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ESTATE TAX REDUCTION THROUGH SECTION 2032A USE VALUATION

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INTRODUCTION

The Economic Recovery Tax Act of 1981 (ERTA) provides a gradual increase in the unified credit which by 1987 will exempt estates of up to \$600,000 from estate taxation. The unlimited marital deduction and the increase of tax-free gifts to an amount of \$10,000 per year per donee has freed many farm families from the gift and estate tax burdens that arguably had been causing the break-up of small farms (U.S. Congressional Record, vol. 122; Begleiter). At the same time, however, the estate tax relief resulting from the provisions incorporated in ERTA has not completely remedied the tax problems of farmers. Farm estates greater than \$600,000 are still subject to taxation. Expensive technology together with inflation and the appreciation of the value of farm real estate will undoubtedly continue to cause the value of many farm holdings to increase in size beyond the amount exempted by the uniform tax credit. The resultant estate tax liability could require the sale of farm assets in order to raise cash to pay these taxes. Thus, estate planning techniques which diminish estate taxation are still important to farmers.

One available technique is the special use valuation provisions of section 2032A of the Internal Revenue Code. Section 2032A, however, contains an exacting set of preconditions which must be met before an agricultural producer may elect to take advantage of its tax-savings provisions. This article delineates the requirements of these provisions, discusses some of the special problems associated with section 2032A, and analyzes data concerning a 150-cow New York dairy farm to show the benefits of section 2032A use valuation for estate tax planning purposes.

SECTION 2032A REQUIREMENTS

Section 2032A was added to the tax code by the Tax Reform Act of 1976 to afford relief to farmers and others who owned real property used in their business. This elective section offers farmers an alternative estate tax valuation for qualifying real estate. Rather than valuing the farm real estate of the decedent at its "fair market-value," as required by section 2031 of the Internal Revenue Code (Code), section 2032A allows qualified property to be valued for the use under which it qualifies. Since the fair market value of farm real estate, which is the value of the property put to its highest and best use, is often greater than its actual value for farming purposes, valuation under section 2032A thereby can decrease the size of the estate. The maximum aggregate decrease in value of qualified real property of decedents dying after 1982 is limited to \$750,000. Internal Revenue Service districts

in the Northeast reported that the average discounts on fair market values from section 2032A elections were between 23 and 67 percent (Hartley). Section 2032A thereby offers farmers an opportunity to decrease markedly the size of their estates if they maintain their eligibility and qualified heirs elect to continue with the farming operations.

The eligibility requirements prescribed by section 2032A constitute a demanding set of limitations which necessitates careful planning and appropriate documentation so that a decedent's farming operations qualify for section 2032A special use valuation. The complex requirements concern the decedent, the property of the decedent's estate, and the heirs. There are three basic subrequirements for the decedent. The decedent must be a citizen or resident of the United States at the time of his death. The decedent, or a member of the decedent's family, must have been using the "qualified real property" for a "qualified use" on the date of the decedent's death, and the decedent or a member of decedent's family must have materially participated in the operation of the farm or other business for at least five years during the eight-year period ending on the date of the decedent's death. A qualified use includes the use of property as a farm for farming purposes.

"Qualified real property" is the heart of the decedent's property requirements and is comprised of several subrequirements. Qualified real property within the meaning of section 2032A only applies to real property located in the United States and the property must pass from the decedent to a qualified heir (defined below). Fifty percent of the adjusted value of the decedent's estate must consist of real or personal property being used for a qualified use by the decedent or a member of the decedent's family on the date of death and pass or have passed from the decedent to a qualified heir. Twenty-five percent of the adjusted value of the decedent's estate must be qualified real property used for a qualified use by the decedent or member of decedent's family for five years during the eight-year period ending on the decedent's death which passes or has passed from the decedent to a qualified heir.

Section 2032A also has three subrequirements concerning the heirs. In order for property of a decedent to qualify for section 2032A use-valuation treatment it must pass to a qualified heir. A qualified heir only includes a member of decedent's family that is an ancestor or spouse of the decedent, a lineal descendant of a parent or spouse of the decedent, or the spouse of any lineal descendant of a parent of the decedent. The qualified heirs must elect section 2032A tax valuation treatment on tax Form 706 and sign a written agreement consenting to the penalty provisions of subsection c of section 2032A if any interest in the qualified real property is disposed of to a nonqualified heir within ten years after the decedent's death or the qualified heir

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ceases to use the qualified real property for the qualified use within this ten-year period.

PRESERVING THE USE VALUATION ALTERNATIVE

Farmers who have heirs who are interested in continuing the farming operations should consider qualifying for section 2032A treatment if their net worth at their death may be greater than \$6000,000. The preservation of the availability of this special estate tax reduction technique would enable the heirs to take advantage of estate tax savings which might be possible by electing use valuation treatment. Data reported by Smith suggests that New York dairy farms with more than 150 cows will have a net worth of more than \$600,000 (see Table 1). An analysis of these dairy operations suggests that the owners are able to preserve the use valuation alternative with a minimum of planning.

Qualifications concerning the decedent may raise the problem of the rental of land to non-

qualifying heirs or the management of the farm by nonqualifying heirs. The rental of land to nonqualifying heirs at the time of the decedent's death may mean that the land is not being used in a qualifying use as required by section 2032A(b)(1). This may be circumvented by a rental arrangement that retains for the lessor part of the risk of the farming operation (Hartley). Section 2032A(b)(1)(C) stipulates that the decedent or a member of the decedent's family must be involved in the management or operation of the farm for five years during the eight-year period ending on the date of the decedent's death. This management requirement is satisfied by material participation by the decedent or family member.

The qualification of property under section 2032A requires at least fifty percent of the adjusted value of the decedent's estate to consist of real or personal property being used for a qualified use. A 150-cow New York dairy farm would presumably meet this requirement. Infor-

Table 1. Net Worth of a 150-Cow New York Dairy Farm*

Assets:		
Land and Buildings	\$504,471	
Livestock	312,810	
Feed and Supplies	98,764	
Machinery and Equipment	183,404	
Other Farm Assets	<u>58,401</u>	
Total Farm Assets		\$1,157,850
Total Nonfarm Assets		<u>29,987</u>
TOTAL ASSETS		\$1,187,837
Liabilities:		
Real Estate Mortgage	\$200,187	
Liens on Cattle and Equipment	161,000	
Other Farm Liabilities	<u>67,186</u>	
Total Farm Liabilities		\$ 428,373
Total Nonfarm Liabilities		<u>3,445</u>
TOTAL LIABILITIES		<u>431,818</u>
FAMILY NET WORTH		<u>\$ 756,019</u>

* Data by S.F. Smith, Dairy Farm Management: Business Summary New York 1981.

mation reported by Smith shows farm assets (\$1,157,850) less farm liabilities (\$428,373) as clearly being greater than fifty percent of the net worth (\$756,019). It follows that more than fifty percent of the adjusted gross estate would be comprised of farm assets.

The requirement that at least twenty-five percent of the adjusted value of the gross estate must be real property would also presumably be met on a New York dairy farm with more than 150 cows. The value of the land and buildings (\$504,471) less the adjustment for the mortgage (\$200,187) shows an adjusted value of (\$304,284) for real property (Smith). This amount is clearly greater than twenty-five percent of the net worth (\$756,079) so it follows that more than twenty-five percent of the adjusted gross estate would be comprised of real property. It should be noted, however, that a decedent who owned real estate that was encumbered by a substantial mortgage could have a problem meeting this twenty-five percent requirement.

USE VALUATION

Section 2032A(e)(7) prescribes the basic method for determining a use value of farm property which must be used whenever possible. This involves the capitalization of gross cash rents or net share rentals. A second method enables the executor of the decedent to elect the use-valuation factors of paragraph 8 of section 2032A. A determination of use value by the capitalization of gross cash rents requires the existence of cash rental values for comparable farm property in the locality of the decedent's farm. A five-year rental average is used. The rental values less applicable real estate taxes are divided by the Federal Land Bank's effective average annual interest rate to establish the use value for the property.

Bratton reported that in 1980 New York cropland was renting for approximately \$36 per acre with taxes of \$20 per acre. The resultant excess average gross cash rental would thereby be \$16 per acre. Snyder suggests that the \$36 per acre rental amount may be high as his data showed an average rental value of \$24 per acre. If Bratton's figures are accepted and the \$16 per acre figure is adopted as the five-year average rental values for comparable cropland of a dairy farm, this figure would be divided by the Land Bank's effective average annual interest rate to establish the use value. The effective average annual interest rate for the past five years for the Springfield District is calculated as being 10.27 percent. The \$16 excess average gross cash rental divided by the 10.27 percent effective interest rate establishes a use value of only \$156 per acre. This is markedly less than the state average in 1979 of \$554 per acre (Boisvert et al., p. 21).

If cash rental values for comparable land do not exist but there are other rentals, the use value under section 2032A may be calculated using the net share rental. The net share rental is the value of the product received by the lessor minus the cash operating expenses which are paid by the lessor. The net share rental is then sub-

stituted for gross cash rents to determine a use value.

In the absence of rental value of comparable land, or at the option of the executor, paragraph 8 of section 2032A may be elected for use valuation. The method delineated by paragraph 8 requires five factors to be considered in the determination of a use value: (1) the capitalization of income which the property can be expected to yield under prudent management over a reasonable period; (2) the capitalization of the fair rental value of farm property; (3) the assessed land values in the event the state has a use-value assessment law; (4) comparable sales of other farmland where resort or metropolitan uses do not significantly influence the sales price; and (5) any other factor which fairly values the farm property.

New York has a plethora of information which could be considered under a paragraph 8 use-value determination. The State Board of Equalization and Assessment has developed an income capitalization approach for each soil group in the land classification system based upon economic profiles developed by the New York State College of Agriculture and Life Sciences at Cornell University (Dunne). Extensive rental information for croplands has been compiled and is available for consideration (Snyder; Knoblauch and Milligan). Many farms are within agricultural use-value assessment districts pursuant to the provisions of the Agriculture and Markets Law (McKinney's, section 300 et seq.) so that these values may be considered (Dunne and Boisvert, p. 4). Prior to 1980, the State had compiled extensive information concerning comparable sales as part of the market price information used to determine use-value assessments (Boisvert et al.; Dunne and Boisvert, p. 2). Thus, there should be adequate information available in New York to determine a use value employing the factors delineated in paragraph 8.

SUMMARY AND CONCLUSIONS

Section 2032A use valuation of property of dairy farms with more than 150 cows offers qualifying heirs an opportunity to reduce estate taxes. Owners of such farms would be advised to structure their operations in order to preserve this use-value option if there is a possibility that they might have heirs who may want to continue with the farming operations. The heirs or the executor must also be aware of the requirement that an election for section 2032A use valuation must be made on the first filed estate tax return.

Section 2032A offers two major methods for determining a use value. The low rental values reported by Snyder and Bratton suggest that the capitalization of rents would be the preferred method. If the rental values for comparable land seem high, then the possibility of having the executor elect paragraph 8 use valuation should be examined. If there are no rental values for comparable land, the executor would have to apply for paragraph 8 use valuation in order to determine a use value under section 2032A. Further research involving a comparison of these two

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methods of section 2032A use valuation for New York farms should be encouraged to determine if either method is superior for reducing the value of farm property.

Farm owners who desire to preserve the section 2032A use-valuation alternative should avoid several common practices which could operate to disqualify their heirs from electing use-value treatment. The farm owner should avoid cash rentals to nonqualifying heirs. The owners should be sure that there is material participation in the business by a family member in order to meet the requirements of a qualified use on the date of death. Any major disposition of farm real property should be scrutinized to determine whether it may defeat the fifty percent or twenty-five percent tests. Careful planning and the avoidance of the common pitfalls may enable one's heirs to avoid estate taxes and help conserve the family farm for future generations.

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