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NatAgLaw@uark.edu · (479) 575-7646

An Agricultural Law Research Article

An Analysis of the “Actual Use” Valuation Procedure of Section 2032A

by

Bradley Holtorf

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I. INTRODUCTION

In recent years the value of America's farmland has increased at a phenomenal rate. Statistics compiled for the year ending November 1, 1976, show that farmland values have more than doubled over the past five years and are expected to continue to rise in the future.¹ According to the Department of Agriculture, farmland in America's agricultural heartland appreciated in value an average of thirty-three percent last year.² The reasons given to explain this recent increase have been numerous and varied.³ However, one thing is certain; the rising land values have had a drastic impact on farmers owning large amounts of real estate at their death.

Normally, farmland is valued at its fair market value for purposes of assessing the federal estate tax.⁴ Under section 20.2031-1 (b) of the treasury regulations,⁵ this means, among other things, that farm property will be valued at its highest and best use, even though the valuation cannot be justified because of the lack of profitability of the farm or small business.⁶ This valua-

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1. ECONOMIC RESEARCH SERVICE, U.S. DEP'T OF AGRICULTURE, FARM REAL ESTATE MARKET DEVELOPMENTS (Jan. 1977).
 2. *Id.* This average was computed from the Corn Belt states which include Ohio, Indiana, Iowa, and Missouri. In Nebraska, farmland values have increased 25% the past year and 153% in the past 5 years.
 3. Some of the reasons given by economists are: (1) desire by farmers to enlarge their farmland holdings; (2) improved farm income; and (3) investment in farmland as a hedge against inflation. *Id.*
 4. See Treas. Reg. § 20.2031-1(b) (amended 1965). Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts. These facts include the highest and best use to which the property can be put, rather than its actual use. See 21 FED. TAX COORD. 2d (RIA) ¶ 6000.
 5. Treas. Reg. § 20.2031-1(b) (amended 1965).
 6. Avery & Benjamin, *Valuation of Farm and Closely Held Business Property: Recapture: Special Lien*, 2 ALI-ABA OUTLINE OF TAX REFORM ACT OF 1976 59 (1976).

tion method, combined with the gradually progressive rate of the federal estate tax, has resulted in the heirs being faced with higher estate taxes. In many cases, the greater estate tax burden has caused the heirs to discontinue the operation of the farm because the income potential from farming was insufficient to service extended tax payments or loans obtained to pay the tax.⁷ In less extreme cases, the heirs were forced to sell part of the family farm real estate in order to pay the estate taxes.

This farm valuation problem, however, did not go unnoticed or unremedied. In the Tax Reform Act of 1976, Congress enacted section 2032A of the Internal Revenue Code to remedy this problem and encourage the continual use of real property for farming purposes.⁸ Section 2032A is designed to apply to the family farm or closely-held business which is largely comprised of real property used in the trade or business. Basically, it allows a personal representative to elect, under certain conditions, to value such property on the basis of its "special use as a farm or business" rather than valuing it at its "highest and best use," which would take into account the other uses for which the property could be utilized. The effect is to permit a method of valuation in the estate tax field somewhat similar to the real property-tax-use valuation approach adopted in nine states and two provinces of Canada.⁹ As a result, for the first time the federal estate tax law recognizes that estates of equal size in terms of market value, which would otherwise be taxed at the same rate, will be taxed differently because of the nature or quality of the assets which form the taxable estate.¹⁰

This comment will lay out the complex operation of section 2032A in a typical family farm situation and discuss the major considerations a personal representative should evaluate in deciding whether to take advantage of this new "use" valuation provision. The application of section 2032A to a business other than farming will not be discussed in any detail, but will be mentioned in passing.

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7. H.R. Rep. No. 94-1380, 94th Cong., 2d Sess. 22, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 3356, 3376 [hereinafter cited as COMMITTEE REPORT].
 8. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003, 90 Stat. 856 (1976) (codified as I.R.C. § 2032A).
 9. Avery & Benjamin, *supra* note 6, at 59. For an extensive article on use valuation for property taxes, see *Use-Value Assessment Legislation in the United States*, 49 LAND ECON. 206 (1973).
 10. Huffaker, Ledwith, & Ting, *Many Provisions of the New Law Require Estate Planning Decisions Before 1977*, 45 J. TAX. 325, 328 (1976).

II. OPERATION OF SECTION 2032A

When a personal representative is contemplating the use of 2032A of the Internal Revenue Code he will have to ask himself the following questions. Does the estate qualify for actual use valuation under section 2032A? If it does, how much tax can be saved by using the valuation methods set out in section 2032A? If I make the election, what are the consequences to the heirs of the real property? If the estate qualifies and benefits from the valuation provision how do I elect it? In order for the personal representative to answer these questions he must have a good working knowledge of the operation of section 2032A. For discussion purposes, this comment divides the operation of section 2032A into four broad categories which parallel the questions the personal representative must answer in coming to a decision.

A. Qualifications for Using Section 2032A

The principal requirement under section 2032A is that the real property¹¹ owned by the decedent¹² be used for a "qualified use" by the decedent or a member of his family¹³ on the date of his death.¹⁴ The Internal Revenue Code¹⁵ defines "qualified use" as the devotion of the real property to either use as a farm¹⁶ for

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11. The real property must be located in the United States to qualify for § 2032A treatment. *See* I.R.C. § 2032A(b)(1). It should be noted that the proposed Technical Corrections Act of 1977, which is likely to pass this year would amend I.R.C. § 2032A(b)(1) by striking out "real property located in the United States" and inserting in lieu thereof "real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent." H.R. 6715, 95th Cong., 1st Sess. § 3(d)(1) (1977).
 12. The decedent at the time of his death must have been a citizen or resident of the United States. *See* I.R.C. § 2032A(a)(1)(A).
The Technical Corrections Act has proposed an amendment to I.R.C. § 2032A(e), which if passed, will add a new paragraph 10 which provides that I.R.C. § 2032A is to apply to community property in the same manner as property owned by the decedent in his individual capacity. H.R. 6715, 95th Cong., 1st Sess. § 3(d)(4) (1977).
 13. The term "member of the family" means only such individual's ancestor or lineal descendant, a lineal descendant of a grandparent or such individual, the spouse of such individual, or the spouse of any such descendant. A legally adopted child is also treated as a child of such individual by blood. I.R.C. § 2032A(e)(2).
 14. I.R.C. § 2032A(b)(1).
 15. I.R.C. § 2032A(b)(2).
 16. In general a "farm" includes stock, dairy, poultry, fruit, fur-bearing animal and truck farms, plantations, ranches, nurseries, ranges, greenhouses, or other similar structures used primarily for the raising of agricultural or horticultural commodities. *See* I.R.C. § 2032A(e)(4).

farming purposes,¹⁷ or use in a trade or business other than farming.¹⁸ In deciding whether real property is used as a farm for farming purposes, the activities engaged in on the real property will be determinative.¹⁹ However, in determining what is a trade or business other than farming, the Committee Report makes it clear that the mere passive rental of real property will not qualify as a trade or business.²⁰ Therefore, a person owning farmland as passive rental property will not qualify for the "actual use" valuation of section 2032A.²¹ It should be noted, however, that if a *related party* rents or leases the property from the decedent and conducts farming or other business activities on the property, the real property may qualify for "actual use" valuation.²²

In addition to the "qualified use" requirement, all of the following conditions must be satisfied to qualify for section 2032A treatment:

1. The adjusted value of the farm assets, both real and personal, in the decedent's estate must constitute at least fifty percent of the decedent's gross estate, reduced by debts and expenses;²³
2. At least twenty-five percent of the adjusted value of the gross estate must be "qualified farm real property;"²⁴

Although § 2032A does not mention fish farms, the regulations might expand the definition to include them, as happened with the soil and water conservation deduction allowed farmers. See I.R.C. § 175; Treas. Reg. § 1.175-3.

17. The term "farming purposes" includes the cultivation of the soil and raising or harvesting of agricultural or horticultural commodities. See I.R.C. § 2032A (e) (5).
18. Real property used in a trade or business other than farming may qualify for actual use valuation so long as the decedent or a member of his family materially participated in the use. See I.R.C. § 2032A (b) (1). It doesn't matter that the party carrying on the business was not the decedent or a member of his family. COMMITTEE REPORT, *supra* note 7, at 23.
19. COMMITTEE REPORT, *supra* note 7, at 23.
20. *Id.*
21. Tax Research Institute of America, Inc., *The RIA Complete Analysis of the '76 Tax Reform Law* 33 (Oct. 1976) [hereinafter cited as *RIA Analysis*].
22. For example, if A, the decedent owned real property which he leased for use as a farm to the ABC partnership in which he and his sons B and C each had a one-third interest in profits and capital, the real property could qualify for special use valuation. COMMITTEE REPORT, *supra* note 7, at 23. However, if the property is used in a trade or business in which neither the decedent nor a member of his family materially participates, the property would not qualify. *Id.*
23. I.R.C. § 2032A (b) (1) (A).
24. I.R.C. § 2032A (b) (1) (B).

3. The "qualified farm real property" must pass to a "qualified heir,"²⁵
4. The "qualified farm real property" must have been owned by the decedent or his family, and used or held for use as a farm for five of the last eight years preceding the decedent's death;²⁶ and
5. There must have been material participation in the operation of the farm by the decedent or a member of his family in such five-out-of-eight-year period.²⁷

Each of these five conditions needs further explanation.

For purposes of the fifty and twenty-five percent tests under (1) and (2) above, the value of the decedent's gross estate and the real and personal property therein is determined under the regular valuation rules, without regard to the value based on "actual use."²⁸ This means that the farmland will have to be valued on the basis of its highest and best use in order to determine whether the fifty and twenty-five percent tests are met. Therefore, the personal representative will have to calculate both the "actual use" valuation under section 2032A and the value of the farmland without regard to this section, *i.e.*, the value at its highest and best use.²⁹ Additionally, both the fifty and twenty-five percent requirements use the term "adjusted value" in referring to the value of the farm assets and the gross estate. "Adjusted value" is the value of the property figured under the regular valuation rules reduced by the amounts allowable as a deduction under section 2053(a)(4)³⁰ for mortgages and indebtedness attributable to the property.³¹

In comparing the fifty and twenty-five percent requirements it should be remembered that the former includes both the real and personal property used by the decedent in his farming operation, even though the personal property does not qualify for the "actual use" valuation. However, the twenty-five percent requirement only takes into account the "qualified real property" in the decedent's estate. This raises the question of what is included in the phrase "qualified real property." Does the farmhouse constitute

25. I.R.C. § 2032A(b)(1)(A)(ii).

26. I.R.C. § 2032A(b)(1)(C)(i).

27. I.R.C. § 2032A(b)(1)(C)(ii).

28. 4 Rabkin & Johnson, *FED. INC., GIFT AND EST. TAX. (MB)* § 52.10(2).

29. *RIA Analysis*, *supra* note 21, at 35. The calculation of both the "actual use" value and the highest and best use value also has to be performed for the \$500,000 limitation imposed by § 2032A. See note 59 and accompanying text *infra*.

30. I.R.C. § 2053(a)(4).

31. I.R.C. § 2032A(b)(3).

“qualified real property?” Fortunately, Congress in the Code and the Committee Report made the meaning of this phrase clear:

[T]he real property which qualifies for special use valuation includes the farmhouse, or other residential buildings, and related improvements located on qualifying real property if such buildings are occupied on a regular basis by the owner or lessee of the real property (or by employees of the owner or lessee) for the purpose of operating or maintaining the real property or the business conducted on the property.³²

In addition, roads and other improvements which are functionally related to the use of the land or contiguous with the farm are included in the term “qualified real property.”³³

On the other hand, elements of value which do not constitute “qualified real property” are mineral rights associated with the land.³⁴ Thus, if there is a coal lease, natural gas lease, or the like on a farm, the full value of the mineral right must be used for estate tax purposes.³⁵ Similarly, if an asset located on the property is neither functionally related to the farm operations nor contiguous with its use, the asset does not meet the definition of “qualified real property.”³⁶

The third condition listed above is that the “qualifying real property” pass to a “qualified heir.” The term “qualified heir” refers to a member of the decedent’s family which includes his spouse, lineal descendants, parents, brothers or sisters, and aunts or uncles and their descendants.³⁷ The fact that the property passes in trust to those individuals will not automatically disqualify the estate from section 2032A treatment. Congress intended for section 2032A to apply in situations where property passed in trust.³⁸ If property passes in trust, the property is deemed to have passed from the decedent to a qualified heir to the extent that the qualified heir has a present interest in that trust property.³⁹

32. COMMITTEE REPORT, *supra* note 7, at 23-24.

33. *Id.* at n.2. The COMMITTEE REPORT states that,

[r]esidential buildings or related improvements shall be treated as being on the qualified real property if they are on real property which is contiguous with qualified real property or would be contiguous with such property except for the interposition of a road, street, railroad, stream, or similar property.

Id. at 24 n.2.

34. *Id.* at 24.

35. Kirby, *How to Plan For New Special Rules of Valuing Farm and Close Corporation Real Estate*, 4 EST. PLAN. 94, 95 (1977).

36. *Id.*

37. See I.R.C. §§ 2032A (e) (1) -2032A (e) (2); note 12 *supra*.

38. COMMITTEE REPORT, *supra* note 7, at 23.

39. *Id.* The Technical Corrections Act, if passed, will amend I.R.C. § 2032A(e) by adding a new paragraph 9 which provides that the real

The last two conditions, (4) and (5) above, require the qualified real property to be used as a farm for five out of the last eight years prior to the decedent's death, during which time the decedent or a member of his family must have owned the property and materially participated in its operation. These conditions are self-explanatory with the exception of two terms: "ownership" and "material participation." What does "ownership" entail? Does it include direct ownership of qualified real property through a partnership, corporation, or trust? Section 2032A(g) states that the Internal Revenue Service is to prescribe regulations setting forth the application of the actual use valuation rules to situations involving otherwise qualifying real property held in a partnership, corporation, or trust.⁴⁰ The Committee Report goes on to state that,

a decedent's estate generally should be able to utilize the benefits of special use valuation where he holds the qualifying real property indirectly, that is, through his interest in a partnership, corporation, or trust, but only if the business in which such property is used constitutes a closely held business (as defined in section 6166, as amended by section 5 of this bill) and the real property would qualify for special use valuation if it were held directly by the decedent.⁴¹

From this, it seems clear that Congress did not intend to penalize those individuals operating their farms in forms other than sole

property is deemed to have passed to a qualified heir even though the property is acquired pursuant to a pecuniary bequest. The new paragraph will read as follows:

(9) PROPERTY ACQUIRED FROM DECEDENT.—Property shall be considered to have been acquired from or to have passed from the decedent if—

(A) such property is so considered under section 1014 (b) (relating to basis of property acquired from a decedent),

(B) such property is acquired by any person from the estate in satisfaction of the right of such person to a pecuniary bequest, or

(C) such property is acquired by any person from a trust in satisfaction of a right (which such person has by reason of the death of the decedent) to receive from the trust a specific dollar amount which is the equivalent of a pecuniary bequest.

H.R. 6715, 95th Cong., 1st Sess. § 3(d) (2) (1977).

Furthermore, the Technical Corrections Act proposes an amendment to I.R.C. § 1040(a) which would provide that the funding of such a pecuniary bequest with I.R.C. § 2032A special use valuation property will not result in recognition of gain other than appreciation occurring after the decedent's date of death. H.R. 6715, 95th Cong., 1st Sess. § 3(d) (3) (1977).

40. I.R.C. § 2032A(g).

41. COMMITTEE REPORT, *supra* note 7, at 24.

proprietorships. However, until the regulations are promulgated, the extent of the application of section 2032A to corporations, partnerships, and trusts is unknown.⁴²

The fifth condition requires "material participation" in the operation of the farm by the decedent or a member of his family in five out of the eight years immediately preceding the decedent's death. Whether there has been "material participation" by an individual in the operation of a farm is to be determined in a manner similar to that used for purposes of computing self-employment tax on the production of agricultural or horticultural commodities under section 1402(a)(1).⁴³ Therefore, mere passive rental of the real property will not qualify as material participation. However, if a landowner under a sharecropping arrangement leases or rents his land to another individual for the production of agricultural commodities, it is possible that the estate of the decedent landowner may meet the material participation requirement.⁴⁴

Clearly, if the arrangement provides that the landowner, while alive, will actually participate in the production, it would appear that the requirement is satisfied. Likewise, if the landowner materially participates in the management decisions of the production, his estate would appear to qualify. This conclusion seems evident because the share-farming arrangement is more than mere passive rental of the land. Suppose, however, that physical work and management decisions are not part of the arrangement. Whether there was material participation by the decedent landowner now becomes less obvious:

"While, physical work and management decisions are the princi-

42. Some people have come to the conclusion that the actual use valuation procedure of § 2032A will be useless to estates holding stock in a closely-held farm corporation when such stock is of less than liquidating control. Relying on Rev. Rul. 64-19, 1959-1 C.B. 237 it is their position that where less than liquidating control is involved, the primary emphasis in valuing the stock will be on the earning power of the farm corporation, and this will generally produce a lower valuation than one on the underlying asset valuations. See *Outline of Tax Reform Act of 1976, Estate and Gift Tax Changes* (NCLE) V-8 (1977) [hereinafter cited as *Outline of Reform Act*].

43. I.R.C. § 1402(a)(1). COMMITTEE REPORT, *supra* note 7, at 23 n.1.

44. Treas. Reg. § 1.1402(a)-4(b)(4) provides that,

[i]f the owner or tenant shows that he periodically advises or consults with the other person, who under the arrangement produces the agricultural or horticultural commodities, as to the production of any of these commodities and also shows that he periodically inspects the production activities on the land, he will have presented strong evidence of the existence of the degree of participation contemplated by section 1402(a)(1). If, in addition to the foregoing, the owner or tenant shows that he furnishes a substantial portion of the machinery, implements, and livestock used in the production of the commodities or that he furnishes or advances funds, or assumes financial responsibility, for a substantial part of the ex-

pal factors to be considered, the furnishing by the landowner of machinery, implements and livestock used in the production activities, or the furnishing or advancing of funds or the assuming of financial responsibility for expenses involved in the production of a commodity are additional factors which may be considered in arriving at a decision in a borderline case."⁴⁵

Therefore, it becomes apparent that the determination of each case as to whether there was material participation by the decedent rests on its own facts and circumstances.

In the case of trusts, material participation by an independent trustee or by an independent farm management agency may not be attributed to the grantor or principal.⁴⁶ Furthermore, the appointment of the grantor or a family member as trustee or co-trustee will probably not suffice. Evidence of actual participation will be required and compliance with fiduciary responsibility will not be assumed.

B. Methods for Valuing Farmland Under Section 2032A

Once the personal representative establishes that he meets the qualifications set down by section 2032A, the Code provides a special "farm method" to value the real property.⁴⁷ Under this method, the value is determined by dividing the *average annual cash rental* for comparable farmland in the locality, which is the net of the state and local real estate taxes, by *the average annual effective interest rate* for all new Federal Land Bank loans.⁴⁸ For purposes of this special "farm method," each average annual computation is made on the basis of the five most recent calendar years ending before the date of the decedent's death.⁴⁹ It has been estimated that this formula approach will result in discounts of approximately thirty percent with respect to farmlands and higher discounts in the case of ranchlands.⁵⁰ For example, assume that the decedent's estate contained farmland that was selling for \$1,200 per acre.

pense involved in the production of the commodities, he will have established the existence of the degree of participation contemplated by section 1402(a)(1) and this paragraph.

45. Kirby, *supra* note 35, at 95-96 (quoting Rev. Rul. 57-58, 1957 C.B. 270).

46. *Outline of Reform Act, supra* note 42, at V-7.

47. The valuation of the qualified real property under § 2032A refers to the "value of the use under which it qualifies." Does this refer to the actual use of the property at the date of the decedent's death or does it refer to the "highest and best" *agricultural use*? One authority takes the position that it only refers to the actual use in effect at the decedent's death. See Avery & Benjamin, *supra* note 6, at 63.

48. See I.R.C. § 2032A(e)(7).

49. *Id.*

50. *Outline of Reform Act, supra* note 42, at V-9.

Further, assume that the average annual cash rental per acre is \$50 and the average annual effective interest rate for all new Federal Land Bank loans is eight percent. The value of the farmland for estate tax purposes under section 2032A would be \$625 ($\$50 \div .08$). That would mean a savings of \$575 per acre to the decedent's gross estate.

The reason Congress tied the farmland value for estate tax purposes to the cash rental value of the farmland was to avoid the "speculative values" associated with farmland prices. As the Committee Report stated:

[W]here the valuation of land reflects speculation to such a degree that the price of the land does not bear a reasonable relationship to its earning capacity, your committee believes it unreasonable to require that this "speculative value" be included in an estate with respect to land devoted to farming or closely held businesses.⁵¹

The cash rent approach is designed to reflect the productive value of farm and ranchland, since cash rents are direct costs which must be paid from production derived from the land. By using this method Congress saw three advantages: first, it should reduce subjectivity, and thus controversy, in farmland valuations because it provides an objective method of valuation; second, it should eliminate any values attributable to the potential conversion of the farmland to nonagricultural use; and third, it should also eliminate as a valuation factor any amount by which the farmland is bid up by speculators in situations where nonagricultural use is not a factor in inflated farmland values.⁵²

Although the advantages set forth by Congress are meritorious, the special "farm method" of valuation is not without its problems. Section 2032A(e)(7) only allows capitalization of comparable gross cash rental farmland. Ranchland lends itself to such a valuation approach, but farmland is often leased on a crop share basis rather than for cash rent. Therefore, personal representatives may have a hard time establishing comparable cash rental of farmland in the area. Additionally, how large is the "locality" by which the personal representative must establish the comparable cash rentals? It could mean the particular county in which the farm is located. Similarly, it could mean the state or the Federal Land Bank Region in which such farm is to be found. The Code does not give the personal representative any guidance in this area. Hopefully, the regulations will dispel these problems by clarifying and expanding the meaning of these terms.

51. COMMITTEE REPORT, *supra* note 7, at 22.

52. *Id.* at 24-25.

Furthermore, determination of the average annual effective interest rate for all new Federal Land Bank loans cannot be computed without guidelines. There are twelve Federal Land Bank regions located throughout the United States, each of which may have varying interest rates on the same day of the year. The rates may vary with the amount of the loan, its duration, the economic climate, and the like.⁵³

However, in the meantime the Code provides that if there is no comparable land from which the average annual gross cash rental can be determined, or if the personal representative so elects, the special "farm method" for valuation is not available.⁵⁴ Instead, the personal representative must use a multiple factor method of valuation which includes the following factors: (1) capitalization of income which may be expected from the farm or business under the applicable factual circumstances; (2) capitalization of the fair rental value of the land for farming purposes; (3) assessed land values, where a farm differential is available; (4) comparable sales of other farmland in the locality; and (5) any other factor which fairly values the farm property.⁵⁵ These valuation factors are not alternatives, but are taken into account in the aggregate in determining the special valuation.⁵⁶ Although the multiple factor

53. Kirby, *supra* note 35, at 97. In addition, Kirby noted:

For some time, *Agricultural Statistics* has published a list of all loans outstanding from all Federal Land Banks on a particular day of a given year. If this publication is to serve as the basis for establishing the average annual effective interest rate, the same will be relatively easy to calculate. But, these statistics are not completely accurate in reflecting the true interest rate picture. A weighted average of the rates would be more precise in revealing the true effective interest rate for a particular day in a given year. The calculations involved in computing an interest rate based on weighted averages may, however, prove to be burdensome to compute as well as costly to the estate insofar as the practitioner's time is concerned.

Id.

54. This alternative method of valuation under § 2032A is the only one available for closely held businesses engaging in a trade or business other than farming. See I.R.C. § 2032A (e) (8).

55. See I.R.C. § 2032A (e) (8).

56. These factors standing alone provide minimal guidance for the personal representative. Kirby suggests that,

[t]o effectively use this provision, reference is made to Section 2031 and, in particular, to *Rev. Rul. 59-60, 1957-1CB 237*, which offers a detailed discussion of the factors to be considered in valuing closely held business interests. The burden is on the executor to convince the Service that the value he has established is a fair value representative of the closely held business interests of the decedent.

Kirby, *supra* note 35, at 98.

method is designed to avoid considering the potential use of the farmland for something other than agricultural use it does consider the comparable sales of other farmland in the area. The comparable sales of farmland in the area will include "speculative values" attributable to the land, i.e., part of the sale price of the land is due to pure speculation that the land prices will continue to rise. Once again this will create a situation where the valuation of the farmland does not bear a reasonable relationship to its earning capacity. In addition, disagreements are bound to occur between the Internal Revenue Service and the personal representative as to which factors are the most appropriate or influential in determining value.⁵⁷ Therefore, if a personal representative has to resort to the multiple factor formula of valuation the advantages of section 2032A are drastically reduced. In this situation he will probably use the normal valuation method of "highest and best" use.

Regardless of whether the special "farm method" or the multiple factor method is used, section 2032A sets a maximum on the amount a gross estate can be reduced by the actual use valuation.⁵⁸ Section 2032A(a)(2) provides that the aggregate decrease in the value of the qualified real property in the decedent's estate cannot exceed \$500,000. This \$500,000 limitation means that the property will have to be valued both on its highest and best use and its special valuation use in order to check the limitation.⁵⁹

57. For example, the capitalization rate will present one of the most difficult problems in determining a value under this alternative method.

The ratio will vary widely and will fluctuate from year to year depending upon economic conditions. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

In the case of the farmer, perhaps the establishment of a capitalization rate is *the one most* difficult factor to determine. Consider the nature of his business: he must expend considerable sums of money for equipment, fertilizer, feed, etc. He must hope that the particular crops he harvested are bought at a price sufficient to provide him a decent return on his investment. In this regard he is like any other businessman. However, his business is one in which success or failure is extremely difficult to predict. The farmer is at the mercy of the weather. A drought, an unexpected frost, or the like could destroy his entire crops for a growing season. Farming is, undoubtedly, one of the highest risk ventures an individual can undertake. In view of these risks, the stability or the irregularity of his earnings may present wide variances over the years. Thus, while a proper capitalization rate is a very important factor, it, standing alone, is not enough to establish the value of one's closely held farm business.

Id. (citations omitted) (emphasis in original).

58. See I.R.C. § 2032(a)(2).

59. See note 29 and accompanying text *supra*.

To any farmer with substantial amounts of real property this maximum limitation will not take long to reach. For example, if we take the per acre savings of \$575 from the prior example, the decedent would have to own approximately 870 acres ($\$500,000 \div \575 per acre) in order to reach the \$500,000 maximum limitation. Therefore, there could be a lot of estates taking full advantage of the reduced valuations under section 2032A.

C. The Recapture Rules

In enacting section 2032A Congress recognized that it would be a windfall to the beneficiaries of an estate to allow real property used for farming to be valued at its "actual farm use" unless the beneficiaries continued to use the real property in a farming operation for a reasonable period following the decedent's death.⁶⁰ As indicated earlier, one of the primary purposes of the provision was to eliminate from farmland valuations the "speculative values" associated with the land and instead, value it only on the basis of its earning capacity as a farm. This allows the heirs to pay the estate taxes attributable to the land from the income derived in using the real property for farming. It would clearly be inequitable to discount the "speculative value" associated with the farmland if the heirs, shortly after the decedent's death, sold or changed the land's use thereby realizing the discounted amount. Therefore, in order to prevent this possible abuse Congress provided for recapture rules with respect to the tax savings obtained by section 2032A.

The estate tax benefits obtained by the reduced valuation under section 2032A are recaptured if, within fifteen years after the decedent's death, the qualified heir or heirs dispose of any interest in the real property to a nonfamily member, or cease to use the real property for farming purposes.⁶¹ It is important to note that the death of the qualified heir within this fifteen year period does not trigger the recapture rules.⁶² Moreover, the qualified heir's death eliminates the potential liability of recapture to the extent of his interest in the real property.⁶³ For example, if the father leaves farmland to his children as tenants in common and they elect the actual use valuation, the death of one of the children will free that child's interest in the property from any further potential liability for the recapture tax.⁶⁴

60. COMMITTEE REPORT, *supra* note 7, at 22.

61. I.R.C. § 2032A(c)(1).

62. COMMITTEE REPORT, *supra* note 7, at 26.

63. *Id.*

64. However, if the decedent leaves qualified real property for which special use valuation was elected to two or more qualified heirs with suc-

Since a disposition of the real property to a nonfamily member triggers the recapture event, the personal representative will need to know what the term "disposition" encompasses. The Committee Report makes it clear that the recapture provision applies not only if the real property is sold to nonfamily members, but also where the property is disposed of to nonfamily members in a tax-free exchange.⁶⁵ Therefore a like-kind exchange under section 1031⁶⁶ or an involuntary conversion under section 1033⁶⁷ will result in the recapture provision being applied.⁶⁸ The recapture on the involuntary conversion, however, will not take place if the proceeds are *reinvested in the real property which originally qualified for actual use valuation*.⁶⁹ Presumably, this would have to take place within two years from the date of the involuntary conversion.⁷⁰ However, if the "qualified real property" is condemned, what use or uses consistent with the original use which initially qualified the property for special use valuation remain?

Suppose the qualified real property was the subject of an eminent domain proceeding. If the property is condemned or converted for public use by the government, there would appear to be no means available by which the qualified heir could reinvest in the real property which originally qualified for special use valuation. This seems to present a difficult problem. On the one hand, the exception to the recapture provision precludes its applicability if the proceeds are reinvested in the qualified real property. On the other hand if the land is taken via eminent domain proceedings, the Congress effectively has excluded the qualified heirs from coming within the ambit of the exception.⁷¹

A tax-free transfer by the qualified heir to a controlled corporation under section 351⁷² or to a partnership under section 721⁷³ will avoid recapture only if the following conditions are met: (1) the qualified heir retains the same equitable interest in the real property; (2) the corporation or partnership would, with respect to the qualified heir, be considered a closely held business under section

cessive interests in the property, potential liability for the recapture tax is not diminished and none of the property is to be released from potential liability for the recapture tax until the death of the last of the qualified heirs. *Id.*

65. *Id.* at 25.

66. I.R.C. § 1031.

67. I.R.C. § 1033.

68. COMMITTEE REPORT, *supra* note 7, at 25.

69. *Id.*

70. See I.R.C. § 1033(a)(2)(B).

71. Kirby, *supra* note 35, at 99.

72. I.R.C. § 351.

73. I.R.C. § 721.

6166;⁷⁴ and (3) the corporation or partnership consents to personal liability for the recapture.⁷⁵

Section 2032A(c)(1)(B) provides that the recapture tax is imposed if the qualified heir ceases to use the real property for the qualified use within fifteen years after the decedent's death.⁷⁶ The "cessation of qualified use" occurs if:

- (1) the property ceases to be used for the use under which it originally qualified;⁷⁷ or
- (2) during any eight year period ending after the date of decedent's death and before the death of the qualified heir, there are three years or more during which,
 - (a) there was no material participation in the operation by the decedent or a member of his family while the property was held by the decedent, and
 - (b) there was no material participation in the operation by the qualified heir or any member of his family while the property was held by the qualified heir.⁷⁸

A number of observations can be made from the above rules. First, switching the real property from a farm use to a use in a trade or business other than farming would apparently trigger the recapture.⁷⁹ Second, the three year period of no material participation does not have to be consecutive.⁸⁰ Finally, under (2) above, the lack of material participation by the decedent is apparently tacked onto the lack of material participation by the qualified heir in order to determine whether there has been a cessation of qualified use. For example, suppose for the two year period immediately before the decedent's death there was no material participation by the decedent. The property may still have qualified for special use valuation if the five-out-of-eight-years test was met. But, in this case, the recapture rules will apply if there is no material participation by the qualified heir for a period of only one year during the six years (eight less two) ending after the decedent's death. The two year nonparticipation by the decedent tacked onto the one year nonparticipation by the qualified heir adds up to three years of nonparticipation during an eight year period ending after the decedent's death.⁸¹

74. I.R.C. § 6166.

75. COMMITTEE REPORT, *supra* note 7, at 24 n.3.

76. I.R.C. § 2032A(c)(1)(B).

77. I.R.C. § 2032A(c)(7)(A).

78. I.R.C. § 2032A(c)(7)(B).

79. *RIA Analysis*, *supra* note 21, at 37.

80. *Id.* at 38.

81. *Id.* at 37-38.

Partial recapture may result where there is disposition or cessation of qualified use of a portion of an interest in the qualified real property.⁸² If there is a partial disposition or partial cessation of the qualified use, the recapture amounts are determined on a pro rata basis. Also, if there are two or more recapture events, the recapture tax is imposed only once with respect to any portion of qualified property. For example, if recapture applies to any portion of an interest in qualified real property because of a cessation of qualified use, recapture will not be applied against the same portion because it is later disposed of to a nonfamily member.⁸³

The qualified heir is expressly made personally liable for the recapture tax imposed with respect to his interest in the qualified property.⁸⁴ What happens, however, if he sells his interest to a family member during the fifteen year period following the decedent's death? Since a sale, exchange, or other disposition⁸⁵ by one qualified heir to another qualified heir is not treated as a recapture event, the second qualified heir is treated as if he had received the property from the decedent. Thus, the second qualified heir steps into the shoes of the first heir and becomes liable for the recapture tax even though the second qualified heir may have paid the first qualified heir full fair market value for the qualified property.⁸⁶

In the event that the real property is transferred outside the family or ceases to be used for farming, the amount of the recapture tax is figured on a sliding scale; full recapture is provided for the first ten years with a phase out of the amount subject to recapture during the remaining five year period.⁸⁷ The Code provides that the measure of recapture for the first ten years following the decedent's death is the lesser of the estate tax saved by using section 2032A, or the excess of the amount for which the property was sold, or its fair market value if otherwise disposed of, over the special use estate tax value.⁸⁸

82. See I.R.C. § 2032A(c)(2)(D).

83. *RIA Analysis*, *supra* note 21, at 38. See I.R.C. § 2032A(c)(4).

84. I.R.C. § 2032A(c)(6). The recapture obligation is imposed on all heirs who have signed the agreement referred to in § IID of the text *infra*, each in proportion to his interest in the property. This is true even though the will specifies that all estate taxes will be paid by the residuary estate, and is true although many of the signers may have no control over the disposing or ceasing-use heir's actions. Under these circumstances how could a minor's guardian, or why should any specific legatee, ever agree to a § 2032A election? Avery & Benjamin, *supra* note 6, at 64.

85. Such as a gift.

86. COMMITTEE REPORT, *supra* note 7, at 26-27.

87. 221 TAX MNGM'T (BNA) 99.

88. I.R.C. § 2032A(c)(2).

If the disposition or cessation occurs within ten to fifteen years after the decedent's death, the amount subject to recapture is reduced by twenty percent per year, figured on a monthly basis.⁸⁹ This method of figuring the recapture tax provides for a maximum amount of tax that can be recaptured but no minimum. Thus, if the fair market value of the property decreases during the recapture period the qualified heir will get the benefit by reducing the potential amount of recapture taxes due. However, if the property increases in value during the recapture period the amount of the potential recapture tax will not increase. Nothing is specified for the situation in which the real property decreases in value below its special use value.

The total amount of the recapture tax is due and payable six months after the date of disposition or cessation of the qualified use.⁹⁰ Note, however, that no interest is charged on the recapture tax if the full amount is paid by the due date.⁹¹ Moreover, the recapture estate tax may qualify for the credit on prior transfers. For purposes of computing the credit, the value of the property and the taxable estate of the transferor are determined without regard to actual use valuation. The Committee Report states:

While the recapture tax is generally treated as a separate estate tax it is treated as a tax on the estate of the decedent for purposes of the previously taxed property credit. If the qualified heir dies within 10 years of the time of the death of the decedent but after a recapture event has occurred, this recapture tax would be utilized in computing the previously taxed property credit. However, it would be treated as having been imposed as of the date of the decedent's death, rather than at the time the actual recapture event occurred.⁹²

Finally, the statutory period for assessment of any recaptured estate tax is extended until three years after the date the treasury is notified that the qualified real property has been disposed of or has ceased to be used for a qualified use.⁹³

D. Making the Election

Once the personal representative has established that the estate qualifies and benefits by using the special use valuation he will have to make an election as set forth in section 2032A(d). The election must be made not later than the due date, including exten-

89. Avery & Benjamin, *supra* note 6, at 64.

90. I.R.C. § 2032A(c)(5).

91. RIA *Analysis*, *supra* note 21, at 38. Payments after that date would be subject to the regular rate of interest which is currently 7%.

92. COMMITTEE REPORT, *supra* note 7, at 27.

93. See I.R.C. § 2032A(f).

sions, for filing the estate tax return and in a manner prescribed by the regulations to be issued.⁹⁴ Although there are no regulations issued at this time, one of the requirements for making a valid election is the filing of a written agreement signed by each person in being who has an interest in any of the property for which the actual use valuation was used.⁹⁵ The fact that a person is not in possession of the property does not excuse him from signing this agreement.⁹⁶ For example, if there are five individuals who have an interest and only four of them sign the agreement, strict construction of the language dictates that the personal representative would be precluded from employing the special use valuation.⁹⁷ The agreement must establish the consent of each person to the application of the recapture tax discussed earlier.⁹⁸ The written agreement amounts to a consent to be personally liable for any recapture tax imposed with respect to the qualified heir's interest in the real property.⁹⁹ Presumably, the consent agreement will indicate the difference between the actual use and the fair market valuation that will be subject to recapture.

Furthermore, upon election a tax lien for the amount of the potential recapture tax is imposed on the property.¹⁰⁰ This lien will continue until the tax benefit is recaptured or until the potential liability for recapture ceases, *i.e.*, the qualified heir dies or a period of fifteen years from the decedent's death lapses.¹⁰¹ The regulations are to prescribe ways by which security can be substituted for the lien. It must be filed of record in a public index in the pertinent Internal Revenue Service District Office to affect third parties' rights.¹⁰²

III. THE RELATIONSHIP OF SECTION 2032A WITH OTHER CODE PROVISIONS

The personal representative or estate planner cannot read

94. I.R.C. § 2032A(d)(1).

95. I.R.C. § 2032A(d)(2).

96. *Id.*

97. Kirby, *supra* note 35, at 94.

98. COMMITTEE REPORT, *supra* note 7, at 27.

99. The Technical Corrections Act has proposed a new paragraph 11 to I.R.C. § 2032A(e), which if passed, would provide that the qualified heir may be discharged from personal liability by furnishing a bond for the maximum amount of recapture tax which may be imposed with respect to such person's interest. The Internal Revenue Service must provide the heir this amount upon written request. H.R. 6715, 95th Cong., 1st Sess. § 3(d)(5) (1977).

100. I.R.C. § 6324B.

101. COMMITTEE REPORT, *supra* note 7, at 27.

102. I.R.C. § 6324B(c).

section 2032A in complete isolation. Instead, he must consider it in light of numerous other Code provisions. To begin with, the use of section 2032A must be compared with the effect it might have on the use of section 6166.¹⁰³ Section 6166 provides for a fifteen year extension on the payment of estate taxes if the closely-held business comprises sixty-five percent of the adjusted gross estate.¹⁰⁴ During this fifteen year period no principal payments are required in the first five years and the rate of interest is only four percent. The purpose behind this section is to reduce the risk that farms and other small businesses may be sold on a forced basis because of the lack of liquidity at the owner's death. However, the use of section 2032A valuation may lower the value of the farm to such an extent that the estate no longer meets the sixty-five percent requirement and thus would not qualify for section 6166 tax deferral.¹⁰⁵ If this is the case, the personal representative will have to determine whether a low estate tax value or a deferred payout is preferable.¹⁰⁶

Some thought by the estate planner will also have to be given to the form of ownership or method of doing business, particularly if the spouses own the real property in joint tenancy.¹⁰⁷ Section 2040(b)¹⁰⁸ now provides that if an election is filed under section 2515(c)¹⁰⁹ to have the creation of the joint tenancy treated as a gift, only one-half of the value of the real property will be included in each joint tenant's estate.¹¹⁰ Such an election could have significant ramifications in determining the fifty and twenty-five percent requirements of section 2032A. By making the election under 2515(c) you might be disqualifying both spouses from meeting the percentage requirements of section 2032A and section 6166. Therefore the estate planner will have to consider whether the election under section 2515 to utilize the fractional interest rule will have an effect upon the later election of section 2032A.

Another consideration by the estate planner will be whether to take advantage of giving gifts of interest in the real property during the owner's lifetime. The actual use valuation rule of section 2032A

103. I.R.C. § 6166.

104. An estate which qualifies for actual use valuation may qualify for the 10 year or 15 year installment payment privilege. See *RIA Analysis*, *supra* note 21, at 34.

105. Avery & Benjamin, *supra* note 6, at 70.

106. *Id.*

107. Huffaker, Ledwith, & Ting, *supra* note 10, at 328.

108. I.R.C. § 2040(b).

109. I.R.C. § 2515(c).

110. See I.R.C. § 2040(b)(1).

does not apply for gift tax purposes.¹¹¹ Therefore, if the owner is making lifetime gifts of interests in the farmland to take advantage of the present interest annual exclusion, the property will be valued for gift tax purposes at its highest and best use. Thus, the estate planner will have to compare the reducing of the decedent's estate by lifetime gifts with the benefit of using section 2032A at the owner's death. He may find it advisable to hold the qualified real property until the owner's death and make gifts of other non-qualifying real property during his lifetime. However, throughout the gift-giving program he must always be aware of the percentage requirements of section 2032A. In addition, section 2035¹¹² creates a problem with gifts of property which qualifies for section 2032A treatment. It is not clear whether, if the real property is brought back into the estate under section 2035, the "special use" value can be elected if a gift was previously made of the real property and a gift tax paid based on its "highest and best use" value.¹¹³ Hopefully, the regulations will answer this question.

Another relationship that the personal representative must be aware of in deciding whether to use section 2032A is the basis of the farmland for future income tax purposes. If the farmland is valued under the special valuation provision the basis of such property in the hands of the qualified heir will be limited to the value determined under the special valuation rule. Normally, the "fresh-start" rule of section 1023¹¹⁴ would allow the property's income tax basis to be increased to its "value" at December 31, 1976, which is conclusively presumed to be the decedent's basis increased by the pro rata proportion of the appreciation between the date of acquisition by the decedent and the date of death.¹¹⁵ If the value of the property figured under section 1023 is greater than that under section 2032A a reduction in basis will result.

Thus obtaining a low value by using Code Section 2032A may mean lowering the income tax basis of the real property in the hands of the heirs. Is a lower value of estate taxes worth a possible lower income tax basis? That will depend on the existence of depreciable assets, the amount of basis allocable to the depreciable assets, and the tax brackets (for several years) of the beneficiaries.¹¹⁶

Furthermore, if the carryover basis is determined by reference to the "special use" value and recapture of the difference in tax occurs,

111. See *RIA Analysis*, *supra* note 21, at 34; *Avery & Benjamin*, *supra* note 6, at 72.

112. I.R.C. § 2035.

113. *Avery & Benjamin*, *supra* note 6, at 72-73.

114. I.R.C. § 1023.

115. *Avery & Benjamin*, *supra* note 6, at 71.

116. *Id.*

does the heir get a retroactive increase in his basis? Again, the Code does not speak to this issue. It is one scholar's opinion that the heir would be entitled to such an increase in basis.¹¹⁷ However, there are other opinions to the contrary.¹¹⁸ The future regulations will have to clarify this problem.

The use of section 2032A could also have an effect on marital deduction gifts under section 2056.¹¹⁹ A special valuation under section 2032A could affect the size of the marital deduction gift. For example, if the decedent left his spouse the maximum marital deduction allowable and his gross estate is \$600,000 when valued under normal valuation rules, i.e., highest and best use, the marital deduction would be \$300,000. However, if a special valuation election reduces the gross estate to \$400,000, the marital deduction would be \$250,000.¹²⁰ With this difference in the marital deduction area, it has been suggested that a pecuniary or other formula clause should be funded by valuing any special use valuation property at its highest and best use.¹²¹

Section 2032A may also complicate the calculations under the alternate valuation provision of section 2032.¹²² At this point it is not clear how the election under section 2032 to value the property at the alternate valuation date affects the actual use valuation. If the "farm method"¹²³ under section 2032A is used to value the farm, then the valuation will be based on an average of certain figures for the five years before the decedent's death.¹²⁴ However, if the valuation is determined by applying the multiple factor method,¹²⁵ the factors would apparently be applied as of the alternate valuation date.¹²⁶

Therefore, from the foregoing paragraphs it can readily be seen that the decision of a personal representative or estate planner in deciding whether to use the "actual use" valuation will not be limited to an analysis of the requirements of section 2032A alone. Instead, he will have to analyze the effect of a section 2032A election upon the other estate, gift, and income tax provisions.

117. *Id.*

118. *See Outline of Reform Act, supra* note 42, at V-9.

119. I.R.C. § 2056.

120. *Outline of Reform Act, supra* note 42, at V-10.

121. *Id.*

122. I.R.C. § 2032.

123. *See* § IIB of text and note 46 *supra*.

124. *RIA Analysis, supra* note 21, at 34.

125. *See* § IIB of text and note 53 *supra*.

126. *RIA Analysis, supra* note 21, at 34.

IV. CONCLUSION

With the stringent qualifications in electing section 2032A treatment and the recapture rules once elected, the "actual use" valuation will clearly not be used by those who are not already engaged in farming operations, nor by those individuals whose intended beneficiaries do not intend to engage in farming. However, for those individuals who have farmed for a lifetime and whose children will continue to operate the farm in the future, section 2032A could offer them a substantial estate tax savings. However, the estate tax savings are not obtained without incurring some unfavorable results. Beyond the recapture rules already discussed,¹²⁷ the owners of the farmland will have to do extensive pre-death planning in order to meet the qualifications of section 2032A. This might consist of taking care that qualified farm property is left to those beneficiaries who will continue to operate the farm for the qualified use. Also, the owners will have to watch their lifetime form of ownership and disposition of the farmland in order that the percentage requirements of section 2032A will be met.

In addition, a substantial increased burden will be placed upon the personal representative of the decedent's estate. To begin with, the personal representative will have to calculate the value of the farmland both at its highest and best use and at its "actual use."¹²⁸ This is required to ascertain whether the percentage requirements are met and to determine that the \$500,000 limitation is not exceeded. Moreover, the farmland will have a different valuation for each of the following determinations: estate tax, state inheritance tax, capital gain determination, state property tax, and income tax depreciation, etc.

The personal representative will also have to maintain accurate records of "material participation" and "qualified use." These records will have to be maintained for eight years or until the qualified heir dies in order to make sure that the "material participation" and "qualified use" continued for the sufficient length of time. The personal representative will have to be especially alert to periods of nonparticipation immediately prior to the decedent's death so that participation by a member of the family can be arranged during the executorial period. If a trust is involved a member of the family must be given a right to participate in the management of the farm so that the material participation requirement is met.

127. Section IIC of text *supra*.

128. Sections IIA and IIB of text *supra*.

Therefore, the benefits of the "actual farm use" valuation of section 2032A will have to be compared with the adverse consequences inherent in making the election. Generally speaking, this special valuation provision should provide the much needed estate tax relief in the family farm situation. However, only time will tell the number of estates that will benefit by electing the valuation procedure under section 2032A.

Bradley Holtorf '77