# Chapter 13.

## Special Use Valuation

Section 2032(A) of the Internal Revenue Code (IRC) permits certain real property to be valued for Federal estate tax purposes on the basis of its "current use" rather than at "highest and best use." This is commonly termed "special use valuation." Real property may qualify for special use valuation if it is located in the United States and is devoted to either (1) use as a farm for farming pur-poses or (2) use in a closely held trade or business other than farming. In either case, there must be a trade or business use. Personal property also qualifies for special use valuation if it is used in connection with eligible real property.

The term "farm" is defined to include woodland. The term "farming purposes" includes the planting, cultivating, caring for, cutting down, and preparing for market of trees. The qualified property to be specially valued includes buildings, structures, and improvements functionally related to the qualified use. Unrelated items of value, such as mineral rights, are not eligible.

### REDUCTION IN VALUE

Special use valuation cannot reduce the fair market value of the gross estate by more than $750,000. If the woodland in question was owned by both spouses, the $750,000 limitation applies to each estate. Consequently, a reduction in value of up to $1.5 million is available. This can have a profound effect on application of the unlimited marital deduction to a forest estate.

#### Community Property

The full statutory reduction in value ($750,000) is allowed for a decedent's community property interest in timberland, even though the decedent made no contribution to the property (Letter Ruling 8229009). Revenue Ruling 83-96 applies the same rule to all community property eligible for special use valuation.

### QUALIFYING CONDITIONS

In the right situations, special use valuation of tree farms can save substantial amounts of estate taxes. Careful planning--both predeath and postdeath--will be required, however, in order to qualify and receive the maximum benefits. There are six major predeath requirements, as follows:

(1) The decedent must have been a resident or citizen of the United States, and the property must be located in the United States.

(2) The property must pass to a qualified heir or heirs.

(3) The decedent and/or a member of his (her) family must have owned the qualifying property for at least 5 of the last 8 years immediately preceding the decedent's death; and during at least 5 years of such ownership, the qualifying property must have been used for farming or a closely held business purpose--to include timber growing--by the decedent and/or a member of the decedent's family, and have been devoted to such use on the date of the decedent's death.

(4) The decedent and/or a family member must have materially participated in the operation of the property for at least 5 years during the 8 year period ending on the earliest of: (a) the date of the decedent's death, (b) the date on which the decedent became disabled, provided disability continued until the date of death, or (c) the date on which the decedent began receiving social security retirement benefits, provided the benefits continued until the date of death.

(5) The adjusted value of the real and personal property qualifying for special use valuation must comprise, at fair market value, at least 50 percent of the adjusted value of the decedent's gross estate.

(6) At least 25 percent of the adjusted value of the decedent's gross estate must be qualified real property.

Requirements 2 through 6 will be discussed in more detail in the following paragraphs.

#### Qualified Heirs

The term "qualified heir" is defined as an ancestor of the decedent; spouse of the decedent; lineal descendent of the decedent, of the decedent's spouse, or of

the decedent's parents; or the spouse of any such lineal descendent. Where there is a further dis-position of any interest in the property from a qualified heir to a member of the qualified heir's family, such member of the family must also meet the definition of "qualified heir." In interpreting this provision, the Tax Court has held that the nephew of a decedent's predeceased spouse was not a quali-fied heir because the nephew was not a lineal descendent of the decedent's parents, but rather was a lineal descendent of the decedent's spouse's parents (*I.M. Cone Estate,* 60 TCM 137, TC Memo 1990-359).

*Possible Passage to Nonqualified Heirs.*--All interests in the property to be specially valued must pass to a qualified heir or heirs. Any possibility that all or part of the property may pass from the dece-dent to a nonqualified heir will render the property ineligible. For example, the power existing in a trustee or executor to use discretion to place property either in trust for qualified heirs or in trust for nonqualified heirs will destroy eligibility (Letter Rulings 8244001, 8441006). Also, the Internal Revenue Service (IRS) regulations stipulate that if successive interests are created in the property, such as a life estate followed by a remainder interest, qualified heirs must receive all interests. Neverthe-less, the IRS has ruled that an estate could elect special use valuation for property in which a quali-fied heir received a life estate under the decedent's will, even though the heir also received the power to appoint the remainder interest in the property to a nonqualified heir. The election was allowed because the heir executed a qualified disclaimer (see chapter 7 for a discussion of disclaimers) of the power of appointment, thus causing the remainder interest to vest in another qualified heir (Revenue Ruling 82-140). Additionally, at least three court decisions have held that, when unqualified heirs are in a position to receive remainder interests, special use valuation will not be precluded if the possibility of receiving those interests is extremely remote (see *D. Davis IV Estate*, 86 TC 1156; *C. M. Clinard Estate*, 86 TC 1180; and *L. Smoot, Executor*, CA-7, 90-1 USTC ¶ 60,002).

*QTIP Trusts.*--Proposed QTIP regulations (see chapter 6 for definition and discussion of QTIP) may have created a trap for the unwary in the use of a QTIP trust to receive property for which a special use valuation election is planned to be made in the sur-viving spouse's estate. Under Proposed Regulation 20.2044-1(b), in order for property passing to a QTIP to be eligible for special use valuation, the remain-dermen following the surviving spouse's life interest must be qualified heirs of the surviving spouse, not of the decedent.

**Qualified Use**

The 5-of-8-years requirement for predeath qualified use will be met if either the decedent or a member of his (her) family has utilized the property for the required time in a qualified use. "Member of family" is defined to include the same persons as are listed in the definition of "qualified heir." The IRS has further interpreted the qualified use requirement to mean that the decedent or a family member must have borne some of the financial risk (have had an equity interest) associated with the operation (Technical Advice Memorandum 8201016, 9-22-81). In furtherance of this concept, numerous court decisions have held that a cash lease of otherwise qualified property by the decedent, particularly to nonrelatives, did not constitute a qualified use.

*Profit-making Activity.*--The IRS has also man-dated that qualified use be synonymous with a profit-making activity by the decedent (Letter Ruling 8820002). Here the estate included forest land and a cattle operation. Woodland was ruled ineligible because no timber had been cut from it, there were no records of regular inspections or mainten-ance activities, and there was no showing of an intention by the decedent to profit from timber growing and harvesting.

*Christmas Tree Operations.*--In Letter Ruling 9117046, the IRS ruled that an executor of an estate was entitled to make a special use valuation election for a Christmas tree farm. The farm was qualified real property because it was used for farming pur-poses. It was willed to qualified heirs who were chil-dren of the deceased. The heirs also had materially participated in the operation of the tree farm for the required length of time by making all management decisions and performing substantially all of the physical work.

**Material Participation**

The material participation regulations adopted under IRC Section 2032(A) discuss in detail the factors to be considered in determining whether the decedent and/or a member of his (her) family materially participated in operation of the prop-erty in question for the required period of time prior

to the decedent's death. No single factor is determinative; each situation stands on its own set of facts.

*Employment and Management.*--Physical work and participation in management decisions are the principal factors considered. At a minimum, the decedent and/or family member must have regularly advised or consulted with the other managing parties (if any) on operation of the business. The decedent and/or family member need not have made all management decisions alone but must have participated in making a substantial portion of the decisions. Production activities on the property should be inspected at regular intervals by the participant.

*Financial Risk.*--Another factor considered in the determination of material participation is the extent to which an individual has assumed financial responsibility for the business. This includes the advancement of funds and assuming financial responsibility for a substantial portion of the expenses involved.

*Self-employment Tax.*--Payment of self-employment taxes on income derived from the business is also an indicator of material participation. Although payment of such taxes is not conclusive evidence, if they have not been paid, material participation is presumed not to have occurred unless the executor demonstrates otherwise and explains why no tax was paid. With a timber operation, of course, the presumption would be that all timber income is capital gain under Section 631 of the IRC--not ordinary income--and, therefore, not subject to the self-employment tax. Thus payment or nonpayment should not be a consideration with respect to specially valued tree farms unless timber sale receipts are reported as ordinary income.

*Other Considerations.*--The sole activities of either the decedent or a family member must amount to material participation at a given time, because the activities of more than one person at a given time cannot be considered in the aggregate. If nonfamily members participate in the business, part time activities by the decedent and/or family members must be pursuant to a provable oral or written agreement providing for actual participation by the decedent and/or family member(s).

*Active Management.*--A special rule applies to liberalize the material participation requirement with respect to a surviving spouse who receives qualifying property from a decedent in whose estate the property was eligible for special use valuation, whether or not such valuation was actually elected. Active management by the surviving spouse will satisfy the material participation requirement for purposes of electing special use valuation in the surviving spouse's gross estate. The IRC defines active management as the making of management decisions of a business rather than daily operating decisions.

*Tree Farm Considerations.*--Example 7 of the IRS Section 2032A material participation regulations concerns a tree farm. Although not definitive of each timberland situation, the example does provide an insight as to how the IRS views material par-ticipation with respect to woodland.

> Example 13.1. [Regulation § 20.2032A-4 (Example 7)]. K, the decedent, owned a tree farm. He contracted with L, a professional forester, to manage the property for him as K, a doctor, lived and worked in a town 50 miles away. The activities of L are not considered in determining whether K materially participated in the tree farm operation. During the 5 years preceding K's death, there was no need for frequent inspections of the property or consultation concerning it, in as much as most of the land had been reforested and the trees were in the beginning stages of their growing cycle. However, once every year, L submitted for K's approval a proposed plan for the management of the property over the next year. K actively participated in making important management decisions, such as where and whether a precommercial thinning should be conducted, whether the timber was adequately protected from fire and diseases, whether fire lines needed to be plowed around the new trees, and whether boundary lines were properly maintained around the property. K inspected the property at least twice every year and assumed financial responsibility for the expenses of the tree farm. K also reported his income from the tree farm as earned income for purposes of the tax on self-employment income. Over a period of several years, K had harvested and marketed timber from certain tracts of the tree farm and had supervised replanting of the areas where trees were removed. K's history of harvesting, marking, and replanting of trees showed him to be in the business of tree farming rather than merely passively investing in timber land. If the history of K's tree farm did not show such an active business operation, however, the tree farm would not qualify for special use valuation. In light of all these facts, K is deemed to have materially participated in the farm as his personal involvement amounted to more than managing an investment.

*The Sherrod Case.*--The forestry example above has been considered in at least one court decision (*Sherrod v. Commissioner*, 82 TC 40). At death, the decedent (Mr. Sherrod) was the beneficial owner of nearly 1,500 acres of land. During the last 25 years of his life, 1,108 acres were in timber, 270 acres in row crops, and 100 acres in pasture. All of it was under the exclusive management and control of the decedent until 5 years before his death when he put the property into a revocable living trust. Thereafter, until the decedent's death, management and control were exercised by the decedent's son who was one of the trustees. Management activities included: (1) negotiation of annual rental payments on the crop and pasture lands; (2) contact from time to time with tenants and neighbors to check tenant performance and to see if they were aware of any problem with respect to the timberland; (3) supervision of the tim-berland by personal inspection, and contact with the tenants and adjoining landowners to protect against trespassers, insect infestation, and disease; (4) negotiation of timber-cutting contracts; and (5) payment of property taxes. Timber harvesting consisted of selection cutting and all regeneration was natural. The decedent personally supervised all logging by the timber purchasers. The IRS argued that these activities did not rise to the level of a qualified use and material participation because they did not include construction of fire lines, pruning dead and undesirable growth, and thinning--citing the forestry example in the material participation regulations. The Tax Court, however, held that the activities of the decedent and his son did constitute a qualified use and material participation because they had made every managerial decision and had performed every act necessary to carry on the business for the last 25 years. That these activities did not require a great deal of time, were not extensive, and did not conform in a number of respects to the forestry example in the IRS regulations was immaterial. The court con-cluded that the activities cited by the IRS as lacking were not practical or financially feasible with respect to the property in question--that management actions taken on one woodland are not necessarily those required for good management of another timber property.

*The Mangels Case.*--Timberland material participation has also been considered in at least one other court decision (*Mangels*, DC Iowa, 4/22/86). Here, for 6 years before the decedent's death, her conservator, a bank, leased her timberland and pasture on a cash basis to parties unrelated to her. The issue was whether the material participation test was met. The court ruled for the government. The conservator's participation in the operations of the property was insufficient to satisfy the threshold requirements for material participation. No agent of the conservator did physical work on the property, and participation in management decisions was minimal.

**The 50- and 25-percent Tests**

Several important considerations must be kept in mind with respect to meeting the 50- and 25-percent tests. The determination of sufficiency of property for both tests is based on fair market value minus mortgages and related liens. Increasing an existing mortgage or taking out a new one on property previously qualified for special use valuation could cause the net value to drop below one or both of the percentage thresholds.

*Partial Election.*--The special use valuation election does not have to be made for all the qualified property used to satisfy the 50-percent test. The 25-percent test, however, must be met from property actually elected for special use valuation.

*Gifts within 3 Years of Death.*--Nonqualified property cannot have been gifted by the decedent within 3 years of death in order to meet the 50- or 25-percent eligibility tests. Any transfer of property within this time period will be includable in the gross estate for the limited purpose of determining the estate's qualification for special use valuation.

**Example 13.2.** Mr. Tree Farmer, a widower, owns a tree farm with a fair market value of $300,000 and a special use value of $150,000. His other assets, which are not eligible for special use valuation, have a fair market value of $400,000. The total estate thus has a fair market value of $700,000. On this basis, the tree farm could not qualify for special use valuation because its fair market value is only 42.9 percent ($300,000 ÷ $700,000) of the fair market value of the total estate. Assuming no change in asset value, $100,000 would be subject to Federal estate tax at Mr. Tree Farmer's death. With the special use valuation percentage requirements in mind, Mr. Tree Farmer gifts $105,000 of securities to his only child, using $95,000 of his unified credit. The fair market value of the estate is now $595,000, with the tree farm's fair market value now comprising more than half. Mr. Tree Farmer gives a sigh of relief--he has just saved

$33,300 in estate taxes--or so he believes. Unfortunately, he has a heart attack and dies 35½ months after making the gift. The gift will, therefore, be brought temporarily back into his estate for the sole purpose of determining whether the special use valuation percentage requirements have been met. On this basis, the fair market value of the tree farm as a percentage of total fair market estate value once again drops below 50 percent. Eligibility for special use valuation has been lost, and the estate is liable for more than $33,000 in unanticipated Federal taxes. If Mr. Tree Farmer had died 3 weeks later, special use valuation could have been elected with the result that no estate taxes would be due.

## ELECTION AND AGREEMENT

When making the special use valuation election and signing the accompanying agreements, attention to detail is necessary. Many elections have been voided because of carelessness.

### Election

The election for special use valuation is made on Form 706 (U. S. Estate and Generation Skipping Tax Return--see appendix) by checking the box marked "yes" in the "Elections by the Executor" section of the return. For timber properties, a second election is also necessary by checking the woodlands election box in part 2 of schedule A-1. The elections may be made on a late-filed return if it is the first return filed. In order to validate the election, an estate must complete and file schedule A-1, and attach all of the required statements and appraisals. Schedule A-1 contains the "Notice of Election" and the "Agreement to Special Use Valuation." The "Notice of Election" provides the fair market value of the property to be specially valued, its special use valuation, and the method used for computing the special use value. An estate may elect special use valuation for less than all of the qualified property included in the gross estate. However, as noted earlier, real property for which an election is made must comprise at least 25 percent of the total value of the adjusted gross estate.

*Corporate and Partnership Interests.*--In order for a decedent's partnership interest in qualified property to be eligible for the special use valuation election, 1 of 2 requirements must be met: (1) the partnership must have had 15 or fewer partners, or (2) 20 percent or more of the partnership capital interest (see page 98 for a discussion of partnership capital interest) must be in the decedent's estate. Eligibility requirements for corporate interests are similar. The corporation must have had 15 or fewer shareholders, or 20 percent or more of the voting stock must be included in the decedent's estate.

*Protective Election.*--When it is not certain that real property meets the requirements for special use valuation, the estate executor may make a protective election to specially value the property, contingent upon property values as finally determined. The protective election is made by filing a notice of protective election with a timely filed estate tax return. If it is finally determined that the property qualifies for special use valuation, the estate must file an additional notice of election within 60 days of the determination.

*Technically Defective Elections.*--If a timely special use valuation election is made, and the estate tax return, as filed, shows evidence of substantial compliance with the requirements relating to special use valuation, the executor has a reasonable time--not to exceed 90 days--in which to cure any technical defects or flaws in the form of the election that would prevent it from being otherwise valid. The 90-day period commences following notification by the IRS that a defect exists. Examples of such technical defects or flaws are the failure to include all required information in the notice of election and the failure to include signatures of heirs with relatively small interests.

### The Agreement

The "Agreement to Special Use Valuation," which is part 3 of schedule A-1 of the Federal estate tax return, must be signed by each person having an interest in the qualified real property for which the election is made. It does not matter whether any of these persons are in possession of the property or not. In the case of a qualified heir, the agreement expresses consent to personal liability for any additional estate tax that may become due in the event of recapture due to any of the postdeath requirements (as discussed on page 87) not being met. Signees other than the qualified heirs are not personally liable but must express consent to collection of any such additional tax from the qualified property.

*Corporate and Trust Interests.*--Corporate interests

cannot be valued underspecial use valuation unless the agreement contains a signature that binds the corporation. Signatures by shareholders or heirs in their individual capacities is not enough (Technical Advice Memorandum 8602007, 9/7/85). Similarly, a decedent's interest that passes to a testamen-tary trust is not eligible for special use valuation unless the trust beneficiaries consent to be personally liable for the recapture tax. The trustee's signature alone is insufficient (Technical Advice Memorandum 8802005, 9/29/87).

*Tenants in Common.*--The Tax Court has held that the IRS regulation governing the signing of the agreement is invalid insofar as it requires that all individuals having tenancy in common interests in property subject to a special use election sign the agreements. The court noted that the surviving tenants in the situation in question did not have "an interest in the property" because only the dece-dent's tenancy in common interest was includable in his gross estate and thus subject to the election.

## VALUATION

In making the election, two valuations must be determined for the affected property: special use value and fair market value. Both must be reported on the estate tax return. With respect to woodlands, either bare land or standing timber or both may be specially valued. Often, it is only by including some or all of the standing timber on the property that the 50- and/or 25-percent tests can be met. For a detailed discussion of the procedures applicable to fair market valuation of timber property, see chapter 4.

### Alternate Valuation

When an estate elects to use the alternate valuation date of 6 months after the decedent's death (see chapter 4 for a discussion of the alternate valuation date) and also elects special use valuation, the special use value must be determined as of the alternate valuation date. The alternate valuation date must also be used when determining whether the aggregate decrease in value of the qualified property exceeds the statutory limit of $750,000 (Revenue Ruling 88-90).

### Special Use Valuation of Woodlands

Timberland special use valuation procedures must follow the general special use valuation rules appli-cable to farms, as set out in the IRS regulations. No valuation procedures specifically applicable to wood-lands are provided. Two methods of farm valuation are described: the "farm" method and the "multiple factors" method.

*Farm Method.*--The farm method is the preferred IRS special use valuation method. It is determined by dividing the average annual gross cash rental for comparable land used for the same purpose and located in the same locality, minus the average annual property tax for such land, by the average annual effective interest rate for all new Federal land bank loans. The average annual computations are to be made on the basis of the 5 most recent calen-dar years ending before the date of the decedent's death.

Timberlands in the South are sometimes specially valued under the farm method by using rental payments specified in long-term leases of forest lands to forest product companies--when the details of such leases for comparable forest property can be obtained.

If no comparable land can be identified for which the average annual gross cash rental can be deter-mined, the farm method may be used by substituting the average annual net share rental. Obviously, this has no applicability to forest land.

*Multiple Factors Method.*--As an alternative to the farm method, if no comparable rented timberland can be documented, the executor may elect to value the property using the multiple factors method. The regulations list the following factors: (1) capitaliza-tion of income that the property can be expected to yield over a reasonable period of time under prudent management, taking into account the soil and other features affecting productivity; (2) capitalization of the fair rental value of the land for farming purposes; (3) the assessed property tax value in a State that provides differential or use value property tax assessment procedures for rural land; (4) comparable sales of other property in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price; and (5) any other factor which fairly values the farm value of the property.

The IRS has ruled, with respect to the multiple factors method, that the executor cannot select only one of the factors enumerated above as the exclusive basis of valuation unless none of the other fac-tors is relevant. Each factor relevant to the valua-tion

must be applied, although, depending on the circumstances, certain factors can be weighed more heavily than others (Revenue Ruling 89-30).

*Technical Advice Memorandum 9328004.*--The IRS recently (March 1993) addressed the valuation method to be used for special use valuation purposes with respect to a Douglas-fir tract included in a decedent's estate. The executor used the farm method, citing a single property in the area that included woodlands and that was leased on a cash basis. The IRS ruled that the two properties were not comparable and that the executor thus was required to use the multiple factors method of valuation. The memorandum discusses at length the applicability of the multiple factors method to woodlands and how it is to be used to specially value forest property.

*Woodland Special Use Valuation.*--The special use valuation election for forest land is directed toward limiting the highest and best use of such acreage to timber growing. Purely speculative and inflationary components of value are designed to be eliminated by the election. Factors 1, 3 and 4 above are the most likely to apply to forest land. Of these, income capitalization is probably the most often used factor. This method of valuation, depending on the circumstances and characteristics of the property involved, may actually result in a value lower than the current market value for timber use.

## Postdeath Requirements

Certain requirements must continue to be met during a 10-year recapture period measured from the decedent's date of death. If not met, a recapture tax applies.

### Continued Ownership within the Period

Ownership of the specially valued property must continue solely within the decedent's family, as the term "family members" was defined earlier. Exceptions apply in the event of involuntary conversions or tax-free, like-kind exchanges. With respect to the former, however, the proceeds from the involuntary conversion must be reinvested in real property that is used for the same qualified use as was the involuntarily converted property. Similarly, property received in an exchange must also be employed in the same qualified use.

### Material Participation

At least one member of the decedent's family as defined earlier must materially participate in operation of the property during 5 of every 8 years before the qualified heir's death during the 10-year period following the decedent's death. The less stringent active management test, as discussed on page 83, may be substituted for material participation by surviving spouses, qualified heirs under the age of 21, full-time students, or disabled persons. If the prop-erty in question has been left in a trust to which the surviving spouse is the life beneficiary and other qualified heirs are the remaindermen, the surviving spouse is the qualified heir for purposes of com-pliance with the material participation requirements (Letter Ruling 8652005).

### Qualified Use

The property must continue to be used and managed for the qualified use. However, a qualified heir may begin the qualified use at any time within 2 years of the decedent's death without triggering the recapture tax; the recapture period does not begin to run until the qualified use begins. If property is left in a trust to which the surviving spouse is the life beneficiary and other qualified heirs are the remaindermen, the spouse is the qualified heir for purposes of compliance with the qualified use test (Letter Ruling 8652005).

### Recapture Tax

The tax benefits realized by the estate when special use valuation has been elected may be fully or partially recaptured if one of the postdeath requirements discussed above fails to be met during the recapture period. A second violation will not trigger a second tax on the same qualified property, however. Thus, when a qualified heir ceases to use the property for its qualified purpose and later sells it during the recapture period, a recapture tax will be imposed as to the first event that triggers recapture, that is, cessation of use, but not as to the second event (sale of the property).

### Conservation Reserve Program Enrollment

Letter Ruling 8745016 discusses diversion of cropland to tree cover under the Conservation Reserve

Program (CRP). Here the qualified heir, for specially valued farmland, converted the farmland from cropland to tree cover after enrolling in the CRP program. The IRS ruled that such diversion is not a cessation of qualified use so as to trigger the recapture tax.

**Amount Subject to Recapture**

The amount of the tax benefit potentially subject to recapture is the estate tax liability that would have been incurred had the special use valuation procedure not been used minus the actual estate tax liability based on special use valuation. In other words, the maximum additional or recapture tax is the amount that special use valuation has saved the estate. This is called the adjusted tax difference. The additional tax will be less than the maximum if the fair market value of the property interest in question--or the proceeds from its arm's-length sale--exceed the value of the property interest determined under special use valuation by less than the adjusted tax difference.

**Payment of the Recapture Tax**

The additional tax on recaptured property is due on the day that is 6 months after the recapture event. Interest runs from the due date (Revenue Ruling 81-308). However, if an election is made to adjust the basis of the property in question to its fair market value on the date of the decedent's death, interest is owed from the due date of the estate tax return. Such an election is permitted under IRC Section 1016(c). If interest is paid, it is not deductible by the original estate as an administrative expense. The IRS rea-sons that the recapture tax and the interest on it is not imposed in connection with a testamentary transfer of estate property, but rather is a separate tax imposed on the qualified heir as a result of the heir's own actions (Letter Ruling 8902002).

**Recapture Lien**

A government lien is imposed on all qualified property for which a special use election has been made and applies to the extent of any recapture tax that may be imposed. It begins at the time the election is filed and continues until: (1) the tax benefit is recaptured, (2) the qualified heir either dies or the recapture period ends, or (3) until it can be established to the satisfaction of the IRS that no further liability will arise. If qualified replacement property is purchased following an involuntary conversion of special use valuation property, the lien that was applicable to the original property attaches to the new. Similarly, if specially valued property is exchanged for qualified exchange property, the lien also attaches to the new property. The IRS can subordinate the government's lien if it determines that the interest of the United States will be adequately protected thereafter.

**Release from Recapture Tax Liability**

A qualified heir's liability for the recapture tax can be extinguished in two instances: (1) if the recapture period lapses and (2) if the heir dies without converting or disposing of the property. Additionally, a sale or other disposition by one qualified heir to another of specially valued property is not considered a recapture event, and the second heir is treated as if he (she) received the property from the decedent rather than from the first heir. The second heir then becomes liable for the recapture tax, and the seller is released of further liability.

*Discharge from Liability.*--An heir may be discharged from personal liability for future potential recapture taxes by furnishing a bond for the maximum additional tax that could be imposed on his (her) interest in the property.

**Timber and the Recapture Tax**

Unfortunately, an onerous special rule applies to the cutting of specially valued timber during the recapture period. Any harvesting of such timber or the disposition to another of the right to harvest before the death of the qualified heir will be termed a disposition of the interest in the specially valued timber and, therefore, trigger a recapture tax. The recapture amount will be the lesser of: (1) the amount realized on the disposition (or if other than a sale or exchange at arm's length, the fair market value of the portion of the interest disposed of), or (2) the amount of tax that would be recaptured under the general recapture rules, without regard to the woodland election, were the entire interest in the qualified woodland disposed of. The second of these requires that the computation be made as if there had been a disposition of the land as well, even though it was not actually disposed of.

The valuation of severed specially valued timber for recapture tax purposes is discussed in detail in a 1983 Tax Court decision (*Donald C. Peek*, TC Memo 1983-224, TCM 1382). Calculation of the recapture tax with respect to the sale of a tract of farm and

forest property is set out in Letter Ruling 8741048.

*Designation of Specially Valued Timber.*--In most instances, executors will probably choose not to specially value standing timber except as needed to meet the 25- or 50-percent qualifying tests when there is other property included, such as the underlying forest land and/or farm acreage. Obviously, young timber that would not be harvested during the 10-year recapture period should be utilized first for the special use valuation election. The designa-tion should be made on an acreage basis, if possible, to avoid confusion as to just which trees are included. If older timber is also to be specially valued, the most feasible way would be to do it on an acreage basis as well, for the same reason—-describing specifically the acres containing the trees to be so valued. Alternatively, the distinction could be made by species or diameter classes as they exist at the time of the election, but a very careful description would be required. Specially valuing a certain percentage of a stand's volume--for example, 50 percent of the merchantable volume that exists in a stand at the time of election--should definitely be avoided. A situation was related to the authors in private correspondence where this was done. The IRS accepted the election, but when the executor decided to harvest some of the trees and sought clarification from the IRS as to which trees he could cut, he was confronted with an unexpected problem. The executor wanted to cut the number of trees whose volume would equal the percentage of original stand volume not specially valued. The IRS took the position, however, that the volume breakdown applied to each tree--not to the stand as a whole--and, therefore, part of each tree was specially valued and the other part of the tree was not. This meant that no trees whatsoever could be cut without constituting a premature disposition and triggering a recapture tax.

## THE ELECTION DECISION

Like many other provisions that grant tax relief in particular situations, special use valuation should not be elected without careful thought and analysis. The executor has an obligation to evaluate the election because of its potential significant impact on estate tax liability, and such an evaluation should not be avoided merely because it may be difficult and complex. Like many other provisions of tax law, its effects can be assessed only through mathematical application to the circumstances of the particular estate in question.

The election may be used on a partial basis to control the valuation of only part of the estate, such as the property for which the greatest reduction in value per acre may be achieved, while leaving other property to conventional valuation. Depending on the size and nature of the estate, land that will provide the maximum value reduction may be selected from property intended to be retained in the family, while preserving other property for future liquida-tion, if desired.