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# Agricultural Law Digest

Volume 23, No. 10

May 11, 2012

ISSN 1051-2780

## Additional Advantage For Special Use Valuation

-by Neil E. Harl\*

At the time of enactment of special use valuation in 1976,<sup>1</sup> no mention was made of the possibility of sharp and persistent increases in farmland values or sharp drops in interest rates. Both have occurred (and continue to occur) with the result that special use valuation offers unusually generous discounts within the statutory limits in terms of maximum reduction of the gross estate. The economic environment has also created unusually large potential income tax liabilities on sale of special use valued farmland which was purchased from the estate because of the relatively low income tax basis in estates recently electing special use valuation. Both deserve careful planning attention.

### Rules for valuing farmland under special use valuation

Under the statute, farmland is valued for purposes of special use valuation under the most popular valuation method<sup>2</sup> by locating land comparable to the decedent's land used for farming purposes that has been cash rented and then subtracting from the "average annual gross cash rental" from the land "... the average real estate taxes (state, if any, and local) for such comparable land. . . ." and then dividing the result by the "average annual effective interest rate for all new Federal Land Bank Loans" from the Federal Land Bank District where the land is located, not the Federal Land Bank District where the decedent was domiciled at death.<sup>3</sup> Each of the average annual computations is to use the five most recent calendar years ending before the date of the decedent's death.<sup>4</sup>

**EXAMPLE:** The executor of an estate locates tracts of comparable land to that of the decedent with an average cash rental over the five years preceding the decedent's death of \$270 per acre and property taxes of \$30 per acre. The death occurred on December 15, 2011 with the land located in the AgriBank/FCB District<sup>5</sup> so the "average annual effective interest rate for all new Federal Land Bank Loans" would be 6.12 percent.<sup>6</sup>

The calculation of special use value per acre would be as follows –

$$\begin{aligned} \text{Special use value} &= \$270 - 30 / 0.0612 \\ &= 240 / 0.0612 \\ &= \$3,922 \end{aligned}$$

Any farmland that averaged \$270 per acre cash rent for the five years comprised of 2006, 2007, 2008, 2009 and 2010 would surely have a fair market value close to double the special use valuation figure – or higher. The important point to note is that federal estate tax values

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are figured *as of the date of death*<sup>7</sup> (or the alternate valuation date<sup>8</sup>) but special use valuation is calculated based on cash rents from comparable tracts of farmland *for the last five full calendar years ending before death*, adjusted downward for property taxes for the five year period. The result is striking in the face of the recent run-up in farmland values.

It should also be noted that the interest rate is also based on the last five years.<sup>9</sup> As is widely known, interest rates have declined in recent years (although much of the decline has occurred in the short-term segment of the yield curve and the average interest rate for all “new Federal Land Bank Loans” has been much less affected). The lower the average five-year interest rate, the higher the special use value. However, the rates for deaths in 2011 differ little from those in effect since 2004, primarily because the Federal Land Bank interest rates on new loans tend to reflect the longer term segment of the yield curve which has changed relatively less in recent years.

#### **Impact on sales by heirs purchasing special use land from the estate**

Although not always understood by the heirs who acquire special use land from the decedent’s estate, the farmland purchased from the estate which is subject to a special use valuation election has an income tax basis equal to the special use value established in the estate (or trust), increased by the amount of gain recognized by the estate or trust.<sup>10</sup> The estate, however, does not recognize gain on sale for income tax purposes (of special use value land) except to the extent the fair market value on sale exceeds the fair market value of the property on the date of the decedent’s death.<sup>11</sup> Note the statute does *not* state gain is recognized to the extent the *selling price* exceeds fair market value at the decedent’s death.<sup>12</sup>

Returning to the above example, assuming that the on-farm heir purchased 400 acres of farmland from the estate at its fair market value at death of \$10,000 per acre (total purchase price of \$4,000,000), the estate would have no gain to report inasmuch as the fair market value on sale did not exceed the fair market value at the date of the decedent’s death. The purchasing heir’s income tax basis would be \$3,922 per acre). If commodity prices fall and land values decline to \$8,000 per acre and the purchasing heir is forced to sell at that price (\$8,000 per acre), rather than a loss of \$2,000 per acre, the financially troubled heir would have a gain of \$4,078 per acre (\$8,000 minus basis of \$3,922) for a total gain of \$1,631,200 – even though the purchasing heir paid \$10,000 per acre. The \$10,000 figure (the purchase price) did *not* become the purchasing heir’s basis.

That is one good reason why purchasing heirs should consider letting the special use land pass to all of the heirs and then purchasing whatever they want from the heirs wanting to sell. That strategy results in the purchasing heir having an income tax basis equal to the purchase price and the selling heirs have gain to report based on the lower basis for the special use valued farmland.

#### **In conclusion**

The decision to elect special use valuation or to pass it up and pay additional federal estate tax (the maximum reduction of gross estate from special use valuation is \$1,040,000 in 2012<sup>13</sup>) should

be made only after careful consideration of all of the possible consequences (including sale before the end of the recapture period of 10-years).<sup>14</sup>

#### **ENDNOTES**

<sup>1</sup> Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003(e), 90 Stat. 1525 (1976), enacting I.R.C. § 2032A. See generally 5 Harl, *Agricultural Law* § 43.03[2] (2011); Harl, *Agricultural Law Manual* § 5.03[2] (2011).

<sup>2</sup> I.R.C. § 2032A(e)(7). The less popular valuation method is authorized by I.R.C. § 2032A(e)(8) and involves a five factor formula.

<sup>3</sup> I.R.C. § 2032A(e)(7)(A).

<sup>4</sup> I.R.C. § 2032A(e)(7)(A).

<sup>5</sup> See Rev. Rul. 2011-17, 2011-2 C.B. 160.

<sup>6</sup> *Id.*

<sup>7</sup> I.R.C. § 2031(a).

<sup>8</sup> I.R.C. § 2032(a).

<sup>9</sup> I.R.C. § 2032A(e)(7)(A), (e)(7)(A)(ii).

<sup>10</sup> I.R.C. § 1040(c).

<sup>11</sup> I.R.C. § 1040(a), (b).

<sup>12</sup> *Id.*

<sup>13</sup> Rev. Proc. 2011-52, § 3.30, 2011-2 C.B. 701.

<sup>14</sup> I.R.C. § 2032A(c)(1).

## **FARM ESTATE AND BUSINESS PLANNING**

**by Neil E. Harl**

The Agricultural Law Press is honored to publish the completely revised and updated 16th Edition of Dr. Neil E. Harl’s excellent guide for farmers and ranchers who want to make the most of the state and federal income and estate tax laws to assure the least expensive and most efficient transfer of their estates to their children and heirs.

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