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Be Careful in Using Discounted Land Values in Sales to On-Farm Heirs

-by Neil E. Harl*

The rapid run-up in farmland values since 2008 has focused a great deal of attention on ways to transfer farmland to on-farm heirs, either during life or at death (preferably at death for many parents).[1] Some suggested planning approaches are sound and are supported by ample authority; others are more questionable and merit scrutiny.

Options in wills or trusts

Options included in wills or trusts for the on-farm heirs to purchase the farmland (or some of it) at a discounted price have been used for decades and are rarely challenged – except by unhappy off-farm heirs. After all, except for limits on disinheriting a spouse,[2] testators have the right to dispose of property about as they wish including discounts for assets purchased by particular heirs.

It has long been established that for federal income tax purposes, an option created by will has an income tax basis in the hands of the optionee equal to the difference between the federal estate tax value and the option price and the basis of the option may be added to the option price in determining the basis of the property acquired upon exercise of the option.[3] The exercise of the option and the sale of the property in question by the estate to the optionee ordinarily creates neither gain nor loss for the estate.[4]

Post-death sales at a discount

The more significant problems are likely to arise in connection with discounted sales to certain heirs after death where the discounting is not authorized by a will or trust. Under state law, it is typically specified that, at death, the title to the property passes to the persons to whom the property is devised by will or trust or passes in intestacy to those entitled to receive the property but subject to possession of the personal representative of the estate if needed to pay taxes and costs.[5]

Some have suggested that farmland valued at death under special use valuation[6] can also be used to value land purchases by the on-farm heirs. That is, of course, a possibility but it should be recognized that special use valuation *is only for federal estate tax* purposes[7] and cannot be used to reduce gift amounts for federal gift tax purposes. For example, if the fair market value of a tract of farmland is $1,500,000 and special use value is $900,000, the benefits from special use value in terms of reducing the gross estate would be $600,000 which is well within the maximum reduction of gross estate from special use valuation

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which is $1,020,000 for deaths in 2011.[8] However, if agreed to by the off-farm heirs, a gift of $600,000 could be assessed against the donors (the off-farm heirs) who had agreed to the bargain purchase of farmland by their on-farm siblings. That would mean that a gift, in excess of the federal gift tax annual exclusion ($13,000 per donee for 2011, $26,000 per donee and spouse), had been made.[9] The amount of the gift in excess of the federal gift tax annual exclusion would reduce each donor's $5,000,000 applicable credit amount for federal gift tax purposes during life, for federal estate tax purposes at death and for generation-skipping tax purposes whenever generation skips were set up.

That would be the case for any discount agreed to by the off-farm heirs for the benefit of on-farm heirs (and in all situations where a bargain purchase is agreed to by related persons). Farmland markets are sufficiently robust to make it difficult to argue that discounts from "fair market value" are really the market value as has been the case with some discounting for business property.[10]

Other discounting possibilities

Although co-ownership discounts were not allowed (other than for community property transfers)[11] until the Tax Court decided *Estate of Youle v. Commissioner* in 1989,[12] co-ownership discounts of 20 percent or more[13] have become relatively common. That is the case despite the fact that the IRS position has been that co-ownership discounts should be limited to the costs for partitioning the property into separate interests.[14] It should be noted that, in a 2005 case,[15] litigation costs were awarded against the Internal Revenue Service because the IRS position on limiting co-ownership discounts to cost of partitioning was not justified. Co-ownership discounts have been allowed for federal gift tax purposes[16]

Of course, if farmland is in an entity, an entity discount is usually available for minority interests and lack of marketability[17] and a 2010 Tax Court case[18] endorsed dollar-for-dollar discounting for the potential income tax on built-in gains in a corporation which is notable because that provides "substantial authority" in all states for that practice.

ENDNOTES

[1] See generally 5 Harl, *Agricultural Law* Ch. 43 (federal estate tax); 6 Harl, *Agricultural Law* Ch. 46 (gifts and gift tax), Ch. 48 (disposing of the farm) (2011); Harl, *Agricultural Law Manual* § 5.01 (overall estate planning considerations), § 6.01 (gifts and gift tax), 6.02 (sale of property), 7.02[5][d] stock transfers) (2011); 2 Harl, *Farm Income Tax Manual* §§ 6.03 (partnership sales and distributions), 6.04 (sale or exchange of a partner's interest), § 6.08 (death or retirement of a partner), § 7.03[1] (corporate distributions) (2011 ed.).

[2] See, e.g., Iowa Code §§ 633.236, 633.238 (2009).

[3] Rev. Rul. 67-96, 1967-1 C.B. 195. See Ltr. Rul. 200340019, June 26, 2003.

[4] Ltr. Rul. 8210074, Dec. 10, 1981 (farmland appraised for federal estate tax purposes at a value of $114,293 with the option price set at $26,668; sale of real estate subject to the option for $26,668 equaled the basis of the farmland in the hands of the estate).

[5] See, e.g., Iowa Code § 633.350 (2009).

[6] I.R.C. § 2032A. See generally 5 Harl, *Agricultural Law* § 43.03[2] (2011); Harl, *Agricultural Law Manual* § 5.03[2] (2011).

[7] I.R.C. § 2032A(a) (special use valuation is only "for purposes of this chapter" which is 26 U.S.C. Ch. 11).

[8] Rev. Proc. 2010-40, 2010-2 C.B. 663.

[9] I.R.C. §§ 2503(b), 2513.

[10] See Harl, "Claiming Entity Discounts in Addition to Special Use Valuation," 20 *Agric. L. Dig*. 41 (2009).

[11] Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982). But see Estate of Haydel v. Comm'r, T.C. Memo. 1991-507 (no discount allowed where pre-trial stipulation set value of property interests).

[12] T.C. Memo. 1989-138 (discount of 12 ½ percent allowed for tenancy in common ownership).

[13] See Estate of Cervin v. Comm'r, T.C. Memo. 1994-550, *rev'd* on another issue, 111 F.3d 1252 (5th Cir. 1997) (20 percent discount allowed for 50 percent interest in farm and homestead).

[14] See Ltr. Rul. 9336002, May 28, 1993; Ltr. Rul. 9943003, June 7, 1999 (discount for co-ownership of realty allowed for costs of partition).

[15] Estate of Baird v. Comm'r, 416 F.3d 442 (5th Cir. 2005).

[16] Mooneyham v. Comm'r, T.C. Memo. 1991-178 (15 percent discount allowed for 50 percent undivided interest in real property for federal gift tax purposes); Estate of Williams v. Comm'r, T.C. Memo. 1998-59 (discount allowed for gift of undivided interest in Florida timberland of 20 percent for lack of marketability and 30 percent for lack of control and need to partition for total discount of 44 percent).

[17] See, e.g., Mandelbaum v. Comm'r, T.C. Memo. 1995-255, *aff'd*, 91 F.3d 124 (3d Cir. 1996) (30 percent discount (for gift tax purposes) allowed for non-marketability).

[18] Estate of Jensen v. Comm'r, T.C. Memo. 2010-182.