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Farmland Valuation for Federal Estate Tax - Section 2032A of the Internal Revenue Code

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Highlights

Appreciation in farmland values due to expectations of higher earnings in the future or demand for commercial and residential property may result in high estate taxes relative to the value of property as farmland. Section 2032A of the Internal Revenue Code provides that in certain situations agricultural real estate may be valued below fair market value for purposes of estate tax determination. Election of the "special-use valuation" by the executor of an estate will reduce federal estate tax and may prevent the demise of some family farm operations which would fail if forced to pay estate taxes based on a higher fair market value.

Special-use valuation imposes numerous pre- and post-death requirements upon the landowner, heir, and their family members. Purpose of the demanding requirements is to assure that this beneficial provision is utilized only by those persons and estates for whom Congress intended it; that is, by families which continue operating their farm or small business for several generations.

Two major requirements are that the family have a qualified use (equity interest in operating the land) and material participation (substantial involvement in decisions about the land's use). Generally, these requirements must be met for five of eight years before and for ten years after the death of the landowner. These complexities render it easy to inadvertently disqualify oneself; prudent planning is imperative. Even a rental agreement among family members must be carefully planned and executed to assure these requirements are met.

This report briefly explains the federal estate tax and summarizes the requirements for election of Section 2032A special-use valuation. An attorney or other professional dealing with estate taxes should be consulted before any actions are taken that might affect the eligibility of agricultural real estate for special-use valuation.

FARMLAND VALUATION FOR FEDERAL ESTATE TAX--SECTION 2032A OF THE INTERNAL REVENUE CODE

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Market value of farmland increased dramatically during the 1970s when agriculture prospered. Estimated average value of farmland in North Dakota rose from $205 per acre in 1974 to $325 in 1976. This trend continued throughout the remainder of the 1970s until average land value for the state reached $454 per acre by 1981. Appreciation of farmland was generally viewed as a favorable economic condition since land is a major asset in most farm or ranch operations.

Not all consequences of rapidly rising land values were beneficial to the landowner, however. Appreciating land values increased the dollar value of a deceased landowner's gross estate, which resulted in a greater federal estate tax obligation. Some heirs, intent on continuing the family farm as an operating business entity, were faced with the burden of paying this larger tax liability. Those unable to accumulate the needed cash borrowed money or, less frequently, sold part of the farm to pay the estate tax.

Congress responded to this problem with a provision in the Tax Reform Act of 1976 which is now codified in Section 2032A of the Internal Revenue Code. This section provides an alternative for valuing some farm real estate and is an invaluable tool for reducing federal estate taxes on land transferred from members of one generation to another. The provision offers an opportunity to minimize estate taxes even though the benefit of qualifying for special-use valuation has diminished as a consequence of decreasing farm land values since 1981.

Special-use valuation is a complex topic with numerous requirements that must be met for land to qualify and thereby reduce federal estate tax. This report explains 1) the concept of special-use valuation, and 2) its requirements as set forth by statute and regulations. Throughout the explanation of the requirements, ideas are presented for minimizing the risk of not qualifying. Persons desiring to take advantage of this tax saving tool are encouraged to seek competent professional advice for answers to their specific questions.

Concept of Special-Use Valuation

Congress enacted special-use valuation to reduce the federal estate tax obligation that arises from a transfer of real property used in a closely-held business or farm. This reduction is accomplished by lowering the value of

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qualified land for estate tax purposes. Requirements and benefits of qualifying for special-use valuation are best understood if combined with an awareness of how it fits within the overall scheme of federal estate taxation.

Overview of Federal Estate and Gift Taxation

Federal estate tax is an excise tax levied on the transfer of a deceased person's estate. The amount of tax depends on the value of a decedent property owned at time of death. This property is referred to as the decedent's gross estate and is comprised of 1) all property owned by the decedent at the time of death; 2) all life insurance proceeds from policies in which the deceased had an interest; 3) all property the decedent transferred before death while retaining a right to the income or use of the property; and 4) all annuities and supplemental contracts. A typical North Dakota farm estate would include real property such as farmland as well as the buildings upon it, and personal property such as livestock, machinery, grain, and cash. Fair market value of these properties at their "highest and best use" is the basis for estate tax liability.

Federal estate tax is independent of federal income tax or state sales, income, or inheritance taxes. It is related to the federal gift tax, however. These two taxes are paid by the donor of the decedent's estate rather than by the recipient of the gift or inheritance. Gift tax, like estate tax, is based on the market value of the transferred property.

Together, federal gift and estate tax laws limit the amount of property a person may transfer during their lifetime or after death without federal tax liability. A general rule is that all transfers of property are taxable.

Basic exceptions to the general rule are 1) the annual exclusion, 2) the unlimited marital deduction, and 3) the unified credit. The annual exclusion permits each individual to transfer up to $10,000 annually to each of as many persons as desired without incurring a federal gift tax. A person who desires to maximize the benefit of the annual exclusion may transfer, for example, $10,000 to each of six individuals in one year, resulting in a total transfer of $60,000 without incurring a gift tax. The unlimited marital deduction permits a person to transfer an unlimited amount of property to a spouse without incurring federal gift or estate tax liability.

The unified credit is a direct reduction in a person's gift or estate tax. This credit is $192,800 for persons dying after 1986 and permits the tax-free transfer of $600,000. Each person is allowed one unified credit during their lifetime and, to the extent it is not used by the time of death, it is available to reduce federal estate tax. For example, persons giving more than $10,000 in one year to someone other than their spouse will use part of their unified credit because the gift exceeds the annual exclusion and does not qualify for the marital deduction. The amount of unified credit available for a person's estate will be $192,800 minus the amount used to offset gift taxes during the decedent's lifetime.

Many persons will have their entire federal gift and estate tax liabilities eliminated by these three exceptions. However, a tax obligation will remain for some estates, especially if the decedent was single and owned property valued at more than $600,000. Likewise, married persons must recognize that after the death of one spouse, the survivor will be a single person. Consequently, married persons as well as single individuals may benefit by qualifying their estate for special-use valuation.

Objective of Special-Use Valuation

Special-use valuation offers an alternative method for determining the value of land for purpose of federal estate tax; Congress has not made it applicable to gift taxation. This provision permits real property used in farming or a closely-held business to be valued for federal estate tax purposes based on its actual earning capacity rather than its "highest and best" use. Congress reasoned that land values based on "highest and best use" do not always correspond to the earning capacity of the property. For example, market value of farmland may not reflect current earning capacity if there is an expectation of increased earnings in the future. This expectation is reflected by the market through increased land values based upon speculation. Widespread speculation during the 1970s that prices for agricultural commodities would continue increasing caused the market value of land to be less reflective of its actual earning capacity. Thus, farmland became an overvalued asset.

Market value of farmland near a rapidly expanding urban community also may not reflect its earning capacity because it appreciates as a result of increased demand for residential and commercial property. Heirs of a landowner who wish to continue farming the land would be forced to pay estate taxes based on its higher commercial or nonagricultural value rather than its farming value.

An increase in the market value of farmland without a corresponding increase in the land's earning capacity leaves a taxpayer with an increased tax liability but without added income to pay it. Restated, appreciating land value does not, by itself, generate additional cash income even though it triggers increased cash expenditure in the form of higher estate taxes. Numerous conditions must be met for an estate to qualify, but the methods of valuation permitted by Section 2032A usually result in a reduced gross estate and lower taxes.

Determining Special-Use Value of Real Property

The personal representative of an estate may choose to value farmland under one of two methods, each of which is designed to determine the property's worth in an agricultural use.

Capitalization Method

The first and most widely used method is often referred to as the capitalization method. The initial step under this method is to calculate an average cash rent for comparable farmland during the five years before the date of the decedent's death. This average cash rental is then reduced by the average state and local real estate taxes applicable to the comparable farmland, to arrive at a net cash rental figure. Net cash rental is divided by the average annual effective interest rate on all Federal Land Bank loans in the decedent's district.

The following example illustrates this method of valuation. Assume the average cash rental on comparable land is $55 per acre and the average real estate taxes are $6.50. The net cash rental would be $48.50 (55 - 6.50). Dividing $48.50 by the average Federal Land Bank interest rate on loans (12.46 percent for persons dying during 1986 with land in the St. Paul District) yields a special-use value of $389.25 per acre (48.50/.1246).

Market value of the land in the above example may well exceed $389.25 if it is in a community where speculation has driven up the price of land or where the demand for commercial and residential land is high. Section 2032A allows the personal representative of the estate to use the lower (special-use) value of $389.25 when computing the value of the decedent's gross estate. Special-use valuation frequently reduced the value of farmland by 50 percent for estates of persons who died during the late 1970s and early 1980s. Recently, the reduction has ranged between 10 and 15 percent.

Personal representatives and attorneys settling estates must be careful in acquiring information on comparable cash rent. The IRS has taken the position that average cash rent data--"appraisals or other statements regarding rental value as well as area-wide averages of rentals"--may not be used in computing comparable cash rents. Instead, the personal representative must gather information about cash rentals actually paid for identified tracts of comparable land.

Crop-share arrangements may be relied upon only if there are no comparable cash rentals. Such share-rents are incorporated into the formula explained above by replacing average cash rent with the value of produce received by the landowner minus operating expenses the landowner paid according to the rental agreement.

Several basic principles aid in identifying comparable cash rents. First, rental information must be obtained from land situated in the same "locality" as the property being valued. Second, rental figures must be from arm's length transactions rather than transactions involving related parties. Third, the IRS lists several characteristics to determine whether land is comparable: 1) similarity of soil as determined by any objective means; 2) whether crops grown would deplete the soil in a similar manner; 3) types of soil conservation practiced on the two properties; 4) whether the two properties are subject to flooding; and 5) the slope of the land.

Section 2032A places a limit on the amount by which the property value may be reduced with Special-Use Valuation. Currently, a personal representative utilizing Section 2032A may not reduce the value of the decedent's qualified real property more than $750,000.

Five Factor Method

A personal representative may elect to value the farm on the basis of a five factor formula if no comparable rent information is available. (This formula is the only accepted method for computing special-use value of real property not used in farming.) Essentially, this approach allows a determination of value on the basis of all factors that reflect the real property's current business value.

The five factors are 1) capitalization of income the property can be expected to produce over a reasonable period of time using prudent management; 2) capitalization of the "fair rental value;" 3) assessment value for property tax purposes if the state has a differential or use value assessment law for farmland property; 4) comparable sales of land in the same geographical area; and 5) "any other factor which fairly values the farm or closely held business value of the property."

Purpose of special-use valuation is to provide an estate tax savings for families that operate a farm or closely-held business for more than one generation. The substantial benefit from using this provision along with a Congressional intent to limit the statute's application have underscored the importance of defining who qualifies for special-use valuation. Consequently, the criteria for using 2032A are detailed and involve pre-death requirements for the decedent and post-death requirements for the heir. Both sets of requirements are to assure that the land was (and will be) used in a business owned and operated by the family.

Qualifying for Special-Use Valuation

The numerous requirements explained in the following sections are easily met by a family who fits the simple pattern of a son farming land for the remainder of his life after inheriting it from his father who had owned and operated the land until he died. Few situations follow this pattern, however. Often the landowner bequeaths the farm to a surviving spouse who may not operate the land, or the landowner retires rather than operating the farm until death, or the land is left to several children of which only one is operating the farm. Each of these common scenarios complicates qualifying for special-use valuation because the landowner and farm operator are not the same persons, thus necessitating a rental arrangement. Likewise, involving a trust, partnership, or corporation as part of the family's business and estate plan will raise additional uncertainties.

As the requirements are explained, it is important to recognize that the statutory criteria emphasize the activities and involvement of the family members. Likewise, <u>each</u> of the pre- and post-death requirements discussed must be met for one to qualify for the benefits of special-use valuation. The following explanation will address agricultural land even though most concepts also apply to real estate used in a nonfarm closely-held business.

Pre-death Requirements

The pre-death requirements may be best understood by following a two-step approach. A first step is to determine whether land the family wants to value with special-use is eligible. The second step is to determine whether the estate is eligible for special-use valuation. A major consideration in the first step is whether the family is adequately involved in operation of the land. An issue in the second step is whether a significant portion of the estate's value is attributable to business assets.

Which Land is Eligible?

In order to be eligible for special-use valuation, the decedent's land

1. must be located in the United States; and
2. must have been, during five (5) of the eight (8) years prior to the decedent's date of death:
   a. owned by the decedent or a member of the decedent's family
   b. used for a qualified use by the decedent or a member of the decedent's family; and
3. must have been, during five (5) of the eight (8) years prior to the earliest of the decedent's death, disability or retirement, used as part of a farm business in which the decedent or member of the decedent's family materially participated.

These requirements assure that the land has been owned and operated by family members for a minimum of five years prior to the owner's death. Critical terminology in these requirements are:

disability - mental or physical impairment which renders a person unable to materially participate in the farm operation and continues until death.

retirement - uninterrupted receipt of old-age benefits from Social Security.

member of decedent's family - any person related to the decedent as an ancestor, spouse, lineal descendant, lineal descendant of spouse, lineal descendant of parent, and spouse of lineal descendant. Relations which meet this definition include parents, grandparents, spouse, children, legally adopted children, step-children, son-in-law, daughter-in-law, grandchildren, spouse of grandchildren, brother, sister, nephew, and niece. Cousins, uncles, and aunts are not considered family members. Restated, a nephew or niece is a member of the decedent's family, whereas an uncle or aunt is not.

qualified use - using property (real or personal) as a farm for farming purposes. Regulations refine this definition, however, by requiring that the person have an equity interest in the operation of the land. This significant concept is explained in more detail in a later section.

material participation - level of involvement in operation of the land to assure that the person is fully managing the farm. Passively collecting rent, salary, or dividend from the farm is not material participation. A more complete definition is presented in a later section.

Special-use is available to families which own and operate the business that uses the land being valued. In a practical sense, "qualified use" and "material participation" impose the greatest restrictions upon application of the statute. Qualified use mandates that the decedent (or family member) shares the risk of the business which operates the land, whereas material participation assures that the decedent (or family member) is involved in the actual operation. It also is important to recognize that ownership of the farm business (as opposed to ownership of the land) and involvement in the operation may be met by family members as well as by the decedent. Restated, persons who fit within the definition of family member may fulfill the obligations of the decedent.

Qualified Use

Qualified use requires that the decedent (or a family member) have an equity interest in the business. Evidence of an equity interest is whether the individual has a production price risk; that is, will the landowner's income from the property vary depending on the level of production and the price of the product? Clearly, the person who operates the farm has a production price risk; but does the landlord have such a risk in a rental situation? The type of lease and who is the tenant are two major factors in answering this question.

The Internal Revenue Service views a cash-rent lease as passive income and not involving a production-price risk. The landowner would not have an equity interest in the operation (nor a qualified use in the land). A crop-share lease, however, does preserve an equity interest as long as the arrangement imposes an economic risk upon the landowner.

A cash-rent lease does not render special-use unattainable, however. Recall that either the decedent or a family member may fulfill the requirement of using the land for a qualified use. Therefore, a retired farmer leasing land on a cash-rent basis to a son, nephew, or other member of the family will be eligible for 2032A treatment because the related tenant bears a risk of production and price. Qualified use is not met if the owner cash rents land to a nonfamily member; a crop-share arrangement is required in that case.

> Example. Mike Smith farmed a 500-acre tract from 1960 until his retirement in March, 1983. Smith leased the land to his son from time of retirement until his death in August, 1986. His estate will have met the qualified use requirement because he or his son had an equity interest in the farm operation for five of the last eight years. This would be the result regardless of the lease arrangement.

> Example. Facts are same as in previous example except that Smith leases the land to a neighbor. If a cash lease is utilized for this more than a three-year period, the land would not be eligible for special-use valuation. The specific reason for not qualifying is that neither Smith nor a family member had an equity interest in the farming operation for five of the eight years before his death. A crop-share lease is necessary to establish an equity interest when the tenant is not a family member.

A federal appellate court recently ruled that an "adjustable cash rent lease" to a nonfamily member was "substantially dependent upon production" and therefore met the pre-death qualified use test [Schuneman v. United States, 783 F.2d 694 (7th Cir. 1986)]. Farmland in that case had been owned by the Keefe family since 1895. Kathryn Keefe lived on the farm from her birth in 1897 until her death in 1977. She personally operated the farm from 1956 through 1968 by hiring neighbors to perform most of the labor according to her directions.

Keefe entered into a crop-share agreement with Arthur Wetzell, a neighboring farmer, in 1969. Wetzel and Keefe jointly participated in farm management decisions under the terms of their agreement, including which crops and how many acres would be planted and what crop rotation would be followed. The parties consulted several times each week during the planting and harvesting seasons and shared the operating expenses.

Keefe's health deteriorated in early 1976 and she was unable to fully participate in the management decisions. Keefe's nephew, Edward Keefe, and Wetzell changed the crop-share lease to a fixed cash rent of $80 per acre for a total annual rent of $26,240.

Keefe and Wetzell entered into a second cash lease in 1977 which provided that Wetzell would pay $32,600 if certain production and price levels were met. Wetzell would pay only $26,080 rent if those levels were not met.

The Schuneman court ruled that this dual-level cash lease was "substantially dependent upon production" within the meaning of the qualified-use requirement. The court examined Keefe's actual income from previous years and concluded that there was a "substantial likelihood" that the rent adjustment clause of the 1977 lease would be triggered. The court therefore allowed the farmland to be valued at its special-use value of $191,259 rather than its fair market value of $686,000. Federal estate taxes were reduced by $114,224.

Estate planners may hesitate to rely on Schuneman for several reasons. First, the decision stands alone among several cases with similar facts which have been decided differently. Second, Schuneman does not bind the Eighth Circuit Court of Appeals which has appellate jurisdiction over federal tax law in North Dakota. Thus, sound legal advice compels the conclusion that cash-based leases are not adequate when a nonfamily member is the tenant.

Material Participation

Federal law requires that the decedent or a family member materially participate in the operation of the land to be eligible for special-use valuation. Whether there has been material participation is a factual question and may vary depending on the circumstances. An IRS regulation provides insight as to what constitutes material participation.

> No single factor is determinative of the presence of material participation, but physical work and participation in management decisions are the principal factors to be considered. As a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and/or family members must participate in making a substantial number of these decisions. Additionally, production activities on the land should be inspected regularly by the family participants, and funds should be advanced and financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of the farm, the furnishing by the owner or other family members of a substantial portion of the machinery, implements, and livestock used in the production activities is an important factor to consider in finding "material participation."

The critical period of time is the eight years before the earliest of 1) death; 2) continuous retirement; or 3) continuous disability. Purpose for ending the pre-death material participation requirement at retirement is to prevent landowners from having to choose between Social Security old-age benefits (which are diminished if the owner materially participates in operation of the land) and special-use valuation (which requires material participation). Qualified use (that is, equity interest in the land operation) must be continued, however, during retirement or disability by either the landowner or a family member.

One commentator suggests that farmers who lease their land take several steps to assure they materially participate in the decision making process. First, the lease should be drafted with a view toward material participation and might include provisions addressing the following items:

1. cropping patterns and rotation to be followed each year;
2. levels of fertilization and formulas of fertilizer to be applied;
3. participation or nonparticipation in government programs;
4. plans for chemical weed and insect control, including type of chemical, rate of application, and type of application (broadcast or band);
5. soil and water conservation practices to be followed;
6. scheduling of repairs to buildings, fences, and tile lines;
7. decisions on use of storage facilities;
8. changes in basic tillage practices (e.g., shift to minimum tillage);
9. varieties of seed to be purchased;
10. marketing of the landowner's share of the crop and coordination of delivery by the tenant;
11. for livestock share leases, decisions relative to type of livestock production to be undertaken, level of production planned, nutrition and animal health plans, and marketing strategies.

The commentator also recommends that the material participator's involvement in the lease be recorded in a daily journal. It may prove useful in substantiating the family's involvement if the IRS questions whether there has been material participation.

Rental income from a lease in which the landowner materially participates is subject to self-employment tax. If no self-employment tax has been paid, material participation is presumed to not have occurred. One means of overcoming this presumption to pay the self-employment tax for prior years for which the statute of limitations has not expired. Whether the decedent or family member resides on the farm is another factor in deciding if material participation has been met. The material participation requirement is not met if the landowner hires a manager to oversee the farm operation. This is the case even if the farm manager is related to the landowner. By comparison, material participation does occur if a family member serves as a trustee of a trust which owns the land.

Is the Estate Eligible?

The second part of the pre-death requirements involve determining whether the estate is eligible for special-use valuation. These pre-death requirements are in addition to those explained in the previous section and include:

1. decedent was either a citizen or resident of the United States at the time of death;

2. decedent or a member of the decedent's family was using the land for a qualified use on the date of the decedent's death;

3. at least 50 percent of the adjusted value of the decedent's gross estate (that is, market value minus indebtedness) consists of the adjusted value of real and personal property used for a qualified use by the decedent or a member of the decedent's family on the date of the decendent's death and this property passes to a qualified heir; and

4. at least 25 percent of the adjusted value of the decedent's gross estate consists of adjusted value of qualified real property that passes to a qualified heir.

The second criterion listed above mandates that the decedent or a family member have an equity interest in operating the land on the day of the owner's death. Consequently, a family should be reluctant to temporarily relinquish its risk exposure during the owner's lifetime even though the "five of the last eight years" qualified-use requirement would continue to be met for sometime. The suddenness and uncertainty with which death can strike forces a family to continuously maintain its equity interest in the land's operation. By comparison, material participation is not needed on the date of death. Instead, material participation during five of eight years before the earliest of death, disability, or retirement is sufficient.

The last two requirements assure that the land and the farm business are substantial portions of the decedent's estate (at least 25 and 50 percent, respectively), and that it passes to a family member who will continue to use the land in the farm operation. The percentages are computed on the basis of the estate and business property values after subtracting debt; that is, the percentages are computed using *adjusted value*. A corollary to these requirements is that the estate may not value real estate at its special use if the land comprises less than 25 percent of the estate's value (after subtracting debt), if the business comprises less than 50 percent of the estate's value, or if more than half of the estate's value passes to someone other than a family member.

These percentage requirements will not pose a problem for most farmers and ranchers; however, an individual with substantial nonfarm assets should be mindful of this limitation. The owner of an estate that does not meet the required percentages could consider pre-death transactions to prevent disqualification. One solution is to purchase farm assets with cash or proceeds from nonfarm sources. Another strategy would have the owner gift nonfarm assets to other persons or entities (such as a charitable organization). Either approach increases the proportion of the gross estate that is comprised of farm assets.

Requiring that the property pass to family members raises a concern when specifying successive interests in a will. An estate planning strategy may be for a landowner to specify a life-estate for the surviving spouse (which permits the surviving spouse to use the property for the remainder of his or her life) with a remainder interest to their children. This assures the children and grandchildren will receive the property after the surviving spouse had the use and income from the land. The will also may specify that a charity would receive the land after the spouse's death if there are no living descendants.

The possibility that the land could pass to a nonfamily member (the charitable organization) may disqualify the estate for special-use valuation. Recognizing the difficulty this poses in planning an estate, the Tax Court recently ruled that special-use valuation cannot be denied when the likelihood that a charity will receive the property is "exceedingly remote." Estate planners will likely be cautious in relying on this ruling because the IRS has not agreed to follow it.

Post-death Requirements

The underlying purpose of special-use valuation is to ease the estate tax burden for families that wish to continue farming. Consequently, the law imposes requirements that must be met after the death of the owner to assure that only families which actually continue the business operation enjoy the intended tax savings. The basic post-death requirement can be stated as:

> For 10 years after the decedent's death, 1) the land must be used for a qualified use by the heir, and 2) the heir or a member of the heir's family materially participates in the use of the land.

Numerous details and exceptions accompany this general rule and warrant brief explanation.

General Rule

An heir (or heirs if more than one person inherits the land) is required to own the land and be involved in its operation for 10 years after the decedent's death to retain the full benefit of special-use valuation. The usual penalty for failing a post-death requirement is recapture of the tax savings; that is, the heirs must pay the amount of taxes that were saved by using a lower land value.

To assure payment, the law requires the heirs sign an agreement obligating themselves to pay any tax that is recaptured. They also are permitted to post a bond and thereby discharge themselves from any further personal liability for the additional tax. Likewise, each person with an interest in the property (such as a remainder interest) must agree that the land be available to pay the tax, if necessary.

The personal representative is responsible for deciding whether to apply special-use valuation and appending the required agreement to the estate tax return. Special-use valuation has been denied to estates which failed to timely file the written agreement; but once filed, the IRS will allow a reasonable time (up to 90 days) to correct mistakes in the writing.

A major post-death requirement is that the heir (or a member of the heir's family) materially participate in a qualified use of the land. Material participation, qualified use, and family member for this purpose are defined similar to pre-death, as explained above. Each is briefly reviewed in the following paragraphs.

Member of the Heir's Family

Like pre-death requirements, some post-death requirements may be met by the individual who inherited the land as well as members of the heir's family. Careful planning is necessary however, because the family of the decedent does not encompass the same individuals as the family of the heir. Although members of the heir's family are defined to include the same relations, it does not encompass the same individuals. The following schematics (Figures 1 to 5) illustrate the difference between the decedent's family members and the family members of various heirs.

Family members are identified in the diagrams as they relate to the decedent. A different relation exists between the various heirs and each of the individuals represented in the diagram. For example, the decedent's father and father-in-law are the children's grandfathers, whereas the decedent's sibling is an uncle or aunt of the children.

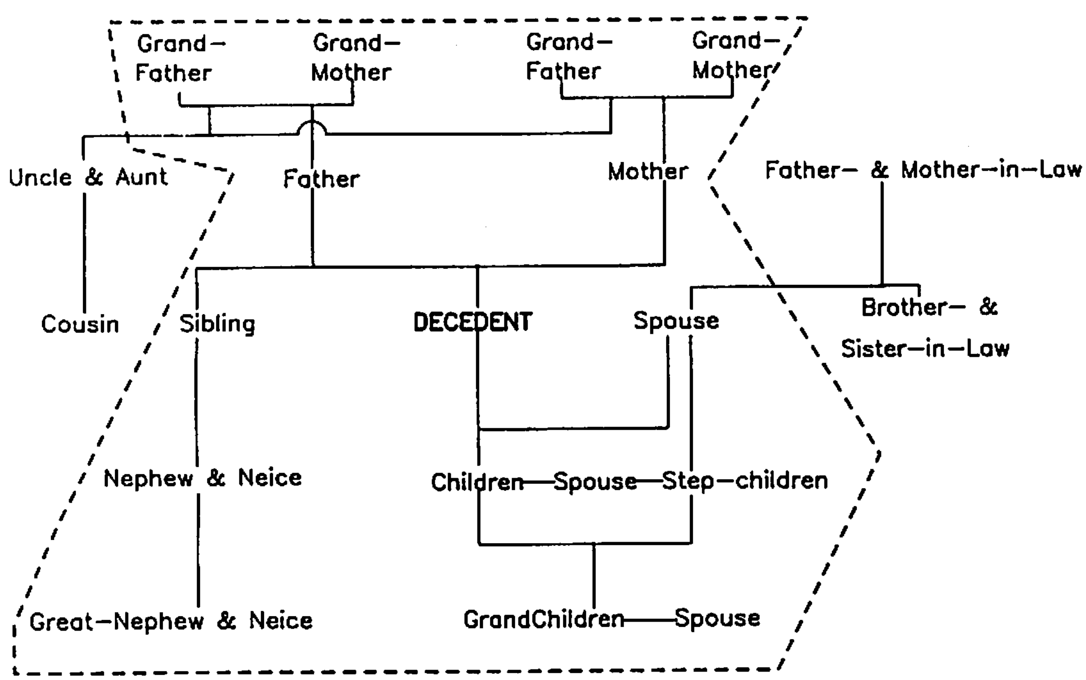

Figure 1. Decedent's Family Members for Special-Use Valuation

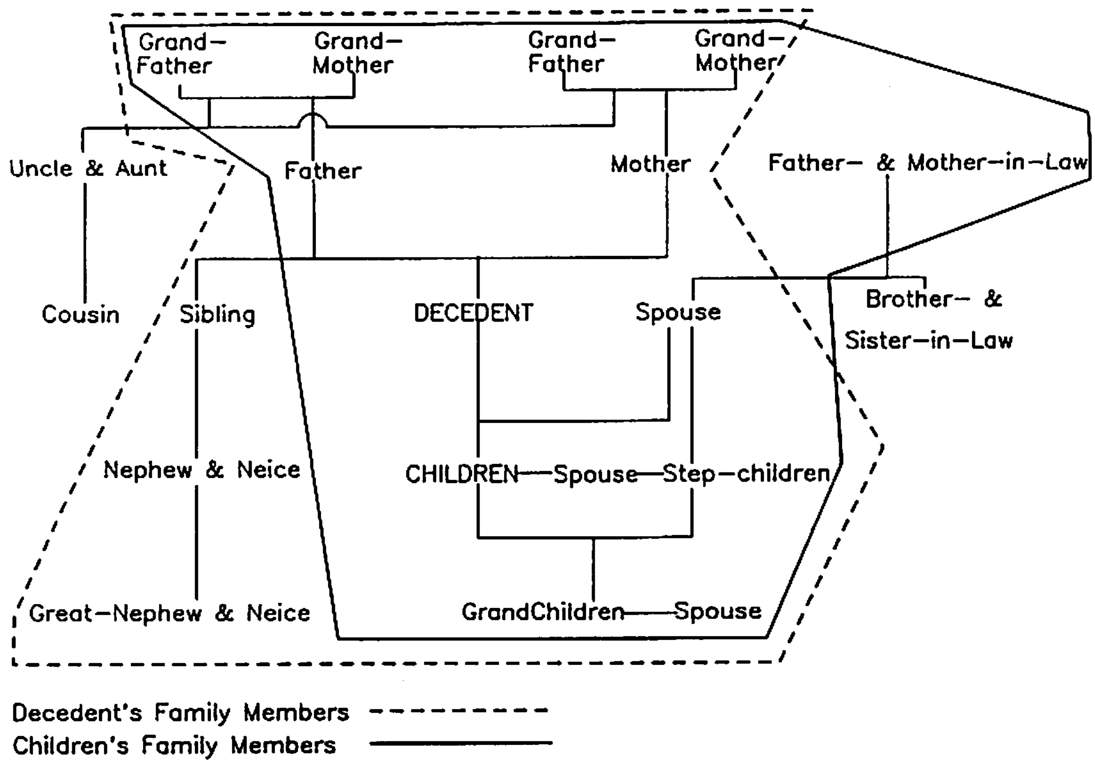

Figure 2. Family Members of Decedent and Children for Special-Use Valuation

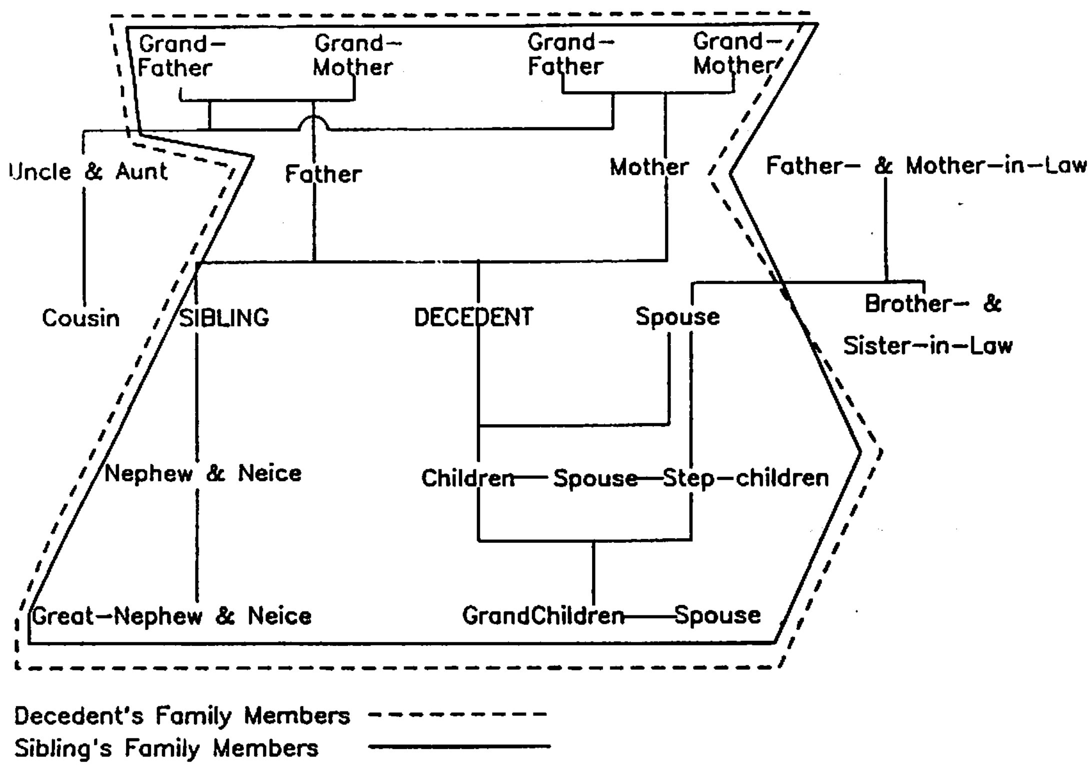

Figure 3. Family Members of Decedent and Sibling for Special-Use Valuation

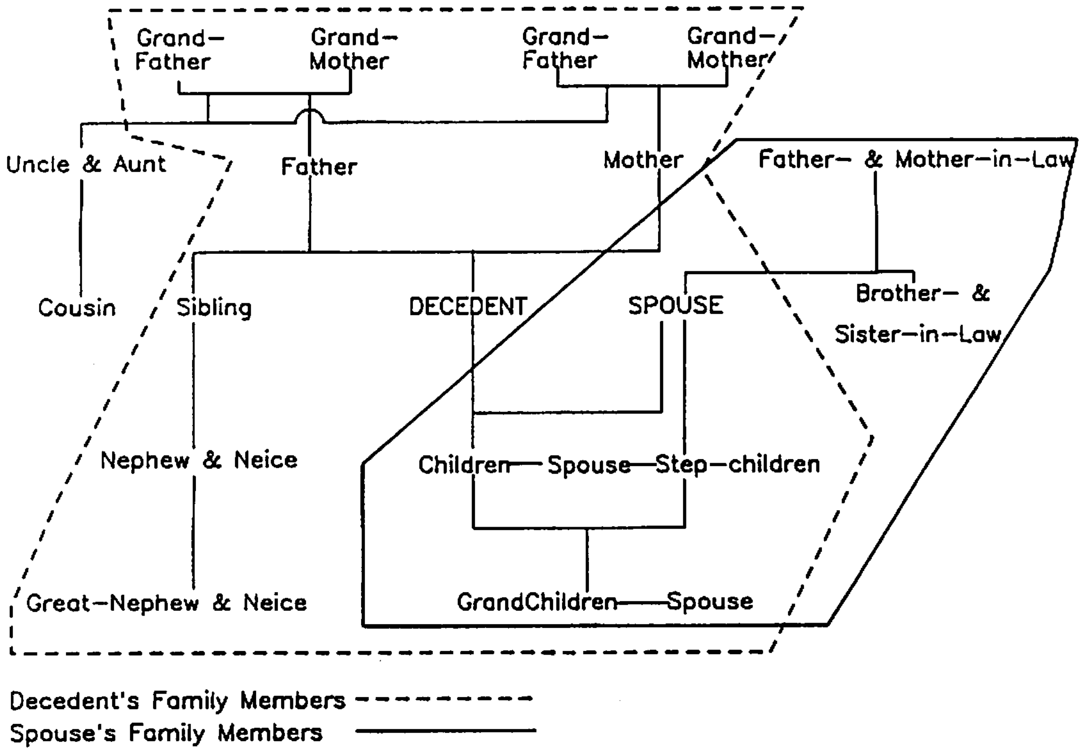

Figure 4. Family Members of Decedent and Spouse for Special-Use Valuation

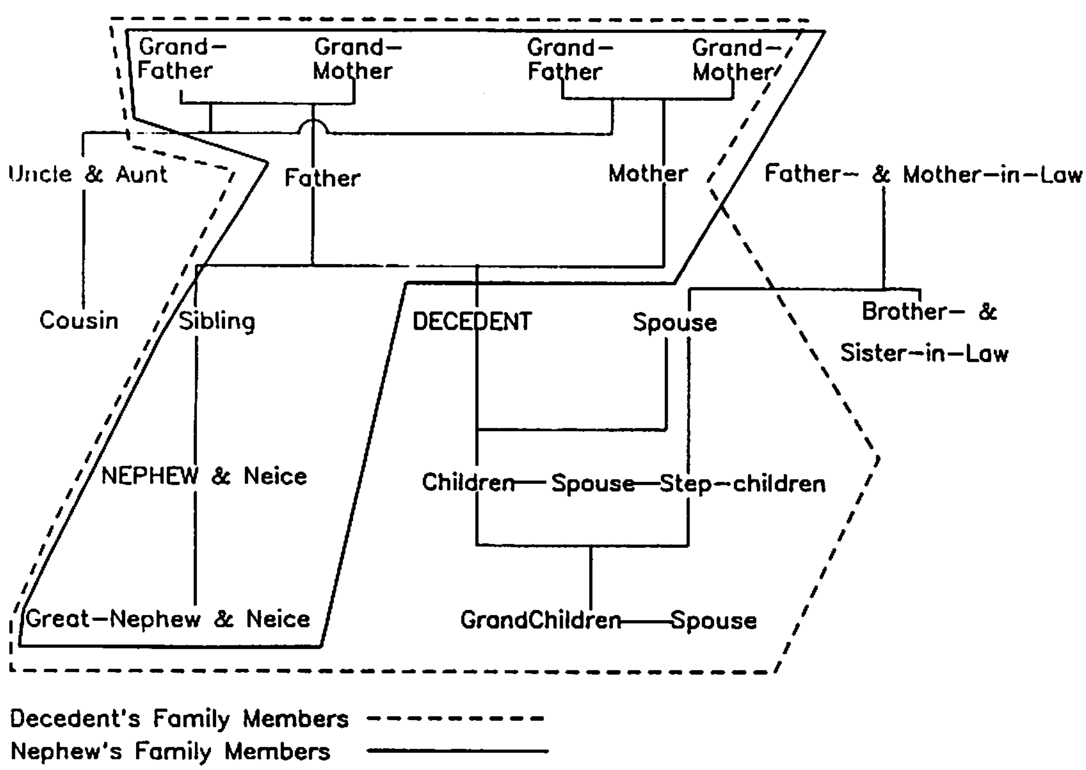

Figure 5. Family Members of Decedent and Nephew for Special-Use Valuation

Relations of person defined as members of the decedent's family are illustrated in Figure 1 (the definition is discussed in a previous section). Figure 2 presumes that a child of the decedent inherits the property. The heir's family includes all grandparents (father, mother, father-in-law, and mother-in-law of the decedent) but does not include uncles, aunts, or cousins (decedent's siblings, nephews, or nieces). This illustrates that the pre-death requirements could be met with a cash lease from the decedent to a nephew; but after the children inherit the land, the cash rental would no longer be adequate.

Figures 3, 4, and 5 compare the family members of the decedent with that of several other possible heirs. It is important to recognize the differences and understand the practical implications. For example, Figure 4 shows that the decedent's brother-in-law could not provide the necessary pre-death material participation, but that he could after his sibling (the decedent's surviving spouse) inherits the land.

A widow or widower of a deceased family member continues to be a qualified heir unless she or he remarries a non-family member before the landowner's death. Grandchildren of a landowner are always qualified heirs even though their surviving parent has remarried outside the family.

> Example: An adult son predeceases his land-owning father. His widow is a qualifed heir of the father as long as she does not remarry outside the family before his death. The couple's children will always be qualified heirs of their grandfather's estate.

Qualified Use

The heir must utilize the property for a qualified use during the entire 10-year recapture period. This is different than the pre-death requirement which allows as much as three years out of eight to be without a qualified use. A second major difference is that a family member of the heir cannot provide the qualified use. The heir must have an equity interest in operation of the land; even a cash-rent lease to a family member will not meet the post-death qualified-use requirement. Any cessation of qualified use after a decedent's death immediately triggers the penalty of having to pay the tax savings.

The statute provides a two-year period after death during which a qualified use is not required. Congress is recognizing with this grace period that time may be needed for probate and for the heir to initiate a qualified use. (The new owner, for example, may farm the land or lease it on a crop-share basis to establish the necessary equity interest in the land's operation.) However, the qualified use cannot be terminated once it has begun and the recapture period extends for ten years from that date. As a result, the potential for recapture will not expire until 12 years after the decedent's death for heirs who utilize the entire two-year grace period. The two-year grace period does not apply to post-death material participation.

Material Participation

The heir or a member of the heir's family must meet the material participation test throughout the recapture period (10 to 12 years depending on when the post-death qualified use is begun). Several points are noteworthy. First, a member of the heir's family can perform the material participation; it is not limited to the heir as is the case for post-death qualified use. Second, although material participation after death (like the pre-death material participation requirement) is not required on a continuous basis, a test for material participation must be met at all times. The test is whether there has been material participation for at least five years of any eight-year period *ending after* the death of the decedent.

> Example. A landowner died in early August 1987, bequeathing the property to an adult daughter. The decedent had leased the land to an unrelated neighbor since 1976 on a crop-share basis but had not materially participated in the land's operation since late November 1984 (a period of 33 months). Special-use valuation was available to the estate because more than five of the eight years before death involved material participation by the decedent. The daughter has until December 1987 to begin material participation in the farm operation. Otherwise, an eight-year period ending after death (December 1979 to December 1987) will include more than three years (November 1984 to December 1987) in which the decedent, heir, or family member did not materially participate in operating the land.

The material participation test does not grant the heir eight years to establish five years of the necessary participation. Instead, the statute mandates five years of material participation for any eight-year period ending after the decedent's death. Technically, this test has to be met each and every day during the period of post-death requirements. If the decedent's activity before the earliest of death, retirement, or disability was not material participation, the heir must be careful to have adequate participation after the death.

> Example. Same facts as previous example except landowner retired November 1984. The 33 months of retirement (during which time there was no material participation) would not be considered in determining whether post-death material participation has been met. (As explained above, it would not be a consideration for pre-death requirements either.) The critical period would be the time since death plus as much as necessary before retirement to total eight years. Consequently, the landowner's involvement prior to November 1984 is crucial.

Congress has defined four classes of heirs who are not required to materially participate. These include 1) disabled individuals; 2) persons who have not yet attained the age of 21 years; 3) students; and 4) surviving spouses. Instead, these persons are required to meet a less stringent criteria of active management; that is, making management decisions of the business, other than the daily operating decisions. Active management by a family member of an heir who fits one of the four definitions is not accepted as fulfilling the post-death material participation requirement. In that case, the family member's involvement would need to be material participation.

The statute clarifies that the estate of a surviving spouse who is only active in managing the farm will not be penalized in its attempts to also elect special-use valuation.

> Example. A married man owns and farms land at the time of his death. Personal representative of his estate elects special-use valuation and the land passes to his surviving spouse according to his will. The widow is active in managing the farm but does not materially participate. At her death several years later, the land is inherited by a son. The wife's estate also will qualify for special-use valuation because her active management is permitted by statute to substitute for material participation. The eight-year pre-death time span will be the period of her ownership plus as much time of her husband's ownership before the earliest of his retirement, disability, or death.
>
> Example. A farmer operates land he owned until his death. His will leaves the property to his retired sister. The new owner's nephew (child of another brother) will rent the land and farm it. The pre-death requirements are met if special-use valuation is elected. Post-death requirements mandate that this be a share-crop arrangement in order for the heir (the sister) to have a qualified use; the nephew's involvement will provide the necessary material participation by a family member.
>
> By comparison, if the tenant was not a family member, not only would the lease need to be on a share basis, but the sister or a family member also must be involved in the operation's decision-making process. For example, the new owner's son could meet this requirement. Active management on part of the son would not be adequate, however, because he is not the heir. Active management by the sister also would be insufficient since she is not disabled, less than 21, a student, nor the spouse of the decedent.

Other Events That Trigger Recapture

Converting the property to a nonfarm use or disposing of the land also will trigger recapture of the tax savings. Examples of changing the property's use would be developing it into a golf course or building homes to be lived in by persons not involved in the farming operation. The law is clear, however, that participation in federal farm programs which remove crop acreage from production (including the Conservation Resource Program) does not trigger recapture.

Disposing of the property during the recapture period will generally trigger the additional tax; there are several exceptions, however. Only a partial recapture of the tax will occur if a portion of the property is disposed of. In addition, transferring the property to a member of the heir's family will not trigger recapture, but the new owner will be responsible for meeting post-death requirements and paying any recaptured tax.

An heir also may dispose of special-use land as long as other farmland is acquired within 180 days. Use of the acquired property will need to meet post-death requirements for remainder of the recapture period. Likewise, selling property due to condemnation or threat of condemnation will not trigger recapture as long as replacement property is acquired within two years. Replacement property will be subject to post-death requirements for duration of the recapture period plus the length of time between disposing of the property and acquiring its replacement.

Granting a mortgage to secure a loan apparently does not trigger recapture, especially if the proceeds are used in the farming business. A related question is whether filing bankruptcy triggers recapture. Although there is no direct authority in cases or regulations, a general provision of the Internal Revenue Code arguably prevents the recapture tax from being imposed upon an insolvent heir. Likewise, transferring land subject to special-use valuation to a farm corporation owned by the qualified heir will not trigger recapture. Finally, the statute is clear that the post-death requirements are considered fulfilled upon the death of the heir.

The decision to utilize special-use valuation followed by a recapture of the tax savings has an *income tax* implication as well as an estate tax consequence. The amount of taxable gain realized upon sale of inherited property generally is the selling price received by the heir minus the value of the property for estate tax purposes when it was inherited. The lower special-use value is the value of land for estate tax purposes means the heir will realize more taxable income upon the sale than if the property had been included in the estate at its market value. Congress does allow an heir to increase the basis of the land from its special-use to its market value after paying the recaptured estate tax *plus interest*.

This negative income tax implication may lead some families to decide to not utilize special-use valuation even though they qualify. This is especially true if the heir does not intend to meet the post-death requirements. Possible reasons for not intending to meet post-death requirements may be

1) a desire to sell the land or convert it to a nonqualified use,

2) a desire to use a cash lease, or rent to a non-family member, or

3) a determination that no benefit will be received from a lower valuation because proper application of the unified credit and marital deduction eliminate the estate tax.

Conclusion

Section 2032A was enacted by Congress primarily for the benefit of persons with family farms and small businesses. It can be an invaluable estate planning tool for the multi-generation family farm.

Section 2032A allows heirs of a decedent to substantially reduce estate tax liability. The lower tax is achieved by valuing farmland according to its worth as an asset used in a farm operation. This method of valuation, called special-use valuation, can be very useful in times of rising land values, especially when the values are attributable to inflation.

Receiving the estate tax benefits of section 2032A requires careful planning both before and after the decedent's death. There must be a "qualified use" and "material participation" by the decedent or a member of the decedent's family for five of the last eight years before the decedent's death. There are similar "qualified use" and "material participation" requirements imposed on the qualified heirs in the post-death period. In sum, the post-death requirements mandate that an heir of the decedent continue to use the land in a farm-related manner for the better part of ten years or until the death of the heir, whichever is first. Section 2032A contemplates long-term estate planning.

Certain transactions could lead to a forfeiture of the tax benefits obtained through section 2032A. The heirs would have to pay the recaptured tax with interest in the event of a forfeiture. Farm families which elect 2032A should consult an expert in estate planning before entering into a lease or other disposition of the qualified real property in the post-death period.