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 Publisher/Editor
 Robert P. Achenbach, Jr.
 Contributing Editor
 Dr. Neil E. Harl, Esq.
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Issue Contents

Bankruptcy

- General
- Exemptions
- Earned income credit **139**

Federal Farm Programs

- Crop insurance **139**
- Organic food **139**

Federal Estate and Gift Taxation

- Allocation of basis for deaths in 2010 **139**
- Disclaimers **139**
- Estate representatives **139**
- Refund **140**
- Trusts **140**

Federal Income Taxation

- Charitable deduction **140**
- Dependents **140**
- Disaster losses **140**
- Employment expenses **141**
- Filing status **141**
- Foreign accounts **141**
- Health insurance **141**
- Home office **141**
- Innocent spouse relief **141**
- Like-kind exchanges **142**
- Passive activity losses **142**
- Payment of taxes **142**
- Returns **142**
- S corporations
 - Elections **142**
 - Trusts **143**
- Safe harbor interest rates
 - September 2013 **143**
- Sale of residence **143**

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Discounting Farmland and Ranchland Values During Life and at Death

-by Neil E. Harl*

The rapidly escalating values of farmland¹ (and some ranchland) in recent years has raised the question of discounting values at death for federal estate tax purposes² and during life for federal gift tax purposes.³ In general, valuation of land for federal estate tax purposes is based on fair market value⁴ unless an election is made to value the property under special use valuation,⁵ the property is owned in tenancy in common and a discount is allowed for the co-ownership, an entity discount is claimed for minority interest or non-marketability or both, a discount is allowed for potential income tax liability for corporations on built-in gains⁶ or a “blockage” or “market absorption” discount is allowed.⁷

For gift tax purposes, the valuation is to be based on the price at which, as of the date of the gift, the property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or sell and both having reasonable knowledge of the relevant facts.⁸

However, recent cases have enlarged the opportunities for discounting in several respects.⁹

The “absorption” discount

The 2008 case of *Astleford v. Commissioner*¹⁰ has produced spectacular results in terms of discounting. Earlier cases had established the concept of an “absorption” discount¹¹ which is similar to a “blockage” discount.¹² *Astleford*¹³ involved gifts of 30 percent interests in a family limited partnership to each of three children. The family limited partnership owned 1,187 acres of farmland in Minnesota. The Tax Court allowed a 20 percent “absorption” discount before allowing a discount for minority interest and non-marketability which reduced the value from \$3,500 per acre originally.¹⁴ The court stated that “. . . a sale of the entire . . . property would flood the local market for farmland and would reduce the per-acre price at which the . . . property could be sold.¹⁵ The Tax Court seemed to be influenced by the taxpayers’ expert who testified that the average Minnesota farm was 160 acres in size.¹⁶ However, *Minnesota Agricultural Statistics*¹⁷ pegged the average size of farm in Minnesota at 332 acres, more than twice the figure mentioned in the testimony.¹⁸ The Tax Court’s handling of the issue appeared to indicate that the land market is local only. That is highly questionable. Research at Iowa State University published in 2012 indicated that 21 percent of the farmland in the state was owned by someone who did not live in the state and 62 percent was owned by non-farmers.¹⁹ Those data suggest that the land market is not totally local and raises a question about the concept

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

of an “absorption” discount as accepted by the Tax Court in *Astleford*.²⁰

Selected cases on combined discounts

In *Estate of Litchfield v. Commissioner*,²¹ the Tax Court allowed a combined discount of 47.6 percent for Iowa farmland for federal estate tax purposes. The combined discount, which involved two corporations, included discounts for built-in gains, lack of control and lack of marketability.²² The estate had claimed a 68 percent combined discount for land in one corporation and 65 percent in the other.²³ The Tax Court scaled down the discount for lack of marketability from 36 percent and 29.7 percent in the two corporations to 25 and 20 percent, respectively.²⁴

In the case that is believed to have produced the largest combined discount (from \$1,818 per share on an undiscounted basis to \$439 per share after the allowed discounts for farmland), *Estate of Smith v. Commissioner*,²⁵ the estate used a 70 percent weight on asset-based methodology and 30 percent on earnings with a 26 percent discount for earnings, 50 percent discount from asset values to the value of stock and a 35 percent discount for lack of marketability.²⁶ A similar valuation approach in *Estate of Dunn v. Commissioner*²⁷ in valuing a 62 percent interest in a corporation, the Tax Court determination placed a 65 percent weight on net asset value and 35 percent on earnings (with a capitalization rate of 21.67 percent), a 15 percent discount for non-marketability, 7.5 percent for lack of control and five percent for built-in gains. However, on appeal, the Fifth Circuit Court of Appeals assigned an 85 percent weight on earnings and 15 percent on assets with a 34 percent discount for built-in gains and 22.5 percent discount for lack of marketability and lack of control and sent the case back to the Tax Court to implement the appellate court holdings.²⁸

In conclusion

The Congressional tax-writing committees have examined the discounting issues in recent years but at the moment there is little reason to think the rules will be changed significantly in the near future, although that remains a possibility.

ENDNOTES

¹ See, g., Duffy, “Iowa Land Value Survey,” Iowa Agriculture and Home Economics Experiment Station, Iowa State University, Dec. 2012 (average value of \$8,296 per acre as of November of 2012, representing an increase of 23.7 percent over 2011).

² I.R.C. § 2031(a). See generally 5 Harl, *Agricultural Law* § 43.02[1][a] (2013); Harl, *Agricultural Law Manual* § 5.02 (2013). See also Harl, “The Allowable Discount for Potential Income Tax Liability on Corporate Stock at Death,” 18 *Agric. L. Dig.* 177 (2007); Harl, “Discount for Potential Income Tax Liability in Valuing S Corporation Stock,” 20 *Agric. L. Dig.* 33 (2009); Harl, “Claiming Entity Discounts in Addition to Special Use Valuation,” 20 *Agric. L. Dig.* 41 (2009).

³ I.R.C. § 2512(a); Treas. Reg. § 25.2512-1; Rev. Rul. 59-60, 1959-1 C.B. 237.

⁴ See, e.g., Estate of Proctor v. Comm’r, T.C. Memo. 1994-

208. For additional cases and rulings see 5 Harl, § 43.02(a), footnote 13.

⁵ I.R.C. § 2032A.

⁶ See, e.g., Estate of Jensen v. Comm’r, T.C. Memo. 2010-182.

⁷ See, e.g., Estate of Auken v. Comm’r, T.C. Memo. 1998-185.

⁸ See note 3 *supra*.

⁹ E.g., *Astleford v. Comm’r*, T.C. Memo. 2008-128 (“absorption” discount where large land tracts involved).

¹⁰ T.C. Memo. 2008-128.

¹¹ Estate of Auken v. Comm’r, T.C. Memo. 1998-185 (6.189 percent discount on apartment complexes). See *Rodgers Estate v. Comm’r*, T.C. Memo. 1999-129 (property could not have been sold within one year).

¹² Estate of Foote v. Comm’r, T.C. Memo. 1999-37 (discount of 3.3 percent allowed, not 22.5 percent as urged by estate). See Estate of Branson v. Comm’r, T.C. Memo. 1999-231, *aff’d*, 264 F.3d 904 (9th Cir. 2001), *cert. denied*, 3/18/02 (blockage discounts of 10 and 20 percent allowed for bank stock); Estate of Brocato v. Comm’r, T.C. Memo. 1999-424 (11 percent blockage discount allowed; involved apartment units in San Francisco).

¹³ See note 10 *supra*.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Page 11.

¹⁸ Moreover, as noted in *Minnesota Agricultural Statistics*, p. 11, “farm” is defined as any establishment from which \$1,000 or more of agricultural products were sold or would have been sold during the year. That tends to greatly understate the average size of farm in terms of commercial farms in the state.

¹⁹ See Duffy, “Farmland Ownership and Tenure in Iowa, 2012,” Iowa State University, Pm 1983 (rev.).

²⁰ See note 10 *supra*.

²¹ T.C. Memo. 2009-21.

²² *Id.*

²³ *Id.*

²⁴ *Id.*

²⁵ T.C. Memo. 1999-368 (the case involved the valuation of both farmland and bank properties).

²⁶ *Id.*

²⁷ T.C. Memo. 2000-12, *rev’d*, 301 F.3d 339 (5th Cir. 2002).

²⁸ 301 F.3d 339 (5th Cir. 2002).