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AVOIDING SPECIAL USE VALUATION RECAPTURE

— by Neil E. Harl*

Although relatively less use has been made of special use valuation of land in recent years, the heavier use of the valuation option in the late 1970s and early 1980s can still lead to recapture.¹ For deaths before 1982, the potential recapture period is 15 years after the death of the decedent;² full recapture occurs within the first ten years with a phaseout between 10 and 15 years.³ For deaths after 1981, the recapture period has been reduced to 10 years after the decedent's death (or 10-years after the commencement of "qualified use" under the two year grace period).⁴

The key question is what events can lead to recapture.

Transfer outside the family. During the recapture period, with a few exceptions, only transfers to a member of the qualified heir's family avoid recapture.⁵ It is important to note that it is transfers to a member of the *qualified heir's* family that avoid recapture, not transfers to a member of the *decedent's* family.

The term "member of the family" is defined in terms of a *base person*: the decedent-to-be in the pre-death period, for purposes of special use valuation eligibility, and the qualified heir in the period the property is held by the qualified heir.⁶

- For deaths before 1982, the term "member of the family" encompasses an individual's ancestors or lineal descendants, lineal descendants of grandparents, the individual's spouse and the spouse of any such descendant.⁷

- For deaths after 1981, the definition of "member of family" was narrowed to include only the ancestors of the individual, the person's spouse, lineal descendants of the individual, lineal descendants of the individual's spouse, lineal descendant of the parents of the individual (not of the grandparents, as under pre-1982 law)⁸ and the spouse of any lineal descendants.⁹ The spouse of a lineal descendant remains a family member even though the descendant dies.¹⁰ But remarriage terminates the prior marriage relationship for purposes of special use valuation.¹¹

Example (1): Grandmother died in 1985 leaving three living children and two grandchildren born of a child that predeceased Grandmother. One of the living children, Charlie, farms the old home place. Can the grandchildren (of the predeceased child) sell their interests in the land to their Uncle Charlie without triggering special use valuation recapture? The answer is no. Their Uncle Charlie is not a member of their family. He's not a lineal descendant of the parents of the "base persons" — the grandchildren as qualified heirs.

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Example (2): Had the death in Example 1 occurred in 1980, could special use valuation recapture be avoided on transfer to Uncle Charlie? The answer is yes. For deaths before 1982, "member of family" includes the lineal descendants of the *grandparents* of the base person.

Example (3): Regardless of the date of death, could Uncle Charlie sell his interest in the land to the grandchildren (his nieces and nephews)? The answer is yes? The grandchildren are lineal descendants of both the parents and grandparents of Charlie.

Exchanges. For exchanges after 1981, recapture does not occur if qualified real property is exchanged in a tax-free exchange for "qualified exchange property."¹² Qualified exchange property is real property used for the same qualified use as the property transferred.¹³

If both qualified exchange property and other property are received, the recapture tax is reduced by an amount bearing the same ratio to the recapture tax as the fair market value of the qualified exchange property bears to the fair market value of the property exchanged.¹⁴

Recapture does not occur if qualified real property is involuntarily converted and "qualified replacement property" is acquired.¹⁵ Qualified replacement property is real property used for the same qualified use as the property involuntarily converted.¹⁶

Handling indebtedness. There is no authority on whether placing a mortgage or other credit obligation on the property would constitute a disposition for special use valuation purposes. It would seem that if the funds obtained remain invested in the business in farm real or personal property, there should be no recapture but authority is lacking on that point.

In a 1989 ruling,¹⁷ specially valued property was sold to non qualified heirs to pay off outstanding debt on other specially valued property, both under threat of foreclosure, and special use valuation benefits were recaptured.

The transfer of property to the bankruptcy estate (where an individual files Chapter 7 or 11 bankruptcy) is apparently not a taxable disposition and does not cause recapture under special use valuation rules.¹⁸ If the special use valuation property is transferred by the bankruptcy estate to a member of the debtor's family, no recapture should occur. In the event the special use property is transferred by the bankruptcy estate to someone who is not a member of the debtor's family and special use valuation benefits are recaptured, the responsibility of payment of the additional tax should be the responsibility of the bankruptcy estate as an administrative expense of the

estate.¹⁹ The recapture obligation is secured by a lien to assure payment of the tax.²⁰ Any special use valuation recapture tax remaining unpaid would be an unsecured claim and if the bankruptcy estate does not have sufficient property to pay the remaining tax, the question is whether the debtor's obligation to pay the recapture tax is dischargeable. There is no authority on that point but it would seem to depend upon whether the debtor's obligation is characterized as contingent liability, which is ordinarily dischargeable, or a tax which is not if the tax arose within three years of filing bankruptcy.²¹

Qualified use test. Failure of each qualified heir to meet the "qualified use" test causes recapture of special use valuation benefits.²² In general, the qualified use test requires that each qualified heir have an equity interest in the farm or ranch operation.²³ With two exceptions, cash rent leases result in recapture of benefits.²⁴ A 1981 amendment created a two-year grace period after the decedent's death for meeting the qualified use test retroactive to January 1, 1977.²⁵ A 1988 amendment, retroactive to 1977, permits a surviving spouse who inherits qualified real property to lease the land on a "net cash basis" to a member of the spouse's family without causing recapture.²⁶ For cash rent leases by trusts, the surviving spouse must be the only beneficiary if the exception is to apply.²⁷ A crop share or livestock share lease, even on a non material participation basis, is a sufficient equity interest to avoid recapture.²⁸ Even a hybrid cash rent lease has met the test in which the landowner was entitled to receive the lesser of the actual production from the land or 40 bushels of corn and 13 bushels of soybeans as rent per acre.²⁹

Although the authority is relatively weak, it appears that participation in government acreage diversion programs by a qualified heir does not lead to recapture of federal estate tax benefits.³⁰ Participation in the federal 10-year Conservation Reserve Program does not result in recapture.³¹ And IRS has ruled that the transfer of land to the Minnesota Land Conservation program (similar to the federal CRP program) does not cause recapture of special use valuation benefits.³²

Material participation test. Absence of material participation for more than three years in any eight year period ending after the decedent's death triggers recapture.³³ Material participation may be by the qualified heir *or any member of the qualified heirs family*, for the period during which the property was held by the qualified heir, and by the decedent or member of the decedent's family during the time the property was held by the decedent.³⁴

For a qualified heir who is the surviving spouse of the decedent, a person who has not reached age 21, disabled individual or full-time student, the material participation test may be met by "active management" by the qualified heir (or by a fiduciary if the qualified heir is a person under age 21 or a disabled individual).³⁵ Active management means the making of management decisions of a business (other than daily operating decisions).³⁶ This provision is effective *for deaths after 1981*.³⁷

As with the qualified use test, participation in government acreage diversion programs by a qualified heir does not appear to lead to recapture of federal estate tax benefits because of absence of material participation.³⁸

FOOTNOTES

¹ I.R.C. § 2032A(c). See 5 Harl, **Agricultural Law** § 43.03[2][g] (1990).

² I.R.C. § 2032A(c), before amendment by Economic Recovery Tax Act of 1981.

³ I.R.C. § 2032A(c)(3), before amendment by Economic Recovery Tax Act of 1981.

⁴ I.R.C. § 2032A(c)(1).

⁵ I.R.C. § 2032A(c)(1)(A). See Rev. Rul. 89-22, 89-1 C.B. 276 (transfer of special use valued property by qualified heir, son of decedent's brother, to member of decedent's family, son of decedent's other brother, resulted in recapture); Ltr. Rul. 8910021, Dec. 9, 1988 (pre-1981 death; lineal descendant of qualified heir's grandparent was qualified heir).

⁶ I.R.C. § 2032A(e)(2). See Rev. Rul. 89-22, 89-1 C.B. 276 *supra* note 5; Ltr. Rul. 8307110, November 18, 1982 (decedent's half brother was member of decedent's family but not member of family of decedent's children as qualified heirs).

⁷ I.R.C. § 2032A(e)(2). Est. of Cowser v. Comm'r, 80 T.C. 783 (1983), *aff'd*, 736 F.2d 1168 (7th Cir. 1984) (grandniece of decedent's spouse was not member of family of decedent); Whalen v. U.S., 86-1 U.S. Tax Cas. (CCH) ¶ 13,661 (C.D. Ill. 1985), *aff'd*, 826 F.2d 668 (7th Cir. 1987) (stepchild of decedent not qualified heir because not adopted by decedent).

See Ltr. Rul. 8304123, Oct. 28, 1982 (brother's spouse was member of family); Ltr. Rul. 8424066, no date given (spouse of decedent's son was "member of family" under pre-1982 law).

⁸ See note 7 *supra* and accompanying text.

⁹ I.R.C. § 2032A(e)(2). See Est. of Cone v. Comm'r, T.C. Memo. 1990-359 (estate not eligible for special use valuation for ranch property passing to nephew of decedent's predeceased husband under residuary clause of joint and mutual will). See also Ltr. Rul. 8724006, March 4, 1987 (second cousin not member of decedent's family for special use valuation requirements).

¹⁰ Rev. Rul. 81-236, 1981-2 C.B. 172 (unremarried widower of decedent's daughter remained qualified heir).

¹¹ Ltr. Rul. 8412014, Dec. 2, 1983.

¹² I.R.C. § 2032A(i). See, e.g., Ltr. Rul. 89526032, April 1, 1985 (emphasis on I.R.C. § 1031 requirements; no mention of "qualified exchange property").

¹³ I.R.C. § 2032(i)(3). See Ltr. Rul. 8526032, April 1, 1985 (exchange of qualified heir's farm for farm of equal value acquired by unrelated party in order to make exchange did not cause recapture); Ltr. Rul. 8850032, Sept. 19, 1988 (qualified heirs may not avoid recapture of special use valuation tax benefits by substituting estate property for which no election was made for

estate property for which election was made but which was involuntarily converted by governmental condemnation).

¹⁴ I.R.C. § 2032A(i)(1)(B).

¹⁵ I.R.C. § 2032A(h).

¹⁶ I.R.C. § 2032A(h)(3).

¹⁷ Rev. Rul. 89-4, 89-1 C.B. 298.

¹⁸ I.R.C. § 1398(f)(1).

¹⁹ 11 U.S.C. § 503(b)(1)(B).

²⁰ See I.R.C. § 6324B.

²¹ See 11 U.S.C. §§ 523(a)(1)(A), 507(a)(7)(E). See generally 13 Harl, *supra* note 1, § 120.06.

²² I.R.C. § 2032A(c)(6)(A).

²³ See generally 5 Harl, *supra* note 1, § 43.03[2][g][i][H].

²⁴ Martin v. Comm'r, 783 F.2d 81 (7th Cir. 1986), *aff'd*, 84 T.C. 620 (1985) (cash rent of 79 percent of farm acreage to unrelated person was cessation of qualified use); Heffley v. Comm'r, 89-2 U.S. Tax Cas. (CCH) ¶ 13,812 (7th Cir. 1989) (cash rental to non family member; qualified use test not met); Williamson v. Comm'r, 93 T.C. 242 (1989) (cash rental of property to nephew caused recapture); Hight v. Comm'r, T.C. Memo. 1990-81 (cash rent lease of ranch land caused recapture of special use valuation benefits).

²⁵ I.R.C. § 2032A(c)(7)(A).

²⁶ I.R.C. § 2032A(b)(5)(A).

²⁷ Ltr. Rul. 9043044, July 31, 1990 (cash rent lease by marital trust was not recapture event because spouse was sole beneficiary; cash rent lease by non marital share caused recapture because spouse was not sole beneficiary, inasmuch as trustee had sprinkling power to benefit spouse and decedent's issue); Ltr. Rul. 9022007, Feb. 27, 1990 (cash rent leases by marital trust and non marital trust (where surviving spouse had life estate with right in trustee to make discretionary principal distribution to others) qualified for exception; lease set to terminate at death of surviving spouse or, if discretionary distributions are made, during spouse's lifetime).

²⁸ E.g., Ltr. Rul. 8330016, April 26, 1983 (50-50 crop share lease met qualified use test).

²⁹ Ltr. Rul. 8217193, Jan. 29, 1982.

³⁰ Ann. 83-43, I.R.B. 1983-10, 29; Ltr. Rul. 8330016, April 26, 1983 ("participation by a qualified heir to be treated as having ceased to use the property for a qualified use under Section 2032A...")

³¹ Ltr. Rul. 8729037, April 21, 1987; Ltr. Rul. 8743004, July 16, 1987; Ltr. Rul. 8745016, Aug. 7, 1987; Ltr. Rul. 8802026, Oct. 15, 1987.

³² Ltr. Rul. 8946023, August 18, 1989 (transfer of 9 acres out of 354 acres).

³³ I.R.C. § 2032A(c)(6)(B).

³⁴ I.R.C. § 2032A(c)(6)(B)(i), (ii). See Ltr. Rul. 8217017, Jan. 26, 1982 (material participation by family members for corporate-owned land under crop share lease); Ltr. Rul. 8939031, June 30, 1989 (no recapture on lease extension where qualified heir materially participated as landowner

under crop share lease with unrelated tenant). Compare Ltr. Rul. 8218008, Jan. 28, 1982 (brother-in-law (as material participator) was not member of qualified heir's family); Ltr. Rul. 8307110, Nov. 18, 1982 (sons of decedent's half brother could not meet material participation requirement for decedent's children as qualified heirs).

³⁵ I.R.C. § 2032A(c)(7)(B), (C). But see *Mangels v. U.S.*, 632 F.Supp. 1555 (S.D. Iowa 1986), *rev'd*, 87-2 U.S. Tax Cas. (CCH) ¶ 13,734 (8th Cir. 1987) (management by court-appointed conservator; material participation test met).

³⁶ I.R.C. § 2032A(e)(12).

³⁷ Pub.L. 97-448, Sec. 104(b)(4)(A), 96 Stat. 2382 (1982), amending Pub.L. 97-34, Sec. 421(k)(5).

³⁸ See note 30 *supra*.

CASES, REGULATIONS AND STATUTES

BANKS

FRAUD. The defendant bank had agreed to allow the plaintiff debtor to receive immediate credit on third party checks, effectively allowing the plaintiff to "kite" checks and obtain unsecured loans during the check float periods. When the amount of such loans exceeded legal limits, the bank proposed that the debtor transfer farm land to the bank by quitclaim deed but assured the debtor that the deed would not change the actual ownership of the land. The deed allowed the bank to write off the plaintiff's loans. The scheme was supported by having the plaintiffs "rent" the land from the bank. The court set aside the deed because the deed transfer was induced by the bank's fraud. The court upheld the trial court's apportionment of damages and various setoffs based on the equities and misconduct of all parties. **National Bank & Trust Co. v. Campbell**, 463 N.W.2d 104 (Iowa Ct. App. 1990).

GOOD FAITH AND FAIR DEALING. The defendant bank had agreed to lend the plaintiff \$50,000 in two equal installments subject to the plaintiffs providing additional collateral. The defendant rescinded the agreement when it learned that the plaintiff had subsequently signed contracts to purchase additional equipment financed by loans from another bank. The court held that the rescission was not a breach of the duty of good faith and fair dealing because the decision was based on reasonable business standard of requiring debtors to fully disclose their financial condition. **Mann Farms v. Traders State Bank of Poplar**, 801 P.2d 73 (Mont. 1990).

BANKRUPTCY

GENERAL

AUTOMATIC STAY. The debtor claimed an exemption in a homestead which had been recovered by the deed of trust holder in a foreclosure. No objection was filed as to the exemption. The debtor's nondebtor spouse filed a state court

action against the creditor for fraudulent transfer of the homestead interest but the action was removed to the Bankruptcy Court which dismissed the action for violating the automatic stay. The appellate court held that although the exemption was not objected to, the exemption was not allowed because the homestead did not exist at the time of the bankruptcy filing. In addition, the debtor did not have any right to avoid the transfer as fraudulent until the trustee failed to file such an action. **Matter of Sherk**, 918 F.2d 1170 (5th Cir. 1990).

DISCHARGE. The debtors operated a construction company which obtained title insurance from the creditor. As was the common practice in the industry, affidavits of completed construction were completed, signed and notarized on the date the construction loan was originally closed, with the date of completion left blank. The debtors falsely used these affidavits to represent that payments had been made to subcontractors and the construction was completed. The creditor insurance company argued that the resulting loss was nondischargeable under Section 523(a)(2)(A) for misrepresentation. The court held that because the affidavits were completed at the time the loan was made, the affidavits were not untrue when made and no intent to deceive was present when the affidavits were made. The court noted that the use of this procedure of completing all paper work at the beginning may have been convenient for the parties but the procedure undermined the integrity of affidavits and under bankruptcy law relieved the debtor of any misrepresentation from improper use of the affidavits. **In re Pitt**, 121 B.R. 493 (Bankr. E.D. Va. 1990).

ESTATE PROPERTY. A creditor manufactured herbicides sold through a distributor to the debtor. The herbicide was shipped to the debtor with an agreement that the purchase by the debtor was not complete until the debtor broke the seals on the storage tanks. In addition, the bills of lading identified the seller and buyer as the manufacturing company. The credi-