A Review and Critique of Selected Problem Areas from the Tax Reform Act of 1976

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A Review and Critique of Selected Problem Areas from the Tax Reform Act of 1976

Abstract
Rarely has agriculture enjoyed the attention it received in the Tax Reform Act of 1976. In addition to various provisions narrowing the scope of tax shelter opportunities, Congressional attention was drawn to the federal estate tax concerns that were believed to be unique to agriculture and other small firms. As a result, legislation was enacted providing two new methods for valuing land, an expanded and more attractive installment option or paying the federal estate tax attributable to a qualifying business, a new rule for taxing post-1976 joint tenancies at death,— an opportunity to continue "Section 303" stock redemptions for the period of installment payment of federal estate tax, if elected; an enlarged federal estate tax marital deduction; and a larger federal gift tax marital deduction for gifts of less than $200,000 between spouses permitting greater flexibility in making interspousal transfers to "balance" the estates.

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A Review and Critique of Selected Problem Areas from the Tax Reform Act of 1976

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A Review and Critique of Selected Problem Areas
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-- by Neil E. Harl **
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Michael D. Boehlje ***

Rarely has agriculture enjoyed the attention it received in the Tax
Reform Act of 1976. In addition to various provisions narrowing the scope
of tax shelter opportunities, Congressional attention was drawn to the
federal estate tax concerns that were believed to be unique to agriculture
and other small firms. As a result, legislation was enacted providing two new
methods for valuing land,\(^1/\) an expanded and more attractive installment option
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a new rule for taxing post-1976 joint tenancies at death,\(^3/\) an opportunity
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marital deduction;\(^5/\) and a larger federal gift tax marital deduction for gifts
of less than $200,000 between spouses permitting greater flexibility in making
interspousal transfers to "balance" the estates.\(^6/\)

\(^1/\) I.R.C. § 2032A. For more detail concerning the implication of this provision,
see Boehlje and Harl, "'Use' Valuation Under the 1976 Tax Reform Act: Problems
and Implications", paper presented at Symposium on Farm Estate Tax Issues

\(^2/\) I.R.C. §6166.

\(^3/\) I.R.C. §2040(b)

\(^4/\) I.R.C. §303(b)(1)(C).

\(^5/\) I.R.C. §2056.

\(^6/\) I.R.C. §2523(a)(2). Gifts of less than $200,000 to a spouse may reduce the

* Presented at Symposium on Farm Estate Tax Issues Raised by the Tax Reform

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Whether all of the above should be viewed as pluses depends upon one's assumptions as to wealth and income distribution, effects on capital flow and impacts of death on farm firms. As noted below, it is entirely possible to argue that some parts of the 1976 legislation designed to favor farm and other small business may have unintended (and possible undesirable) effects. For example, the Congressional change in taxation of property owned in joint tenancy and tenancy by the entirety is so narrow in scope as applied to farm property as to be of limited usefulness. In fact, the amendment may be so seriously misleading as to create traps for the unwary.

Numerous other changes in estate tax law were included in the Tax Reform Act of 1976 including a unified credit applicable to both lifetime and death-time transfer which replaced the $60,000 lifetime exemption, a new tax rate schedule that applies to both taxable gifts and property transfers at death, and new rules concerning the calculation of the income tax basis for property received from a decedent, commonly referred to as the "carryover basis" rules. Many of these changes have implications for both farm and non-farm estates, but some present particular problems for farmers. Few would rank carryover basis as advantageous to agriculture. The extent to which the concept is viewed as disadvantageous rests with the added complexity for tax practitioners, the absence of needed information to calculate the "fresh start" adjustment after death and the projected long-term policy aspects of an unchanging income tax basis with passage of property from one generation to the next by inheritance.

Unification

One of the important underlying concepts of the Tax Reform Act of 1976 is the unification principle. In essence, this principle assures that, with few

\[7/\] I.R.C. §§2010, 2505.
\[9/\] I.R.C. §1023.
exceptions, property transferred during life or at death is treated comparably compared to the pre-1977 advantage resting with transfers by gift. The objective of the 1976 legislation is to tax uniformly the total wealth rather than treat wealth transferred during life as gifts in a manner different from wealth transferred at death. Thus, the credit in the new tax rules is a "unified" credit that applies both to gift and estate taxes. Likewise, the tax rates that apply to gifts and estate are identical, and taxable gifts must be included as part of the tentative tax base at death to obtain cumulative transfers during life and at death. Adding taxable gifts after 1976 to the taxable estate at death is the mechanism by which pre-death utilization of the unified credit and use of the lower tax brackets are taken into account. A credit against the calculated federal estate tax is allowed for any gift taxes paid on post-1976 gifts. Thus, the unified gift and estate tax structure of the 1976 Tax Reform Act endeavors to tax the wealth of the decedent uniformly and does not distinguish between when that wealth was transferred, with the exception of the specific deductions and exclusions allowed in the computation of taxable gifts and the taxable estate.

One major difference may exist in tax treatment of gifts and property held until death, however. Gifts are valued and taxed at fair market value for federal gift tax purposes while land held at death may be eligible for "use" valuation at a substantially lower figure.

One major implication of unification is that the making of taxable gifts is discouraged as compared to pre-1977 law. To the extent that a family business is included in the estate and the giving of taxable gifts of business property contribute to the continuity of the business during the intergenerational transfer process, discouragement of gift giving prior to death is undesirable under the assumption that public policy should favor continuation of family businesses. However, one can also argue that transfers of wealth should be
taxed equitably irrespective of whether the transfer occurs at life or
during death. To the extent that the unified gift and estate tax rules dis-
courage transfer by gift simply to minimize tax, the unification concept has
considerable merit. It should be recognized that there still may be an
advantage to giving taxable gifts of property that is expected to increase
in value rather than making the transfers at death. Property given during
life is valued at its fair market value at the date of the gift for federal
gift tax purposes, and this value is not adjusted when the gift is added to
the estate at death. If a true unification were desired, taxable gifts of
property would be revalued at death.

In addition to the changed treatment of taxable gifts under the 1976
Act, the "use" valuation and installment payment of tax rules also discourage
gifting of business property because of the rules concerning the minimum
amount of the estate that must be comprised of such property to qualify for
these privileges.

The unified credit which is available under the new 1976 tax reform
legislation is clearly differentiable from the exemption available in pre-
1977 estate tax regulations because it's worth the same amount to everyone
regardless of size of estate. As recognized in the debate concerning the 1976
reform legislation, an increase in the exemption would have been worth far more
to those in the highest tax bracket. 10/ The credit thus targets the largest
potential tax benefits to smaller estates as illustrated in Figure 1. Since
the credit is available to each individual decedent, one would anticipate that
additional inter-spousal transfers would be encouraged to obtain full utiliza-
tion of the credits available at the death of both the husband and the wife.

10/ See Harl, "Some Alternatives for Federal Estate Tax Reform", Pm 691,
Iowa State University, June, 1976.
The problems inherent in the "consideration furnished" rule were well known and contributed to the general attitude that something should be done to reduce the burden of proof for surviving joint tenants, especially wives. The result was the "fractional share" rule included in the Tax Reform Act of 1976.

Two fundamental problems gave rise to the 1976 change in federal estate tax treatment of joint tenancy and tenancy by the entirety property — (1) the inability of the surviving joint tenant to meet the burden of proving that the surviving joint tenant's contribution to acquisition of the property in the form of labor and management should be taken into account in the estate of the first joint tenant to die,
and (2) the belief that the wife should be credited with property ownership not only by virtue of labor and management as well as capital contributed to the family business, but also because the wife gave up the chance for a career and an independent income stream to maintain the household and devote full time effort to raising the family.

The 1976 amendment addresses the question of burden of proof and eases that burden by providing that half the value of jointly owned property is subject to federal estate tax at the death of the first joint tenant to die.\textsuperscript{11/}

The 1976 amendment does not deal directly with the second problem, at least with respect to property acquired in joint tenancy prior to 1977. A solution to the second problem would require — (1) that the wife be made privy to the income stream from the family business to a degree appropriate to her contribution thereto and that an opportunity be created for her income to be channeled into a separate estate, or (2) that the essential elements of spousal rights to property inherent in the community property concept be extended to other states.\textsuperscript{12/}

The new rule taxes one-half the value of jointly owned property (joint tenancy or tenancy by the entirety) where the joint ownership was created after 1976 by a husband and wife if the joint interest was created by a transfer subject to federal gift tax.\textsuperscript{13/}

\textsuperscript{11/} It is pointed out that the 1976 amendment is a "two edged sword" and could result in greater overall federal estate tax liability compared to the "old" joint tenancy rule if the wife died first and incurred federal estate tax liability on one-half the value of jointly owned property. Under the "old" rule, the husband, as the survivor might have been able to prove that he provided the total consideration and thus escape federal estate tax liability.

\textsuperscript{12/} See Harl, \textit{infra} note 22 at 24-25.

\textsuperscript{13/} I.R.C. §2042(b).
are unequal.\textsuperscript{14/} Thus, a gratuitous transfer of property by one person to himself and another as joint tenants is considered a gift of half the value.\textsuperscript{15/} However, there are three major exceptions to the general rule. (1) Transfer of funds into a joint bank or brokerage\textsuperscript{16/} account does not produce a gift until and unless the one not providing funds withdraws amounts for his or her own benefit;\textsuperscript{17/} moreover, there appears to be no way to treat such transfers as gifts. (2) Purchase of United States Government savings bonds registered as payable to the one providing the consideration "or" another does not constitute a taxable gift until and unless the one not providing the consideration redeems the bond during the lifetime of the other without any obligation to account for the proceeds to the other owner;\textsuperscript{18/} again, there appears to be no way to treat such transfers as gifts. (3) For a joint tenancy in real property created after December 31, 1954, in a husband and wife with one of the spouses providing disproportionate consideration, a taxable gift does not result at the time of the transfer unless the donor elects to report the transfer as a gift.\textsuperscript{19/} To treat the transfer as a gift, it must be reported on a gift tax return timely filed even though a gift tax return would not otherwise be due.\textsuperscript{20/} If not reported as a gift, the fact of unequal contribution

\textsuperscript{15/} Ibid.
continues to prevail for federal gift tax purposes. Upon severance of the joint tenancy, a gift accrues at that time unless disposition of interests following severance is in accordance with the pattern of consideration furnished upon acquisition.

It is therefore, apparent that the new "fractional share" rule does not reach property acquired in joint tenancy transactions created before 1977, and does not reach transactions created after 1976 if the property is in the form of a joint tenancy bank or brokerage account, U.S. Government savings bond or land acquired by a husband and wife unless reported as a gift. It is noted specifically that joint tenancy transactions in land by a husband and wife after 1976 are not subject to the new "fractional share" rule unless reported as a gift on a gift tax return timely filed. If joint tenancy in real property created prior to 1977 is to qualify for the new rules, the joint tenancy must be severed, an appropriate gift tax return filed and any gift tax due paid, and then the joint tenancy must be recreated after December 31, 1976. Under proposed legislation, an election could be made to treat pre-1977 joint tenancies as gifts without a formal severance for a period through 1979.²¹/ Thus, for purposes of farm estate planning, the new rule has limited application, indeed.

Quite apart from its limited application, the wisdom of using the new "fractional share" rule is subject to substantial debate. For those couples -- (1) wishing to minimize federal estate tax at both deaths (or maximize the amount of wealth passing from the estate of the surviving spouse), and (2) whose property ownership is likely to place one or both spouses in a position of substantial federal estate tax liability, joint tenancy or tenancy by the entirety ownership as to all or substantially all of their property may be inconsistent with the tax saving objective. Unless gifts are made after the death of the

²¹/ H.R. 6715 § 3(k)(2).
first joint tenant to die or the property passes to a qualified charity at the
death of the surviving joint tenant, joint tenancy ownership is inconsistent
with either of the major approaches to minimizing the total federal estate tax
burden over both deaths. Joint tenancy ownership of property may be con-
sistent with plans to minimize federal estate tax (or maximize family wealth)
for both deaths so long as the value of jointly owned property does not exceed
the optimal sized marital deduction and the will is drafted to take property
passing outside the will and qualifying for the marital deduction into account
indetermining the size of the marital deduction created by the will itself.
For couples with approximately equal sized estates, the optimal sized marital
deduction may be at or close to zero, depending upon life expectancy of the
surviving spouse, rate of return expected on deferred tax dollars, the rate
of inflation (or deflation) expected and anticipated changes in death tax rates.

With joint tenancy or tenancy by the entirety ownership beyond that
needed to fund the marital deduction directly competitive with federal estate
tax saving strategies, it is questionable whether such joint ownership is
desirable from a planning standpoint even if the 1976 amendment were extended
to all joint tenancies created after 1976 and to all those created prior to
1977 on an elective basis.

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22/ For a discussion of the Model I (the "two trust marital deduction"
approach), Model II (balanced estates with each leaving the other a life
estate) and Modified Model II (balanced estates that are unbalanced at the
death of the first spouse to die by use of the marital deduction), see Harl,

23/ See Borcherding and Harl, "Optimal Use of the Marital Deduction in
Estate Planning" (Mimeo, 1978).

24/ See H.R. 6715, § 3(k)(2) (provision that would allow elective application
of the "fractional share" rule to realty owned in joint tenancy by a
husband and wife and created before 1977).
One final point on property owned in joint tenancy or tenancy by the entirety -- the federal gift tax treatment of jointly owned real property acquired by a husband and wife after December 31, 1954, creates a substantial tax trap on severance of the joint tenancy. As noted in Fig. 1, jointly owned real property acquired prior to 1955 may be severed into tenancy in common now without a gift. But for joint tenancies created after 1954 where the husband provided the consideration and the fact of gift was not duly reported on a federal gift tax return, severance to tenancy in common would produce a gift of half the property value at the time of the severance.

Figure 2. Gift for federal gift tax purposes on severance of joint tenancies in real property.

Husband(H) - Wife(W) (holding joint tenancy property)

<table>
<thead>
<tr>
<th></th>
<th>H's name</th>
<th>Tenancy in common</th>
<th>W's name</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-1955 acquisition</td>
<td>50% W to H</td>
<td>-0-</td>
<td>50% H to W</td>
</tr>
<tr>
<td>Post-1954 acquisition</td>
<td>-0-</td>
<td>50% H to W</td>
<td>100% H</td>
</tr>
</tbody>
</table>

Moreover, the severance may be inadvertent as well as intentional. It appears that transfer of joint tenancy realty to a partnership or corporation may constitute an effective severance with a gift resulting unless the partnership shares or corporate stock are held in accordance with the federal gift tax status of the contributed property. Sale of joint tenancy realty with installment reporting of the gain may constitute a severance even though
joint tenancy ownership is preserved in the resultant security interest. 25/ Fundamentally, a question is raised as to the wisdom of exempting post-1954 acquisitions from federal gift tax liability upon creation of the husband-wife joint tenancy or tenancy by the entirety ownership pattern. The mischief, at least in the agricultural sector, would appear to have been substantially less had the pre-1955 federal gift tax treatment of jointly owned property been continued unchanged.

Enlarged federal estate and gift tax marital deductions

In apparent response to concerns voiced about the federal estate tax liability of interspousal transfer, the Congress in the Tax Reform Act of 1976 enlarged the maximum marital deduction to the greater of $250,000 or 50 percent of the adjusted gross estate. 26/ This amendment is justifiable to the extent the objective is to reduce the federal estate tax liability at the death of the first spouse to die. And it is consistent with the view held by some that interspousal transfers should not be subject to federal estate tax.

However, a larger marital deduction at the death of the first spouse may result in greater tax liability at the death of the survivor. As noted in the preceding section, it is frequently not optimal to claim a maximum marital deduction if it is desired to minimize federal estate tax (or maximize wealth) at the deaths of both spouses.

Related to the enlarged estate tax marital deduction are changes in the gift tax marital deduction. For gifts made after December 31, 1976, a deduction can be taken for the first $100,000 of gifts to a spouse plus one-half of the amount of gifts in excess of $200,000. 27/ This increase in the gift tax marital


26/ I.R.C. §2056.

27/ See I.R.C. §1023.
deduction compared to prior law facilitates inter-spousal family transfers to "balance estates" or accomplish other estate planning or tax minimizing objectives through reallocation of property between spouses. One should note, however, that the estate tax marital deduction is reduced by the amount of any "excess" gift tax marital deduction utilized. The "excess" gift tax marital deduction is calculated as the amount of the marital deduction above what a 50 percent gift tax marital deduction would have been. However, reduction of the federal estate tax marital deduction may not be disadvantageous. If the spouse making the gift and suffering the reduction survives, a lesser federal estate tax marital deduction is of no consequence. Moreover, if the estates are reasonably well balanced, a maximum federal estate tax marital deduction is rarely consistent with wealth maximization over both deaths.

The integration of the gift and estate tax marital deduction along with the new rules concerning the taxation of gifts are important in assessing the optimal ownership pattern for farm property as between husband and wife and the various strategies for attaining this optimal pattern including gift making during life and the use of the marital deduction at death.

The optimal sized marital deduction can be assured——(1) in approximate fashion by provisions in the wills specifying a particular percentage of the adjusted gross estate, by using life insurance subject to tax made payable to the surviving spouse as named beneficiary or through joint tenancy ownership of some property; (2) by formula clause in the wills involving valuation of

29/ See Borcherding and Harl, "Optimal Use of the Marital Deduction in Estate Planning" (Mimeo, 1978).
both estates and application of relevant variables to define an optimal sized marital deduction\(^ {31}\) and by use of disclaimer provisions after death to pare down a deliberately oversized marital deduction.\(^ {32}\) The disclaimer approach requires approval of the surviving spouse. At present, it appears that disclaimer rules would not permit disclaiming from the marital share to the non-marital share. Proposed legislation would permit such disclaimers which should reduce the reluctance of a surviving spouse to disclaim.\(^ {33}\)

**Carryover basis**

In terms of sheer impact on farm families and farm firms, the carryover basis concept may well prove to be the most notable provision in the Tax Reform Act of 1976.\(^ {34}\) For deaths prior to 1977, property included in the federal estate tax gross estate received a new income tax basis equal to the value placed on the property for federal estate tax purposes.\(^ {35}\) This "new start" for purposes of figuring gain on sale after death was especially beneficial in agriculture because — (1) the income tax basis of raised animals, feed and grain is zero in the hands of a farmer on the cash method of accounting;\(^ {36}\) (2) machinery and equipment is often depreciated at a faster rate than the decline in value and (3) real property, for many farmers, has a relatively low income tax basis.


\(^{32}\) I.R.C. §2518. See also Estate of Hoenig, 66 T.C. 471 (1976).

\(^{33}\) H.R. 6715, §3(m).

\(^{34}\) I.R.C. §2056.

\(^{35}\) See I.R.C. §1023.

\(^{36}\) Except for property producing income in respect of decedent (such as crop share rents in the hands of a non materially participating farm landlord) such assets received a new income tax basis for deaths prior to 1977).
Objections to the carryover basis concept seem to fall into four categories — (1) the extensive and time consuming calculations needed to compute the fresh start adjustment, the adjustment for federal estate tax attributable to the net appreciation in value of carryover basis property, the minimum $60,000 adjustment for all carryover basis property and the adjustment for state inheritance or similar tax attributable to the net appreciation in value of carryover basis property; (2) the lack of records in most estates for determining, for carryover basis property, the holding period, original basis, depreciation claimed through 1976 and substantial improvements made with information on date of the improvement, original cost or other basis and depreciation claimed before 1977; (3) the additional income tax liability incurred on sale of carryover basis property after death and (4) the long range effects of no "new start" at death with the only upward adjustment in income tax basis coming from sale transactions. Although all four areas of concern are important, the last one may eventually prove to be the most difficult to tolerate from a policy standpoint.

Returning briefly to the first area of concern, the matter of complexity in making calculations, there is no question that the complaints about time needed to make the calculations are well founded. A set of illustrative calculations for a simple estate (three assets) appears in Appendix A. The computational burden is especially heavy in an estate of a sole proprietor who held a large number of carryover basis assets. If the concept remains in

37/ I.R.C. § 1023(h).
38/ I.R.C. § 1023(c).
39/ I.R.C. § 1023(d).
40/ I.R.C. § 1023(e).
tax law, the computational problem can be lessened substantially with computer assistance. The calculations are relatively simple in nature given the necessary data.

One dimension of the complexity issue relates to the problems involved with change in organizational structure of a closely-held business. For example, if a farmer operating as a sole proprietor forms a corporation in 1978, transfers farm business assets to the new corporation in a tax-free exchange and then dies in 1980 owning corporate stock, the carryover basis calculations take on an additional complication. The stock held at death "reflects the adjusted basis on December 31, 1976, of any property other than a marketable bond or security" and hence would seem to be eligible for the series of adjustments as carryover basis property including the "fresh start" adjustment based upon the holding period for the property. If this means that the relevant holding period for the corporate stock includes the holding period of the property transferred upon incorporation, it would be necessary either to — (1) maintain identification of stock with predecessor property or (2) calculate a mean or average holding period for corporate stock based upon the mean or average holding period for the property transferred in the tax-free exchange. The first solution would require highly detailed records and would open up new possibilities for selective gifting or sale of stock.

The second area of concern, lack of records to substantiate, for each asset, holding period, original basis, depreciation and improvements, can eventually be overcome with strong educational emphasis on development of an inventory for property held on December 31, 1976, that could be held at death. Moreover, with passage of time, fewer assets will be subject to the

fresh start adjustment which makes the greatest information demands.

It is instructive to note that income tax basis information (but not necessarily holding period data) would be necessary for about any treatment of gain at death other than the traditional "new start". Thus, if the carryover basis rules were replaced with a tax on net appreciation at death, income tax basis information would still be needed. Therefore, unless a return to a new start basis at death is deemed likely, which does not seem to be the case, income tax basis information for carryover basis calculations will be needed.\textsuperscript{42/}

The third area of concern, added income tax liability, affects liquidity planning to pay taxes and costs after death. In addition, it has equity implications relating to income and wealth distribution. The wisdom of imposing a tax on gain on property held until death either as part of the estate settlement process or on later sale of assets is beyond the scope of this commentary.

The fourth area of concern, the matter of long range effects of the shift in income tax treatment of gain on property held until death, may eventually involve important questions of resource allocation and economic constraints in transfer of carryover basis assets. Little, if any, effect is expected for assets with a limited life such as machinery, equipment, livestock and stored grain. But the picture may be quite different for assets, such as real property, with a long life or perpetual existence. If the long-term trend is an increase in the general price level, including the price of land, the amount of gain per unit of land would increase. With no new basis at death,

\textsuperscript{42/} The Senate Finance Committee voted on February 3, 1978, to delay the effective date of the carryover basis rules to January 1, 1980. The position of the entire Congress on this issue is difficult to predict.
the potential income tax liability per unit of land would likewise increase over time unless the property was sold. Sale would be expected to become less likely as the net sale value (after payment of income tax liability) diminishes relative to fair market value. In effect, income tax liability would become a factor inhibiting sale. The result could be to "lock land into families". With each passing generation, the probability of taxable transfer of such assets would be expected to diminish.

It is generally believed that a price oriented, market economy functions best with relatively free transferability of resources. For that reason, it is doubted that the present carryover basis system can long endure without causing significant misallocations of resources.

The arbitrariness of the fresh start adjustment for property other than stocks and bonds may also have implications for investment patterns. This arbitrary adjustment will result in arbitrary differences in the "tax cost" of selling various types of carryover basis property depending upon differences in the appreciation or depreciation of various assets occurring after December 31, 1976.

Figure 3. Application of the "fresh start" rule for carryover basis property.
For example, assume two assets had equivalent fair market values at the time of acquisition on January 1, 1967, as shown in Figure 3. Thereafter, asset A increased in value at an increasing rate with much of the increase in value occurring after 1976. Asset B rose sharply in value after 1967 but plateaued in value with relatively little gain occurring after 1976. By applying the arbitrary "fresh start" adjustment that, in effect, linearizes the gain, a portion of the gain for asset A, shown as amount a in Figure 3, is forgiven even though it represents post-1976 gain. On the other hand, amount b of the gain for asset B is not eliminated at death even though it represents pre-1977 gain. The result would be an added advantage to retain assets that are expected to increase in value more rapidly than those that appreciate at a slower rate or depreciate in value. Part of the post-1976 gain on assets that increase rapidly in value would be forgiven.

**Installment payment of federal estate tax**

For estates in a position to meet the eligibility requirements, the new 15-year installment payment of federal estate tax affords substantial economic benefits with interest at four percent on the first $345,800 of federal estate tax attributable to a closely-held business less the allowable unified credit, and with interest only due for the first five years with the deferred federal estate tax paid in up to 10 equal annual installments thereafter with interest on the unpaid balance. The magnitude of the economic advantage depends principally upon -- (1) the ability to maintain the installment payment schedule against acceleration after death, and (2) the rate of return received on deferred tax dollars.

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42/ I.R.C. § 6166.

43/ I.R.C. § 6601(j).
Eligibility requirements

With respect to eligibility requirements imposed upon the estate, the requirement accompanied by the greatest uncertainty for farm businesses is the definition of "business". To be eligible for 15-year installment payment, the closely-held business must exceed 65 percent of the adjusted gross estate.\(^{44}\) For this purpose, assets are valued at the figure used for federal estate tax purposes. Thus, election of "use" valuation could jeopardize installment payment of federal estate tax by dropping the value of business assets to the 65 percent level or below. For estates holding a partnership interest, 20 percent or more of the partnership interest must be included in the deceased partner's gross estate or the partnership must have 15 or fewer partners for the business interest to count toward the 65 percent requirement.\(^{45}\) For a corporate interest, 20 percent or more of the corporation's voting stock must be included in the deceased shareholder's estate or the corporation must have 15 or fewer shareholders.\(^{46}\) These requirements are quite specific and can be administered with relatively little uncertainty.

A major problem, however, exists in determining whether a leasehold arrangement constitutes a "business" for this purpose. In a 1975 ruling issued under the 10-year installment payment option, farms operated under a crop share lease were held to constitute an interest in a closely-held business.\(^{47}\) In that ruling, farmland was leased to tenants under crop share leases with the landlord receiving 40 percent of the crops and bearing 40 percent of the expenses. The landlord participated in important management decisions and made almost daily visits to inspect the farms and discuss operations.

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\(^{44}\) I.R.C. § 6166(b)(1)(B).

\(^{45}\) I.R.C. § 6166(b)(1).

\(^{46}\) I.R.C. § 6166(b)(1)

although the landlord lived several miles from the farms. The ruling intimates that a cash lease arrangement would not qualify as a business for purposes of installment payment of the federal estate tax.

In a companion ruling, ownership and rental of houses did not qualify as a business. In that ruling, the decedent-landlord rented eight houses, collected the rent, made the mortgage payments and handled the necessary repairs and maintenance. To be eligible for installment payment of federal estate tax, the ruling stated that the operation must be an "active enterprise producing business income rather than income solely from the ownership of property." In a third ruling, the owner of rental units maintained a fully equipped business office to collect rental payments, negotiate leases and, by contract, direct the maintenance of the properties. The arrangement was held to be "merely that of an owner managing investment assets to obtain the income ordinarily expected from them," and not a business. Additional (and more authoritative) guidance as to what constitutes a business where rental of assets is involved would be helpful and would reduce the uncertainty as to this requirement for installment payment of federal estate tax.

For purposes of the 65 percent requirement, interests in "residential buildings and related improvements on the farm which are occupied on a regular basis by the owner or lessee of the farm or by persons employed by such owner or lessee for purposes of operating or maintaining the farm" can be included. In a close case, it can be important whether the farm is rented to a resident tenant or the land is share rented to neighbors and the building site is rented to a family not associated with the farm business.

50/ I.R.C. § 6166(b)(3).
Disposition of interests

The matter of maintaining the installment payment schedule against acceleration merits comment. Except for "Section 303" stock redemptions; testamentary transfers by the decedent by will, state law of descent and distribution or a trust created by the decedent; and certain corporate reorganizations; if one-third or more of the value of the interest in the closely-held business is distributed, sold, exchanged, or otherwise disposed of or is withdrawn from the business, the remaining installments become due. This rule imposes substantial constraints on death-time and post death property transfers. It is not clear, for example, whether property transfer by operation of law to a surviving joint tenant or tenant by the entirety would constitute an accelerating disposition. Certainly such a transfer is not by "... will, the applicable law of descent and distribution, or a trust created by the decedent." A similar question could be raised with respect to the proceeds of life insurance policies carried on key persons in the firm.

A more fundamental question relates to whether transfers within the decedents' family, in a manner parallel to sanctioned post-death transfers for "use" valuation purposes, should be possible for Section 6166 purposes as well.

Economic value of installment payment

As noted above, the economic value of the 15-year installment payment provision depends heavily upon the return received on deferred tax dollars. As shown in Table 1, savings from a 10 percent net return can almost pay the federal estate tax bill over the 15-year installment payment period.

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51/ I.R.C. § 6166(g)(1)(B).
52/ I.R.C. § 6166(g)(1)(D).
53/ I.R.C. § 6166(g)(1)(C).
54/ I.R.C. § 6166(g)(1)(A).
Table 1. Net Savings from Installment Payment of Federal Estate Tax Under Varying Rates of Return
(Assumed Tax Bill of $100,000)

<table>
<thead>
<tr>
<th>Year</th>
<th>FET Paid</th>
<th>5% return on capital (1% net)</th>
<th>8% return on capital (4% net)</th>
<th>10% return on capital (6% net)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>with Form 706</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
</tr>
<tr>
<td>1</td>
<td>100,000</td>
<td>--0--</td>
<td>1,000</td>
<td>--0--</td>
</tr>
<tr>
<td>2</td>
<td>--0--</td>
<td>--0--</td>
<td>1,010</td>
<td>--0--</td>
</tr>
<tr>
<td>3</td>
<td>--0--</td>
<td>--0--</td>
<td>1,020</td>
<td>--0--</td>
</tr>
<tr>
<td>4</td>
<td>--0--</td>
<td>--0--</td>
<td>1,030</td>
<td>--0--</td>
</tr>
<tr>
<td>5</td>
<td>--0--</td>
<td>--0--</td>
<td>1,040</td>
<td>--0--</td>
</tr>
<tr>
<td>6</td>
<td>--0--</td>
<td>--0--</td>
<td>10,000</td>
<td>951</td>
</tr>
<tr>
<td>7</td>
<td>--0--</td>
<td>--0--</td>
<td>10,000</td>
<td>861</td>
</tr>
<tr>
<td>8</td>
<td>--0--</td>
<td>--0--</td>
<td>10,000</td>
<td>769</td>
</tr>
<tr>
<td>9</td>
<td>--0--</td>
<td>--0--</td>
<td>10,000</td>
<td>677</td>
</tr>
<tr>
<td>10</td>
<td>--0--</td>
<td>--0--</td>
<td>10,000</td>
<td>584</td>
</tr>
<tr>
<td>11</td>
<td>--0--</td>
<td>--0--</td>
<td>10,000</td>
<td>489</td>
</tr>
<tr>
<td>12</td>
<td>--0--</td>
<td>--0--</td>
<td>10,000</td>
<td>394</td>
</tr>
<tr>
<td>13</td>
<td>--0--</td>
<td>--0--</td>
<td>10,000</td>
<td>298</td>
</tr>
<tr>
<td>14</td>
<td>--0--</td>
<td>--0--</td>
<td>10,000</td>
<td>201</td>
</tr>
<tr>
<td>15</td>
<td>--0--</td>
<td>--0--</td>
<td>10,000</td>
<td>103</td>
</tr>
<tr>
<td></td>
<td>Total Paid</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>Net Saving</td>
<td>--0--</td>
<td>10,428</td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>Reduction of initial tax bill</td>
<td>--0--</td>
<td>10.4%</td>
<td>100,000</td>
</tr>
</tbody>
</table>
An additional element to consider in determining the economic benefits from installment payment of federal estate tax is whether interest on deferred estate tax is deductible as an expense of administration in the estate for federal estate and state death tax purposes. The Internal Revenue Service has taken the position that interest on deferred federal estate tax is not deductible as an administration expense in the estate. However, that ruling has been held invalid in a Tax Court case that allowed projected interest payments as a deductible administration expense where allowed by local law. Particularly because it involves current deductibility of interest expected to be paid, the economic significance of this issue is substantial.

**Section 303 stock redemptions**

The time for redemptions of stock after death under Section 303 of the Internal Revenue Code to pay federal estate tax, state estate and inheritance taxes, funeral costs and administration expenses allowed for federal estate tax purposes at the cost of capital gains taxation (rather than the dividend treatment typically accorded partial redemption of stock in a closely-held corporation) has been extended to the time needed to pay installments under the 15-year (or 10 year) installment payment of federal estate tax. For those operating in corporate form, this procedure represents a convenient way to use the income generating power of the business to pay the federal estate tax. Two key limitations may make qualification for Section 303 redemption difficult to achieve with planning and probably impossible without pre-death planning. (1) The benefits of a Section 303 redemption are available

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58/ I.R.C. § 6166A.
59/ I.R.C. § 303(a).
only to the extent that the interest of a shareholder whose stock is
redeemed is reduced directly or through a binding obligation to contribute
by payment of death taxes, funeral costs or administration expenses.\footnote{60/}
It is necessary, therefore, for the liability for payment of such costs to
be placed on those who own the stock to be redeemed. \footnote{(2) The value of the
stock included in the decedent's estate must exceed 50 percent of the adjusted
gross estate \cite{60/} (determined without regard to attribution rules).\footnote{61/} If two
corporations are involved, for example, one owning the land and another the
production side of the operation, the stock of each may be counted toward the
50 percent requirement if the decedent's gross estate included more than 75
percent in value of the outstanding stock of each corporation.\footnote{62/}

\textbf{Lien to secure payment of tax}

For deaths after 1976, an estate representative seeking discharge from
liability for payment of federal estate tax may file an agreement giving
rise to a special federal estate tax lien.\footnote{63/} The lien is authorized if 10 or
15-year installment payment has been elected. The lien is against "real
and other property" expected to survive the deferral period.

Once filed, the lien constitutes a priority claim against the property
as against subsequent claimants. However, the special lien is subordinated
to specified "super priority" claims including -- (1) real property tax and
special assessment liens,\footnote{64/} (2) mechanic's liens for repair or improvement
of real property,\footnote{65/} (3) real property construction or financing agreements

\begin{footnotes}
\item[60/] I.R.C. § 303(b)(3).
\item[61/] I.R.C. § 303(b)(2)(A).
\item[62/] I.R.C. § 303(b)(2)(B).
\item[63/] I.R.C. § 6324A.
\item[64/] I.R.C. § 6324(a)(d)(3)(B).
\item[65/] I.R.C. §§ 6323(x)(3)(A), 6324A(d)(3)(C).
\end{footnotes}
to finance the construction or improvement of real property or a contract to construct or improve real property and (4) the "raising or harvesting of a farm crop or the raising of livestock or other animals." For loans falling within one of the "super priority" categories, the special tax lien may not be of great significance. However, for borrowing for other purposes such as to purchase assets from other heirs, the presence of the special tax lien can create problems in financing. The problems may be especially severe where the lender requires a first lien for credit extension. Authority exists for subordination of the special tax lien in such instances with approval of the Department of the Treasury. While it would be unreasonable to expect subordination unless sufficient collateral exists to secure adequately the interest of the Department of the Treasury as well as those of the lender, additional guidance as to situations where subordination could reasonably be anticipated is needed in this area — (1) for taxpayers, (2) Internal Revenue Service field personnel and (3) lenders.

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67/ See I.R.C. § 6324.
Calculating Carryover Basis
Part I - "Fresh Start" Adjustment

Example: A farmer acquired a farm for $190,000 on January 1, 1971. A portion of the purchase price was allocated to the land and a portion to depreciable buildings, fences and tile lines. Depreciation of $9,000 was claimed each year on a straight line basis. At the farmer's death on January 1, 1981, the property was valued at $360,000. The calculation of carryover basis may be handled in five steps as follows:

Step 1: Determine gain at death

Fair market value $360,000
Adjusted income tax basis at death ($190,000 - (10 x $9,000)) 100,000
Gain at death 260,000

Step 2: Determine appreciation of property during holding period net of depreciation, depletion or amortization

Total gain at death 260,000
Depreciation claimed to date of death 90,000
Net appreciation to date of death 170,000

Step 3: Determine net appreciation for holding period before 1977

Number of days in holding period for farm in total 3,650
Number of days in holding period for farm before 1977 2,190
Fraction of total holding period before 1977 2190
3650
= 3/5
Net appreciation of property before 1977 3/5 x $170,000 = 102,000

Step 4: Determine depreciation, depletion and amortization attributable to the period before 1977
Depreciation for period before 1977 54,000

Step 5: Determine carryover basis adjustments to income tax basis of property

Adjusted basis at date of death 100,000
Net appreciation prior to 1977 102,000
Depreciation prior to 1977 54,000
Income tax basis of property after "fresh start" adjustment 156,000 156,000 256,000
Example: Returning to the example of a farm with a calculated carryover basis of $256,000 and a fair market value of $360,000, assume the decedent's federal estate tax calculations were as follows —

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross estate</td>
<td>$785,000</td>
</tr>
<tr>
<td>Deductions</td>
<td>$35,000</td>
</tr>
<tr>
<td>Adjusted gross estate</td>
<td>$750,000</td>
</tr>
<tr>
<td>Marital deduction</td>
<td>$375,000</td>
</tr>
<tr>
<td>Charitable deduction</td>
<td>$10,000</td>
</tr>
<tr>
<td>Taxable estate</td>
<td>$365,000</td>
</tr>
<tr>
<td>Tentative tax</td>
<td>$109,900</td>
</tr>
<tr>
<td>Unified credit (death in 1981)</td>
<td>$47,000</td>
</tr>
<tr>
<td>Total</td>
<td>$62,900</td>
</tr>
<tr>
<td>Credit for state death tax</td>
<td>$5,680</td>
</tr>
<tr>
<td>Federal estate tax due</td>
<td>$57,220</td>
</tr>
</tbody>
</table>

For the adjustment process, three values must be found —

1. Federal estate tax due (no state estate tax applicable) $57,220

2. Net appreciation in value of the property in question

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value</td>
<td>$360,000</td>
</tr>
<tr>
<td>Carryover basis</td>
<td>$256,000</td>
</tr>
<tr>
<td>Net appreciation</td>
<td>$104,000</td>
</tr>
</tbody>
</table>

3. Fair market value of property subject to the tax

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross estate</td>
<td>$785,000</td>
</tr>
<tr>
<td>Less: marital deduction</td>
<td>$375,000</td>
</tr>
<tr>
<td>Less: charitable deduction</td>
<td>$10,000</td>
</tr>
<tr>
<td>Total</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

With those three values known, the fourth, the adjustment for federal estate tax attributable to the net appreciation in value of the property can be computed —

\[
\text{Adjustment factor} = \frac{\text{Net appreciation}}{\text{FMV of all property subject to tax}} \times \text{Federal estate tax due}
\]

\[
\text{A.F.} = \frac{104,000}{400,000} \times 57,220
\]

\[
\text{A.F.} = 0.26 \times 57,220
\]

\[
\text{A.F.} = 14,877
\]

Thus, the adjustment factor for federal estate tax is $14,877, to be added to the fresh start basis for the farm —

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fresh start basis</td>
<td>$256,000</td>
</tr>
<tr>
<td>Plus: adjustment factor</td>
<td>$14,877</td>
</tr>
<tr>
<td>Total</td>
<td>$270,877</td>
</tr>
</tbody>
</table>
**Carryover Basis**

**Part III - Adjustment for Minimum $60,000**

Example I: Farmer A, a widower, dies owning three assets: a farm, a bank account and stored grain. The gross estate totals $475,000 as indicated.

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
<th>Fresh start basis</th>
<th>Federal and state estate tax adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Farm</td>
<td>442,000</td>
<td>2,000</td>
<td>72,320</td>
</tr>
<tr>
<td>Bank Account</td>
<td>8,000</td>
<td>8,000</td>
<td>0</td>
</tr>
<tr>
<td>Grain (1977 &amp; 78 crops)</td>
<td>25,000</td>
<td>0</td>
<td>4,410</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>475,000</strong></td>
<td><strong>10,000</strong></td>
<td><strong>76,730</strong></td>
</tr>
</tbody>
</table>

No further adjustment is possible because the aggregate basis of carryover basis property exceeds $60,000.

Example II: Farmer B, a widower, dies owning three assets: a farm, a bank account and a small beef cow herd. The gross estate totals $142,500 as indicated --

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
<th>Fresh start basis</th>
<th>Federal estate and state estate tax adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>130,000</td>
<td>32,000</td>
<td>0</td>
</tr>
<tr>
<td>Bank Account</td>
<td>2,500</td>
<td>2,500</td>
<td>0</td>
</tr>
<tr>
<td>Cattle</td>
<td>10,000</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>142,500</strong></td>
<td><strong>34,500</strong></td>
<td><strong>0</strong></td>
</tr>
</tbody>
</table>

With the aggregate basis of $34,500 on carryover basis property, the difference between that figure and $60,000 is available for allocation among items of carryover basis property --

$60,000 - $34,500 = $25,500

The amount of $25,500 may be allocated in a two-step procedure as follows --

**Step 1:** First, determine net appreciation in value --

- For the land, the net appreciation in value is the fair market value minus the carryover basis --
  
  $130,000 - 32,000 = 98,000$

- For the bank account, the net appreciation in value is figured using the same formula --
  
  $2,500 - 2,500 = 0$

- For the cow herd, the net appreciation in value is --
  
  $10,000 - 0 = 10,000$

The total net appreciation in value for all assets is --

$98,000 + 0 + 10,000 = $108,000$
Step 2: Allocate the available basis amount ($25,500) among the carryover basis assets.

- For the land: 
  \[
  \text{Basis available} = \frac{\text{Net appreciation in land}}{\text{Net appreciation of all property}} \times \text{Basis available for allocation}
  \]
  
  \[
  = \frac{98,000}{108,000} \times 25,500 \\
  = 0.9074 \times 25,500 \\
  = 23,139
  \]

  Thus, the new adjusted carryover basis for the land would be:

  \[
  = 32,000 + 23,139 \\
  = 55,139
  \]

- For the cow-calf herd:
  \[
  \text{Basis available} = \frac{\text{Net appreciation in herd}}{\text{Net appreciation of all property}} \times \text{Basis available for allocation}
  \]
  
  \[
  = \frac{10,000}{108,000} \times 25,500 \\
  = 0.0926 \times 25,500 \\
  = 2361
  \]

  Therefore, the cow-calf herd has a new adjusted carryover basis determined as follows:

  \[
  = 0 + 2361 \\
  = 2361
  \]

The income tax basis of the bank account of $2,500 is not adjusted because there is no net appreciation in that asset. To recapitulate, the income tax basis of carryover basis assets in Farmer B's estate after the minimum $60,000 income tax basis adjustment would be:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>$55,139</td>
</tr>
<tr>
<td>Bank Account</td>
<td>2,500</td>
</tr>
<tr>
<td>Cattle</td>
<td>2,361</td>
</tr>
<tr>
<td></td>
<td>$60,000</td>
</tr>
</tbody>
</table>
Example: Returning to the previous example, assume the land, the bank account and the cattle are all inherited by the son who pays a state inheritance tax of $4325. The asset value and basis are as follows.

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
<th>Fresh start basis</th>
<th>Federal estate &amp; state estate tax adjustment</th>
<th>Minimum aggregate basis adjustment</th>
<th>Basis before third adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>130,000</td>
<td>32,000</td>
<td>0</td>
<td>23,139</td>
<td>55,139</td>
</tr>
<tr>
<td>Bank Account</td>
<td>2,500</td>
<td>2,500</td>
<td>0</td>
<td>0</td>
<td>2,500</td>
</tr>
<tr>
<td>Cattle</td>
<td>10,000</td>
<td>0</td>
<td>0</td>
<td>2,361</td>
<td>2,361</td>
</tr>
<tr>
<td></td>
<td>142,500</td>
<td>34,500</td>
<td>0</td>
<td>25,500</td>
<td>60,000</td>
</tr>
</tbody>
</table>

The amount of $4325 in state inheritance tax would be allocated among the assets as illustrated in the following three step procedure —

**Step 1:** Determine the net appreciation in value for each item of property. This is defined as the excess of fair market value above the adjusted basis including all adjustments made to this point. Specifically, it includes the adjustment for federal estate and state estate tax and the minimum aggregate $60,000 as well as the fresh start basis amount.

- For the land, net appreciation would be —
  \[= 130,000 - 55,139\]
  \[= 74,861\]
- For the bank account, net appreciation would be —
  \[= 2,500 - 2,500\]
  \[= 0\]
- For the cow-calf herd, net appreciation would be —
  \[= 10,000 - 2,361\]
  \[= 7639\]

**Step 2:** Determine the fair market value of all property acquired by the son which is subject to state inheritance tax —

- Land: 130,000
- Bank Account: 2,500
- Cattle: 10,000

**Step 3:** Allocate the state inheritance tax among the assets

- **Adjustment to land basis** —
  \[= \frac{\text{Net appreciation in value}}{\text{Fair market value of all property}} \times \text{state inheritance tax paid}\]
\[
\begin{align*}
\frac{74,861}{142,500} \times 4325 &= 2272 \\
0.52534 \times 4325 &= 2272 \\
\end{align*}
\]

* Adjustment to basis of bank account --

\[
\begin{align*}
\text{Net appreciation in value} \times \text{state inheritance tax paid} &= \frac{\text{Fair market value of all property}}{142,500} \times 4325 \\
&= 0 \times 4325 \\
&= 0
\end{align*}
\]

* Adjustment to basis of cow-calf herd --

\[
\begin{align*}
\text{Net appreciation in value} \times \text{state inheritance tax paid} &= \frac{7639}{142,500} \times 4325 \\
&= 0.05361 \times 4325 \\
&= 232
\end{align*}
\]

As a final recapitulation, the income tax basis of carryover basis assets in the hands of Farmer B's son would be: -

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
<th>Fresh start basis</th>
<th>Federal estate &amp; state estate tax adjustment</th>
<th>Minimum aggregate basis adjustment</th>
<th>State inheritance tax adjustment</th>
<th>Basis to son</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>130,000</td>
<td>32,000</td>
<td>0</td>
<td>23,139</td>
<td>2,272</td>
<td>57,411</td>
</tr>
<tr>
<td>Bank Account</td>
<td>2,500</td>
<td>2,500</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>2,500</td>
</tr>
<tr>
<td>Cattle</td>
<td>10,000</td>
<td>0</td>
<td>0</td>
<td>2,361</td>
<td>232</td>
<td>2,593</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>142,500</td>
<td>34,500</td>
<td>0</td>
<td>25,500</td>
<td>2,504</td>
<td><strong>62,504</strong></td>
</tr>
</tbody>
</table>

Those figures are derived from the three adjustments to the fresh start basis as follows.