. Since rental income is thought not to depend upon the physical labor of the recipient, it should not diminish due to the advancing age, disability or death of the recipient. Thus, the benefits of social security should not be necessary for the financial security of these individuals. See J. O'BYRNE, *FARM INCOME TAX MANUAL* § 1008(a) (5th ed. 1977); *Valuation of Farm Land*, *supra* note 6, at 863.

11. I.R.C. §§ 1402(a)(1)(A)-(B). The Code was amended in 1956 to add this exception in recognition of the fact that farm "leases" may be quite unlike the urban rental situation. For many years, farmers have developed various arrangements for sharing the elements of production (*i.e.*, land, labor and capital) which may demand substantial personal contributions to farming operations by the landowner. J. O'BYRNE, *supra* note 10, at 891.

12. Treas. Reg. § 1.1402(a)-4(a).

claim social security benefits.¹³ This special exception may be important for a farmer who wishes to semi-retire, and rent his land to another. By materially participating and paying the tax, he can remain eligible for social security benefits.¹⁴ Conversely, the absentee farm owner may already be covered by an adequate pension plan and may wish to structure his lease so as to avoid liability for the tax.¹⁵ The ability of these parties to reach their objectives will be affected by the meaning of material participation.

JOINTS INTERESTS

For many years, section 2040 of the Internal Revenue Code has provided the general rule that the value of the gross estate of the decedent would be presumed to include all jointly-held property for estate tax valuation purposes.¹⁶ Where the surviving joint tenant can show, however, that he or she furnished consideration for purchase of such property, the proportionate part of the consideration furnished is excluded from the gross estate of the decedent.¹⁷ The 1978 Revenue Act added section 2040(c) which permits a decedent's spouse to earn a two percent credit for each year in which the surviving spouse materially participates in the operation of the farm or business, up to a maximum of fifty-percent of the estate tax value of the property (provided the total reduction does not exceed \$500,000).¹⁸ This latest subsection has been heralded as the "antidote to the so called 'widow's tax'" since farm women have been trying for many years to convince the IRS and Congress that their labor constitutes a contribution.¹⁹ But its value to the farm wife or husband now turns up the meaning attributed to material participation. Section 2040(c) defines material participation by reference to its meaning under section 1402(a).²⁰

SPECIAL USE VALUATION

For decedents dying after 1976, executors may elect to value farmland and certain real estate employed in closely held businesses based upon a defined objective standard approximating

13. *Valuation of Farm Land*, *supra* note 6, at 863.

14. J. O'BYRNE, *supra* note 10, at 891.

15. *See id.*

16. Cheifetz, *Joint Tenancy: New Law Simplifies Estate Tax Consequences of this Type of Ownership*, 18 TAX. FOR ACCOUNTANTS 271, 272 (May 1977).

17. *Id.*

18. I.R.C. § 2040(c); Levy, *IRC Section 2040(c): A Questionable Congressional Solution*, 118 TR. & EST. 50, 51 (Oct. 1979).

19. Tevis, *How Does Estate Tax Law Cut the Cake—Equal Partner or Marital Helpmate?* SUCCESSFUL FARMING, Sept. 1979, at 31.

20. I.R.C. § 2040(c)(7).

such property's current use rather than the "highest and best use."²¹ This legislative change was intended to help preserve the family farm.²² Estate taxes based upon the "highest and best use" of the land, rather than its actual use in farming, imposed a substantial burden on many farm estates that often caused the farm to be sold in order to pay the tax.²³ Section 2032A allows for the election of this special valuation if, among other restrictions, there is material participation by the decedent or a member of his family in the operation of the farm or closely held business during the years both before and after the decedent's death.²⁴ It is particularly important to plan for material participation when the landowner wishes to rent his land to another and still qualify for the special valuation.²⁵ It is likewise important for the devisee of the land to be aware of the material participation requirements since failing to meet them after the decedent's death may make the devisee personally liable for the estate tax initially saved by invoking the special valuation provisions.²⁶ Again, material participation for section 2032A purposes is determined in a manner similar to that used for purposes of section 1402(a).²⁷

These are some of the very significant areas where tax planning is a must for avoiding unnecessary taxes.²⁸ A basic under-

21. Boles, *Special Use Valuation for Land Can Be Effective Tax Saver Despite Its Complexity*, 7 TAX LAW. 74 (1978).

22. H.R. REP. NO. 1380, 94th Cong., 2d Sess. 5, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3356, 3359.

23. 122 CONG. REC. 30856 (1976) (remarks of Rep. Sebelius). See *Valuation of Farm Land*, *supra* note 6, at 849-57, for a discussion of the congressional debates pertaining to this legislation.

24. I.R.C. § 2032A. See Hartley, *Final Regs. Under 2032A: Who, What and How to Qualify for Special Use Valuation*, 53 J. TAX. 306, 306 (1980) for a good summary of the other requirements of this special valuation provision.

25. *Valuation of Farm Land*, *supra* note 6, at 862.

26. I.R.C. §§ 2032A(c)(1)(B), (c)(7).

27. I.R.C. § 2032A(e)(6).

28. There are other areas where the distinction between the active farm owner and the mere lessor of farm land may be important. For example, rentals received under a material participation arrangement should not constitute passive investment income under the Subchapter S provisions of the Internal Revenue Code. Rev. Rul. 61-112, 1961-1 C.B. 399; Normand, *supra* note 5, at 269. In Rev. Rul. 61-112, the IRS stated:

For the purposes of section 1372(e)(5) of the Code, the term "rents" does not include income realized by a landowner under a share-farming arrangement where the landowner participates to a material degree in the production of farm commodities through physical work or management decisions, or a combination of both. Compare Rev. Rul. 57-58, C.B. 1957-1,270.

Id. Likewise, the material participation agreement should qualify the taxpayer as being engaged in carrying on a trade or business, as opposed to passively owning income-producing property, under § 6166A (relating to installment payments of estate taxes). Rev. Rul. 75-366, 1979-2 C.B. 672; Kelley, *Valuation of Farm and Ranch Land After the Tax Reform Act*, 1979-1980 AGRICULTURAL L.J. 75, 115-16 (1980). Both

standing of material participation is vital to achieving good tax planning under these provisions.

MATERIAL PARTICIPATION AND SELF-EMPLOYMENT INCOME

As previously noted, the only rental income considered to be self-employment income is rent received by those who materially participate in agricultural production on land they have rented to another.²⁹ This income is taxed under section 1402(a) and the material participant is later able to receive social security benefits.³⁰

Regulations and revenue rulings have been issued which attempt to define material participation under section 1402(a).³¹ The regulations for section 1402(a) note that farm rental income qualifies as self-employment income only if the arrangement between the landowner and the tenant provides for material participation by the landowner in the production or management of the production of the agricultural products; and if there is in fact material participation by the landowner in the production of the agricultural products.³²

There must be an arrangement that contemplates material participation by the owner.³³ This arrangement may be either oral or written³⁴ and must be carried out by actual material participation.³⁵ Since 1974, it has been impermissible to attribute the activities of agents and employees to the landowner in order to support a finding of material participation.³⁶ The participation must be material with respect to production, to the management of production, or to the owner's total involvement with respect to both

the revenue ruling and the Kelley article deal with the installment payment of estate taxes under § 6166, but this was changed to § 6166A under the Tax Reform Act of 1976.

29. See text accompanying notes 10 & 11 *supra*.

30. See text accompanying note 13 *supra*.

31. See Treas. Reg. 1.1402(a)-4; Rev. Rul. 65-149, 1965-1 C.B. 434; Rev. Rul. 57-58, 1957-1 C.B. 270.

32. Treas. Reg. § 1.1402(a)-4(b).

33. J. O'BYRNE, *supra* note 10, at 898-99. Voluntary activities on the part of the landowner do not count. The landowner's participation must be required by the arrangement. *Id.*

34. Treas. Reg. § 1.1402(a)-4(b). An oral understanding is shown by the landlord's acts, the tenant's acts, how both have acted in previous years on similar matters, common practices in the area and statements of the landlord, tenant and third parties who may know the facts. But, of course, it is much easier to prove the agreement when it is written. J. O'BYRNE, *supra* note 10, at 898.

35. Treas. Reg. § 1.1402(a)-4(b).

36. In 1974, Code § 1402(a) was amended to provide that material participation is to be "determined without regard to any activities of an agent." Act of Aug. 7, 1974, Pub. L. No. 93-368, § 10, 88 Stat. 922.

production and management.³⁷ Production encompasses the actual physical work of farming and the furnishing of tools and machinery.³⁸ Management refers to the active and regular process of inspecting, consulting and making decisions.³⁹

There are no definitive rules as to just what level of activity constitutes material participation. The initial Internal Revenue response to material participation indicated that it was a factual determination which often had to be decided on a case by case basis.⁴⁰ Subsequently, the IRS issued four tests of material participation.⁴¹ These tests, together with a study of the relevant case law, provide some guidelines. A person need meet only one of the tests to qualify as a material participant.

Test No. 1. You do any three of the following: (1) advance, pay, or stand good for at least half the direct costs of producing the crop; (2) furnish at least half the tools, equipment, and livestock used in producing the crop; (3) advise and consult with your tenant periodically; and (4) inspect production activities periodically.

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

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

Test No. 4. You do things which, considered in their total effect, show that you are materially and significantly involved in the production of the farm commodities.⁴²

These four tests are designed as "safe harbor" tests, rather than as specific requirements.⁴³ Since only Test Three is a truly objective test, it is helpful to review case law to round out the meaning of these guidelines.

TEST ONE

The taxpayer attempting to satisfy Test One has a rather strenuous burden to meet. Test One seems to require a type of joint venture where both management and the costs of production

37. Treas. Reg. § 1.1402(a)-4(b)(3).

38. Treas. Reg. § 1.1402(a)-4(b)(3)(ii).

39. Treas. Reg. § 1.1402(a)-4(b)(3)(iii).

40. Rev. Rul. 57-58, 1957-1 C.B. 270.

41. INTERNAL REVENUE SERVICE, DEPT. OF THE TREASURY, PUBLICATION NO. 225, FARMER'S TAX GUIDE 52 (1979) [hereinafter cited as FARMER'S TAX GUIDE].

42. *Id.*

43. Normand, *supra* note 5, at 253.

are shared.⁴⁴ It has been held that fifty percent or greater financial contribution without either consultation or inspection is insufficient under this test.⁴⁵

In *Bridie v. Ribicoff*,⁴⁶ the landowner was found to have materially participated under a type of Test One analysis.⁴⁷ Bridie and his tenant both occupied houses on the 203 acre farm. Bridie supplied one-half of the livestock, drove the tractor and inoculated the soybeans. The tenant supplied labor, all the machinery and feed, and one-half of the other costs. Equally important was the fact that they made joint decisions as to management and marketing. Profits were divided equally.⁴⁸

It has been noted that the size of the operation is not important.⁴⁹ The size of the financial contribution, on the other hand, may be especially determinative in finding that the participation is material to the farming operation.⁵⁰ In *Vance v. Ribicoff*,⁵¹ where the owner supplied everything except the labor, and regularly walked the fields and advised her tenant when plowing and spraying were needed, the court found material participation.⁵²

In regard to inspection, advice, and consultation the courts have not set impossible standards.⁵³ It has been expressed that such advice and consultation must be directed toward production and not simply toward the preservation of the realty.⁵⁴ In *Celebrezze v. Wifstad*,⁵⁵ six to eight visits during the growing season, periodic phone calls and a one-half financial contribution were sufficient facts upon which to find material participation.⁵⁶ Only two visits during the year were necessary where the tenant was an experienced farmer and a long time neighbor.⁵⁷

44. *Valuation of Farm Land*, *supra* note 6, at 866. The importance of the landowner bearing the economic risk in the production of the crops is emphasized in *Henderson v. Fleming*, 283 F.2d 882, 888 (5th Cir. 1960).

45. *Bryant v. Celebrezze*, 229 F. Supp. 329, 336-37 (E.D.S.C. 1964); Treas. Reg. § 1.1402(a)-4(b)(3)(ii).

46. 194 F. Supp. 809 (N.D. Iowa 1961).

47. *Id.* at 816; *Valuation of Farm Land*, *supra* note 6, at 866.

48. *Bridie v. Ribicoff*, 194 F. Supp. 809, 812 (N.D. Iowa 1961).

49. *Vance v. Ribicoff*, 202 F. Supp. 790, 794 (E.D. Tenn. 1961); *Valuation of Farm Land*, *supra* note 6, at 867.

50. See Treas. Reg. § 1.1402(a)-4(b)(3)(iii).

51. 202 F. Supp. 790 (E.D. Tenn. 1961).

52. *Id.* at 792-95.

53. *Valuation of Farm Land*, *supra* note 6, at 867.

54. *Id.* at 868.

55. 314 F.2d 208 (8th Cir. 1963).

56. *Id.* at 211-16.

57. *Colgate v. Gardner*, 265 F. Supp. 987, 991 (S.D. Ohio 1967).

TEST TWO

This test seems to mandate a year-round role in management decisions. It is not enough to merely provide general policy planning at the beginning of the season.⁵⁸ The material participant must decide such things as when to plant, cultivate, spray or harvest; what items to buy, sell or repair; what records to keep, what bills to pay, and when and what government programs to participate in.⁵⁹ Retaining ultimate control over decision making is important,⁶⁰ although in *Hoffman v. Gardner*⁶¹ the court stated: "In order to 'materially participate,' the statute does not require a farm owner to settle all the problems, or even all the important problems. . . . Claimant's participation need only be of substantial value or importance."⁶² Still other decisions have indicated that how active the owner must be may partly depend upon the type of farming done⁶³ and the age of the owner.⁶⁴

TEST THREE

The most definite and objective standard is established under Test Three. By working in production for 100 hours or more over a period of five weeks or more during a year, one has materially participated.⁶⁵ It has been noted that emphasis should be placed on physical labor rather than management type work to fit under this test.⁶⁶ It is felt that tax administrators have "a peasant approach to farming, a stereotype of a man and his horse tilling the soil in the fading sunset."⁶⁷

The case of *Whitlow v. Celebrezze*⁶⁸ falls under this test.⁶⁹ There the owner and the tenant made joint decisions and jointly worked the farm. Whitlow spent 200 hours over five weeks with harvesting, weeding, mowing, fencing, purchasing, and applying phosphate. These activities were held to have a direct impact upon

58. *Valuation of Farm Land*, *supra* note 6, at 868.

59. *Hoffman v. Gardner*, 369 F.2d 837, 840-42 (8th Cir. 1966); J. O'BYRNE, *supra* note 10, § 1008(d) at 900.

60. See J. O'BYRNE, *supra* note 10, at 903.

61. 369 F.2d 837 (8th Cir. 1961).

62. *Id.* at 841.

63. *Conley v. Ribicoff*, 294 F.2d 190, 195 (9th Cir. 1961) (landowner who made visits twice each year to farm to inspect and consult with tenant on grain crop found to have materially participated).

64. *Stueckle v. Celebrezze*, UNEMPL. INS. REP. (CCH) ¶ 14,033 (E.D. Wash. 1965) (court expected less activity because of the landowner's age).

65. FARMER'S TAX GUIDE, *supra* note 41, at 52.

66. J. O'BYRNE, *supra* note 10, at 911.

67. *Id.*

68. *Whitlow v. Celebrezze*, UNEMPL. INS. REP. (CCH) ¶ 16,140 (S.D. Ill. 1964).

69. *Valuation of Farm Land*, *supra* note 6, at 870.

production and Whitlow's share of the profits. Therefore, he was found to have materially participated.⁷⁰

TEST FOUR

This test is based upon the totality of the factors. The landowner who fails to meet the more specific requirements regarding certain factors under the other tests may qualify based upon his total involvement in the farming operation.⁷¹ *Celebrezze v. Miller*⁷² provides a representative fact situation for meeting this test.⁷³ Eighty-two year old Miller had an oral agreement with his tenant. Miller paid for one-third of the cost of fertilizer, pesticide, herbicide and labor; he consulted, advised and inspected three or four times each month; and he received one-third of the profit or loss. The tenant supplied all the seed and labor and the remaining costs.⁷⁴ The court found that Miller had materially participated.⁷⁵

In all the cases under section 1402(a) the owner shared in a percentage of the crop rather than a flat cash rental.⁷⁶ The courts have indicated that this factor, while not alone determinative, is significant in distinguishing between the material participant and the mere landlord.⁷⁷ The crop sharing arrangement presents the situation where the income of the owner is dependent upon his participation.⁷⁸ He is actually sharing in the risk of the farming operation.⁷⁹ The greater his contribution of time and money, the greater is his risk, and the more likely he is to be found to be materially participating.⁸⁰

MATERIAL PARTICIPATION AND JOINTLY-HELD PROPERTY

Section 2040 excludes a proportionate part of the value of jointly-held property from the gross estate of a decedent to the extent that a surviving joint tenant can prove that he or she furnished consideration for the purchase of such property.⁸¹ But prior to the enactment of section 2040(c), taxpayers had been argu-

70. *Id.*

71. *Id.*

72. 333 F.2d 29 (5th Cir. 1964).

73. *Valuation of Farm Land, supra* note 6, at 870.

74. *Celebrezze v. Miller*, 333 F.2d 29, 30-31 (5th Cir. 1964).

75. *Id.* at 31.

76. *Valuation of Farm Land, supra* note 6, at 861.

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.*

81. I.R.C. § 2040(a).

ing that services rendered in the growth of a farm or business, rather than strictly monetary contribution, should be considered a factor in deciding whether, and to what extent, consideration had been furnished by a surviving joint tenant.⁸² Section 2040(c) was the legislative response to this position.⁸³ It allows for the recognition of a spouse's material participation in the creation of jointly-held property.⁸⁴

The foregoing analysis of material participation for self-employment purposes should indicate that the concept is still a "term of art" incapable of being defined with certitude in every situation.⁸⁵ For example, when seeking to translate the idea of material participation into concrete guidelines for a farm wife, one is immediately beset with questions regarding the nature and quantity of activity which can safely qualify her as a material participant.⁸⁶ Regulations pertaining to material participation under section 2040(c) have not yet been issued. It could well be that these regulations will condition material participation under section 2040(c) on whether self-employment earnings are issued to the spouse, and whether tax is paid on these earnings.⁸⁷ Such an interpretation seems to create too difficult a standard for many farm women to meet.⁸⁸

In addition, there are practical limitations to the value of section 2040(c) election.⁸⁹ It only applies to joint tenancies between spouses.⁹⁰ Computations under this provision can be complex if items of jointly owned property are purchased at different times and with different proportionate contributions by the spouses.⁹¹ Also, only realty and tangible personal property can qualify for this election.⁹² Therefore, it is not available where the family farm or business is incorporated and the stock is jointly-held by the spouses.⁹³ Likewise, the survivor's interest in intangible assets of the business, such as accounts receivable, cannot be excluded under section 2040(c).⁹⁴ In addition, section 2040(c)(3) requires

82. Levy, *supra* note 18, at 50.

83. *Id.*

84. *Id.*; I.R.C. § 2040(c).

85. Levy, *supra* note 18, at 50-51.

86. Tevis, *supra* note 19, at 31.

87. *Id.*

88. *Id.*

89. Schlesinger & Fuhrman, *How to Maximize Estate Tax Exclusion for Jointly-Held Business Assets*, 7 TAX. LAW. 324, 325 (1979).

90. I.R.C. § 2040(c)(3).

91. Schlesinger & Fuhrman, *supra* note 89, at 325.

92. *Id.*

93. Levy, *supra* note 18, at 52.

94. Schlesinger & Fuhrman, *supra* note 89, at 325.

the property to be held in joint tenancy or in tenancy by the entirety.⁹⁵ Before an interest is considered to be held in joint tenancy, the applicable local law may require that the husband and wife have expressed in writing their intention to hold the property as joint tenants with the right of survivorship.⁹⁶ Such evidence of intent may easily be lacking in the case of a farm or business inventory.⁹⁷ The reform of joint tenancy tax laws which the enactment of section 2040(c) was meant to effect by using the material participation standard to recognize a spouse's contribution has fallen short of expectations.⁹⁸

In some situations, a more advantageous position can be supported under prior case law than by making an election to value eligible property under section 2040(c).⁹⁹ Previous court decisions have recognized that the operation of a farm or business can be a team effort on the part of a husband and wife which is tantamount to an intent to form a partnership.¹⁰⁰ Under this family partnership analysis, the courts have excluded the surviving spouse's interest in the assets of the farm or small business.¹⁰¹ If an intent to form a partnership can be established, one-half of the value of all business or farm assets may be excluded from the decedent's estate.¹⁰² The section 2040(c) election, on the other hand, applies only to eligible jointly owned property and does not necessarily exclude a full half interest for the surviving spouse.¹⁰³ It appears likely that the partnership approach is not superceded by section 2040(c), but rather that section 2040(c) is an alternative election.¹⁰⁴ Thus, section 2040(c) should be elected only when its complex formulas show that a greater tax savings is possible than under the traditional joint interest exclusion provision.¹⁰⁵

But even with the partnership approach, it will be necessary to establish substantial participation by the surviving spouse which

95. I.R.C. § 2040(c)(3).

96. Schlesinger & Fuhrman, *supra* note 89, at 325.

97. *Id.*

98. Tevis, *supra* note 19, at 30.

99. *See* Schlesinger & Fuhrman, *supra* note 89, at 325-26.

100. *Id.* at 326.

101. *United States v. Neel*, 235 F.2d 395, 401 (10th Cir. 1956); *Craig v. United States*, 451 F. Supp. 378, 383 (D.S.D. 1978); *Estate of Otte*, 31 T.C.M. (CCH) 301, 308 (1972). *See* Schlesinger & Fuhrman, *supra* note 89, at 325-26.

102. *Estate of Otte*, 31 T.C.M. (CCH) 301, 308 (1972). *See* Schlesinger & Fuhrman, *supra* note 89, at 326.

103. Schlesinger & Fuhrman, *supra* note 89, at 324.

104. D. KAHN & L. WAGGONER, *FEDERAL TAXATION OF GIFTS, TRUSTS AND ESTATES*, 178 (Supp. 1980).

105. Schlesinger & Fuhrman, *supra* note 89, at 326.

amounts to an intent to form a partnership.¹⁰⁶ At least one court has suggested that the material participation standard used in the self-employment context is, for the most part, equivalent to establishing an intent to form a partnership.¹⁰⁷ Thus, the IRS tests and the case law defining material participation under section 1402 seem to provide relevant guidelines for forming a family partnership, as well as for recognizing a spouse's services under section 2040(c).

MATERIAL PARTICIPATION AND SPECIAL USE VALUATION

Section 2032A is designed to subject qualified family farms to estate taxation based upon their true productive value in the farming use rather than the fair market value of the land itself at its highest and best use.¹⁰⁸ This section is designed to deny this special valuation relief to nonoperators or mere speculators in farmland.¹⁰⁹ The requirement of material participation by the decedent or a member of his family, both before and after the decedent's death, is intended to fulfill this policy by insuring continuing family involvement in the farming operation.¹¹⁰

Although section 2032A states that material participation for this setting is defined by reference to section 1402 dealing with social security taxes for self-employed persons, it appears that the meaning is not identical for both purposes.¹¹¹ In fact, the final regulations for section 2032A set forth detailed requirements which go beyond the existing standards for material participation under section 1402.¹¹² This divergence can be explained by analyzing the differing purposes served by the concept in these two areas of the law. Material participation in the social security context is part of an expansion of that law's coverage, while the idea is used as a limitation under section 2032A.¹¹³ For this reason, and in light of the regulations under section 2032A, the expansive reading given the concept of material participation in some cases under section

106. *See id.*; *United States v. Neel*, 238 F.2d 395, 400-01 (10th Cir. 1956).

107. *Nicherson v. Ribicoff*, 206 F. Supp. 232, 237 (D. Mass. 1962).

108. *Kelley*, *supra* note 28, at 79.

109. *Id.* at 76.

110. *Hartley*, *supra* note 24, at 307. There must be material participation during periods totaling five years (60 months) of the eight years immediately preceding the date of decedent's death and during periods totaling five years (60 months) of every eight-year period ending after the date of the decedent's death. I.R.C. §§2032A(b)(1)(C)(ii), A(c)(7)(B).

111. *Kelley*, *supra* note 28, at 113.

112. *Id.*

113. *Hartley*, *supra* note 24, at 310.

1402(a)(1) may not be appropriate to section 2032A.¹¹⁴

The requirement that material participation cannot be determined with regard to the activities of an agent or an employee is also incorporated in section 2032A.¹¹⁵ However, this general rule is subject to an exception in the case of specially valued property. Both before and after a decedent's death, material participation under section 2032A may be satisfied by a "member of the family".¹¹⁶ Thus, the owner can materially participate through agents or employees for special use valuation purposes as long as they satisfy the necessary family relationship requirements.¹¹⁷

The regulations provide that full-time employment as a working farmer will constitute material participation.¹¹⁸ In the case of operations which do not require this full time involvement (*i.e.* small or seasonal operations), actual employment to the extent necessary to fully manage the farm is sufficient under the regulations.¹¹⁹

If the involvement in the farm is less than its full operation (as with leased property), the activities that do occur must be contemplated by an "arrangement" in order to be considered in determining whether there is material participation.¹²⁰ The arrangement may be oral or written but must be capable of proof by a means satisfactory to the IRS.¹²¹

Participation in the operation of the farm can be achieved by involvement in production, in management, or in a combination of the two as is provided in the self-employment regulations.¹²² However, the regulations under section 2032A use the payment of self-employment taxes on farm income as a "litmus test" for material participation for special use valuation purposes.¹²³ During the period this tax is not paid, material participation will be presumed not to have occurred.¹²⁴ The executor must factually demonstrate to the satisfaction of the IRS that material participation did occur,

114. *Id.*

115. *Id.*; Treas. Reg. § 20.2032A-3(e)(1) (1980).

116. I.R.C. § 2032A(b)(1)(C). Family for this purpose is defined as decedent's spouse, ancestors and lineal descendants (and their spouses) of the decedent's grandparents. Adopted children are treated as blood relatives. I.R.C. § 2032A(e)(2).

117. Treas. Reg. § 20.2032A-3(e)(1). But this is true only if the family relationship existed at the time the activities occurred. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. Hartley, *supra* note 24, at 310.

123. *Id.* at 311.

124. Treas. Reg. § 20.2032A-3(e)(1).

and why no self-employment tax was paid, in order to overcome this presumption.¹²⁵ In addition, the participant must pay all self-employment taxes found due, plus interest and penalties.¹²⁶

Payment of the self-employment tax is not, however, conclusive evidence of material participation for section 2032A purposes.¹²⁷ The regulations list a number of factors, no one of which is determinative of the issue, to be used in making this judgment.¹²⁸ The factors specified in the regulations are: (1) physical labor; (2) regular advice and consultation with the other managing party; (3) participation in making a substantial number of management decisions; (4) regular inspection of the farming operation (the examples speak of weekly visits to the farm); (5) advancing funds and assuming financial responsibility for a substantial portion of the expenses; (6) furnishing a substantial portion of the machinery, implements and livestock used in the farming operation; (7) living on the farm.¹²⁹

In addition, one of the examples under the regulations gives some weight to the value of the farm landlord's experience in assessing his participation.¹³⁰ In this example, the decedent operated the farm for twenty years prior to leasing it for ten years. During the lease, he was to be consulted on where the crops were to be planted and he supervised the marketing of the crop. Earnings and expenses were to be shared equally. The example concludes by stating that the activities of the decedent, his assumption of the risk, and the valuable knowledge he possessed of the proper farming techniques for the particular land were sufficient facts upon which to find material participation.¹³¹

As is true with farms in which the participant fully operates the business, the size and type of operation will affect the amount of activity needed to materially participate in the case of leased farms.¹³² For example, a decedent who is present on the land during the planting and harvesting seasons, but who leaves the farm during the growing season may, if the other factors are present, be materially participating.¹³³ The regulations also suggest that periods of less than thirty days in which there is no material participation are disregarded, but only if preceded or following by periods

125. *Id.*

126. *Id.*

127. *Id.*

128. Treas. Reg. § 20.2032A-3(e)(2).

129. *Id.*

130. Treas. Reg. § 20.2032A-3(g), Example 1.

131. *Id.*

132. Hartley, *supra* note 24, at 311.

133. Treas. Reg. § 20.2032A-3(g), Example 1.

of more than 120 days in which there was uninterrupted material participation.¹³⁴

When the specially valued property is owned by a partnership or corporation, involvement of family members must be under an "arrangement" with the entity specifying the services to be performed.¹³⁵ The regulations provide that holding an office where such services are inherent may constitute the necessary arrangement.¹³⁶ For example, a member of the decedent's family who serves as president of a family farm corporation, can be a material participant without a formalized "arrangement."¹³⁷ But whether the arrangement is formalized by an agreement or is satisfied by holding an office, the activity of the family members must be such that it subjects them to the self-employment tax.¹³⁸

If property is owned by a trust, the "arrangement" with the decedent or a family member may arise from appointment as a trustee, employment by the trust, through a management contract with the trustee, or where the trust agreement expressly grants the management rights to the beneficial owner.¹³⁹ After finding the requisite arrangement, the actual activities of the participant must be examined to determine if they are material.¹⁴⁰

PLANNING FOR MATERIAL PARTICIPATION

It is crucial to plan for material participation long before the particular tax provision requiring this activity is invoked.¹⁴¹ Many of the benefits for the material participant actually flow to his estate. But by then it is too late to change the factual basis for establishing material participation.

SELF-EMPLOYMENT INCOME

The farmer who stays actively engaged in his farming operation will have no trouble demonstrating his material participation.¹⁴² This is not necessarily the case for the farmer who wishes to retire, and rent his land to others, or the absentee farm owner who wishes to pursue other activities besides farming.¹⁴³ In order

134. Treas. Reg. § 20.2032A-3(c)(2).

135. Treas. Reg. § 20.2032A-3(f)(1).

136. *Id.*

137. Hartley, *supra* note 24, at 311-12.

138. Treas. Reg. § 20.2032A-3(f)(2).

139. Treas. Reg. § 20.2032A-3(f)(1).

140. Treas. Reg. § 20.2032A-3(f)(2).

141. See *Valuation of Farm Land*, *supra* note 6, at 862.

142. *Id.*

143. *Id.*

to provide evidence of an arrangement calling for material participation, a written lease agreement should be carefully drafted for this situation.¹⁴⁴ The lease should clearly provide that the owner will materially participate.¹⁴⁵ It should provide that the decision making power resides in the lessor and that the tenant is to consult with the lessor for his advise.¹⁴⁶ The lease should specifically provide for the owner's inspecting, consulting and advising activities.¹⁴⁷ It would also be prudent to require enough physical work from the lessor so as to meet the 100 hour requirement as set forth by the IRS in its Test Three.¹⁴⁸ The lease should also set forth rent in terms of crop shares.¹⁴⁹ As a further indication of the owner's assumption of risk, the lease should indicate that the lessor is financing some of the costs of production.¹⁵⁰

Equally important as preparing a proper lease is the preservation of a record of the actual participation.¹⁵¹ The farmer should keep a record of the hours worked and the jobs accomplished.¹⁵² Accurate records of expenditures relating to production must be kept.¹⁵³ There should be copies of correspondence and records of phone calls.¹⁵⁴ The lessor should work to maintain notes of inspection tours and consultations, as well as of machinery furnished for use in the farming operation.¹⁵⁵ To be successful, recordkeeping must be systematic and detailed.¹⁵⁶ Since the attorney generally can not supervise this entire process, it is important to inform the owner in writing of the value of making contemporaneous documents to reflect his participation.¹⁵⁷

SPECIAL USE VALUATION

Material participation can be accomplished through a family member under section 2032A.¹⁵⁸ Therefore, as long as the decedent or a family member is actively operating the farm, material

144. *Id.* at 882.

145. *Id.*

146. *Id.*

147. *Id.* at 882-83.

148. *Id.* at 882. See the IRS tests regarding material participation in the text accompanying note 42 *supra*.

149. *Id.*

150. *Id.* at 882.

151. *Id.* at 883.

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.*

156. Normand, *supra* note 5, at 263.

157. *Id.* at 264.

158. Treas. Reg. § 20.2032A-3(e)(2).

participation will be present.¹⁵⁹ It would still be advisable to prepare a written lease specifying the duties and the management responsibilities of the family member.¹⁶⁰ If the land is leased to non-family members, the written lease agreement contemplating the material participation of the decedent or a family member becomes vital.¹⁶¹ In this type of situation, the prudent draftsman should pay careful attention to the interpretation given material participation in the regulations under section 2032A, rather than merely examining the case law pertaining to its use in the self-employment context.¹⁶² For example, the section 2032A regulations appear to place a heavier emphasis on great frequency of visitation to the farm land by the owner than has been required under section 1402.¹⁶³ Such distinctions should be incorporated in the written agreement.

Where real property which may qualify for special use valuation is owned through a corporation, partnership or trust, the regulations provide that holding an office in which certain material functions are inherent may constitute the necessary arrangement for material participation.¹⁶⁴ But it is wise not to rely exclusively on this language.¹⁶⁵ The relationship between the entity and the decedent or family member should be formalized in a written document.¹⁶⁶ Furthermore, the document should specify the services to be performed, and the involvement contemplated in the management of the real property by the decedent or family member.¹⁶⁷

Where real property is owned by a trust, the prudent draftsman will incorporate into the trust agreement a clause expressly granting the required management rights to the beneficial owner if it is possible that special use valuation may be elected by the decedent's estate.¹⁶⁸ This will satisfy the requirements of an arrangement contemplating material participation if the beneficial owner is the decedent or a family member.¹⁶⁹

As in the self-employment tax area, records of the actual participation in the farming operation are of great importance.¹⁷⁰ It

159. *Id.*

160. Boles, *supra* note 21, at 75.

161. See *Valuation of Farm Land*, *supra* note 6, at 882.

162. See Kelley, *supra* note 28, at 113.

163. *Id.*

164. Treas. Reg. § 20.2032A-3(f)(1).

165. Boles, *supra* note 21, at 75.

166. *Id.*

167. *Id.*

168. *Id.* at 75-76.

169. See Treas. Reg. § 20.2032A-3(e).

170. *Valuation of Farm Land*, *supra* note 6, at 883.

may be especially vital for the personal representative of the decedent to maintain these records during the administration of the estate¹⁷¹ since the regulations do not exempt this period in determining whether the material participation requirements are fulfilled.¹⁷²

JOINTLY-HELD PROPERTY

Estate planning for spouses who jointly own property and wish to come under section 2040(c) or establish that they are operating as partners, should begin with placing the family partnership in writing.¹⁷³ Furthermore, the agreement must be bona fide.¹⁷⁴ This will mean either that a substantial contribution of capital is made by each partner or a substantial part of the labor or management is performed by each partner.¹⁷⁵ The family should keep a record of all property acquisitions, including the source of the down payment and how the mortgage was paid off.¹⁷⁶ If separate wills are drawn, a clause should be inserted recognizing the role of each spouse in the operation of the business.¹⁷⁷ These considerations should provide the records necessary to prove that the spouse was a material participant or, alternatively, a partner.

IN GENERAL

It is advisable for the owner using a material participation arrangement for any of these purposes to file Schedule F to report his farm income or loss.¹⁷⁸ This would be preferable to using Schedule E, Part II (Rents and Royalties) which is appropriate for more conventional rental arrangements.¹⁷⁹ In addition, Schedule SE should be used to report self-employment earnings from the material participation arrangement.¹⁸⁰ It may be advisable to file these schedules even if it is unnecessary to file the particular schedule or the tax return because of insufficient earnings.¹⁸¹ To further support a claim of material participation, the taxpayer

171. Comment, *An Analysis of the "Actual Use" Valuation Procedure of Section 2032A*, 56 NEB. L. REV. 860, 881 (1977).

172. Treas. Reg. § 20.2032A-3(f) (2).

173. Tevis, *supra* note 19, at 31.

174. J. O'BYRNE, *supra* note 10, at 756.

175. *Id.*

176. See Estate of Otte, 31 T.C.M. (CCH) 301, 308 (1972).

177. See Craig v. United States, 451 F. Supp. 378, 382 (D.S.D. 1978).

178. Normand, *supra* note 5, at 267.

179. *Id.*

180. *Id.*

181. *Id.*

should designate his or her occupation as "farmer" in the return.¹⁸²

In all these areas, the planner should remember that the material participation test represents a minimum level of activity.¹⁸³ It is wise to plan and record participation which exceeds the minimum.¹⁸⁴ Also, the feasibility and attractiveness of each of these provisions depends upon more than merely being able to meet the material participation requirement. An analysis of the total tax provision in relation to the particular case at hand must be undertaken as part of an overall estate planning effort.

Material participation will continue to be an animal that defies exact definition. For this reason, and because of the significant tax dollars which may be involved, it is likely to be a major issue in the audit of estate tax returns.¹⁸⁵ This means that the tax and business planner must use care and caution in determining whether any particular fact situation has reached this status.

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182. *Id.*

183. *Valuation of Farm Land*, *supra* note 6, at 883.

184. *Id.*

185. Kelley, *supra* note 28, at 87.

