Chapter 12

Special Use Valuation

Section 2032A 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 its "highest and best use." This commonly is 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 purposes, or (2) use in a closely held trade or business other than farming. In either case, there must be a trade or business use; investment property is not eligible. 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 forest land. The term "farming purposes" includes the planting, cultivating, caring for and cutting down of trees, and preparing them for market. 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, as adjusted for inflation since 1999; for 2008 the limit is $960,000. If the forest land in question (and other qualified property) was owned by both spouses, the limitation applies separately to each estate. Consequently, a reduction in value of up to $1,920,000 is available in 2008. 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 is allowed for a decedent's community property interest in forest land and other qualified property, even though the decedent made no contribution to the property (Private Letter Ruling 8229009, April 12, 1982). Revenue Ruling 83-96 (1983-2 CB 156) applies the same rule to all community property eligible for special use valuation. This position was codified by the Taxpayer Relief Act of 1997 (TRA; Public Law 105-34).

Qualifying Conditions

In the right situations, special use valuation of forest land can save a substantial amount of estate taxes. Careful planning—both pre-death and post-death—will be required, however, in order to qualify and receive the maximum benefits. There are six major pre-death requirements:

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 family member must: (a) have owned the qualifying property for at least 5 of the last 8 years immediately preceding the decedent's death; (b) had an equity interest in the operation at the time of death and for at least 5 of the last 8 years before death; and (c) during at least 5 years of such ownership, the qualifying property must have been used for farming or a closely held business purpose—including timber growing—by the decedent and/or a member of his (her) 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 (gross estate, less secured debts). As discussed below, however, the special use valuation election may be made for as little as 25 percent of the adjusted value [Treasury Regulation 20.2032A-8(a)(2)].

6. At least 25 percent of the adjusted value of the decedent's gross estate must be qualified real property. This test must be met from property actually elected for special use valuation.

Requirements 2 through 6 are discussed in more detail in the paragraphs below.

Qualified Heirs

The term "qualified heir" is defined as an ancestor of the decedent; spouse of the decedent; lineal descendent of the decedent, the decedent's spouse, or the decedent's parents; or the spouse of any such lineal descendent. Where there is a further disposition of any interest in the property from a qualified heir to a member of the qualified heir's family, such member of the family also must meet the definition of "qualified heir" [IRC section 2032A(e)(1)]. In interpreting this provision, the Tax Court has held that the nephew of a decedent's predeceased spouse was not a qualified 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 (*Estate of Cone, I.M*., 60 TCM 137, TC Memo. 1990-359). Also, a disposition by a qualified heir to his cousin within the recapture period (see the Postdeath Requirements section, below) resulted in the recapture tax being imposed because the cousin did not meet the definition of a qualified heir's family member (Revenue Ruling 89-22, 1989-1 CB 276).

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 decedent to a nonqualified heir will render the property ineligible [Treasury Regulation 20.2032A-8(a)(2)]. The Internal Revenue Service (IRS) has disallowed a number of special use valuation elections because not all successive interests in otherwise qualifying real property passed to qualified heirs. 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 (Private Letter Rulings 8244001, January 14, 1981, and 8441006, June 26, 1984). Also, 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. Nevertheless, the IRS has ruled that an estate could elect special use valuation for property in which a qualified 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) of the power of appointment, thus causing the remainder interest to vest in another qualified heir (Revenue Ruling 82-140, 1982-2 CB 208).

Remote possibility of passage to nonqualified heirs—Two Tax Court decisions have held that Treasury Regulation 20.2032A-8(a)(2) is invalid to the extent that all successive interests are required to go to qualified heirs. In the Davis case (*Estate of Davis, D*. IV, 86 TC 1156, CCH Dec. 43,105), the Court held that de minimis successive interests that do not go to qualified heirs will not prevent special use valuation for otherwise qualified property. Similarly, the Clinard case (*Estate of Clinard, C.M*., 86 TC 1180, CCH Dec. 43,106) limited Treasury Regulation 20.2032A-8(a)(2) by holding that special use valuation is permitted where a qualified heir possesses a life estate with a special power of appointment. In other words, the fact that a qualified heir could direct that an unqualified heir receive a remainder interest would not preclude special use valuation for the interest in question. Both cases recognize that where unqualified heirs are in a position to receive an interest, special use valuation will not be precluded if those interests are exceedingly remote. This principle also has been followed by the United States Court of Appeals for the Seventh Circuit in affirming a decision of a United States District Court in Illinois that allowed special use valuation despite a remote possibility that the contingent remainder interest in the property could pass to nonqualified heirs (*Smoot, L. Executor*, 892 F2d 597 (CA-7), 90-1 USTC 60,002, affirming DC Ill., 88-1 USTC ¶13,748).

Qualifying property passing in trust—The rules for the special use valuation procedure apply to qualifying property that passes in trust. However, future interests in trust property will not qualify for special use valuation. Trust property will be considered to have passed from the decedent to a qualified heir only to the extent that the qualified heir has a present interest in the property. Real property otherwise qualifying for special use valuation and passing to a trust may be specially valued even if the trustee has the discretionary power to fix the amounts receivable by any individual beneficiary, so long as all potential beneficiaries are qualified heirs [IRC section 2032A(g)]. As well, if the decedent created successive interests in the trust property that is to be specially valued, all of those interests must be received by qualified heirs.

Qualified terminal interest property (QTIP) trusts—The QTIP regulations (see chapters 6 and 9 for discussion of QTIP trusts) may have created a trap for the unwary in the use of a QTIP trust to receive property for which it is planned to make a special use valuation election in the surviving spouse's estate. Under Treasury Regulation 20.2044-1(b), in order for property passing to a QTIP to be eligible for special use valuation, the remaindermen 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 year's requirement for pre-death qualified use will be met if either the decedent or a family member has utilized the property for the required time in a qualified use. "Member of family" is defined to include the same persons as listed in the definition of "qualified heir." Further, the IRS has interpreted the qualified use requirement to mean that the decedent or a family member must have borne some of the financial risk (had an equity interest) associated with the operation (Technical Advice Memorandum 8201016, September 22, 1981). 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 also has mandated that qualified use be synonymous with a profit-making activity by the decedent (Private Letter Ruling 8820002, February 8, 1988). Here the estate included woodland and a cattle operation. The woodland was ruled ineligible because no timber had been cut from it, there were no records of regular inspections or maintenance activities, and there was no showing of an intention by the decedent to profit from timber growing and harvesting.

Christmas tree operations—In Private Letter Ruling 9117046 (January 29, 1991), 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 purposes. It was willed to qualified heirs who were children of the deceased, all of whom 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 2032A discuss in detail the factors to be considered in determining whether the decedent and/or a family member materially participated in operation of the property 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 also is an indicator of material participation, although payment of such taxes is not conclusive evidence. If, however, the taxes 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 forest land unless timber sale receipts are reported as ordinary income.

Multi-participation—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).

Passive activity losses—The estate of a decedent who reported losses from a ranch as passive activity losses, rather than losses from an active trade or business, could not elect special use valuation because the decedent had not materially participated in the ranch operation during her lifetime (Technical Advice Memorandum 9428002, March 29, 1994).

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 actually was 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 IRC section 2032A material participation regulations concerns a tree farm. Although not definitive of every forest land situation, the example does provide an insight as to how the IRS views material participation with respect to forest land.

> **Example 12.1. Treasury 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, inasmuch 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 above forestry example from the IRS regulations has been considered in at least one court decision [*Estate of Sherrod, H.F. v. Commissioner*, 82 TC 523; reversed on other grounds, 774 F2d 1057 (CA-11), 85-2 USTC ¶13,644]. At death, the decedent, 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 the land 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 timberland by personal inspection, and contact with the tenants and adjoining landowners to protect against trespass, insect infestation, and disease; (4) negotiation of timber-cutting contracts; and (5) payment of property taxes. Timber harvesting consisted of selection cutting; 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 IRC section 2032A 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 concluded 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 forest property are not necessarily those required for good management of another.

The *Mangels* case—Forest land material participation has been considered in at least one other court decision [*Mangels, R.W. v. United States*, 632 F Supp 1555 (DC-IA), 86-2 USTC ¶13,682]. Here, for 6 years before the decedent's death, her conservator, a bank, leased her forest land and pasture on a cash basis to parties unrelated to her. The issue was whether the material participation test was met. The Court, holding for the government, ruled that it was not met. 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 12.2.** Mr. Tree Farmer, a widower, owns a tree farm with a fair market value of $1.4 million and a special use value of $700,000. His other assets, which are not eligible for special use valuation, have a fair market value of $1.6 million. He has no debts. The adjusted estate thus has a fair market value of $3 million. On this basis, the tree farm cannot qualify for special use valuation because its fair market value is only 46.7 percent ($1,400,000 ÷ $3,000,000) of the fair market value of the total estate. Assuming no change in asset value, $1 million would be subject to Federal estate tax at Farmer's death. With the special use valuation percentage requirements in mind, Farmer gifts $500,000 of securities to his only child. The gift uses up $500,000 of his $1 million lifetime exclusion amount for gifts and also reduces his estate exclusion at death by $500,000. The fair market value of the estate is now $2.5 million with the tree farm's fair market value comprising more than half. Farmer gives a sigh of relief; he has just saved $270,000 in Federal estate taxes—or so he believes. Unfortunately, Farmer has a heart attack and dies 24 months after making the gift. The value of the gift, therefore, will be brought back temporarily into his estate for the 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 again drops below 50 percent. Eligibility for special use valuation has been lost, and the estate is liable for an additional $270,000 in unanticipated Federal taxes. If Farmer had died more than 36 months after making the gift, special use valuation could have been elected.

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 IRS Form 706, United States Estate (and Generation-Skipping) Tax Return, Schedule A-1, Part 1 (see appendix II) by checking the box marked "yes" in the "Elections by the Executor" section of the form. For forest properties, a second election also is necessary if standing timber in addition to the land is specially valued. This is made by checking the woodlands election box in Schedule A-1, Part 2, line 11. These elections may be made on a late-filed return if it is the first return filed. The Fifth United States Circuit Court of Appeals has upheld a denial by the Tax Court of an estate's attempt to make a section 2032A election during the computational phase of its negotiations with the IRS because both parties had previously stipulated to the value of the underlying property with no mention of or claim to section 2032A valuation [*Estate of Kokernot, G.E.R. v. Commissioner*, 112 F3d 1290 (CA-5), 97-1 USTC ¶60,276; affirming TC Memo 1995-590].

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. As noted above, however, real property for which an election is made must have an adjusted value of at least 25 percent of the adjusted value of the gross estate. See, however, *Miller, M.S. Executor*, 680 F Supp 1269 (DC-IL), 88-1 USTC ¶13,757, holding the governing regulation for this rule [Treasury Regulation 20.2032A-8(a)(92)] invalid insofar as it imposed an additional substantive requirement to the statutory rules governing qualification for special use valuation. If an estate contains both property that qualifies for special use valuation and property that does not, and alternate valuation is elected (valuation as of six months after the decedent's date of death; see chapter 3), the estate must determine the special use value (if elected) as of the alternate valuation date (Revenue Ruling 88-89, 1988-2 C.B. 333).

Corporate and partnership interests—For a decedent's partnership interest in qualified property to be eligible for the special use valuation election, one of two 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 chapter 15) must be in the decedent's estate. Eligibility requirements for corporate interests are similar: (1) the corporation must have had 15 or fewer shareholders, or (2) 20 percent or more of the voting stock must be included in the decedent's estate.

Protective election—When it is uncertain whether real property meets the requirements for special use valuation, or if there is the risk that values may be substantially raised upon IRS examination of the return, the estate executor may

make a protective election to specially value some or the entire qualified 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.
In 1997, the Fifth United States Circuit Court of Appeals held that an estate which had made a protective special use valuation election must make a final election within 60 days of the issuance of a deficiency notice by the IRS *Estate of Kokernot, G.E.R. v. Commissioner*, 112 F3d 1290 (CA-5), 97-1 USTC ¶60,276; affirming TC Memo 1995-590.

Technically defective elections—TRA eased the rules for correcting incomplete special use valuation elections [IRC section 2032A(d)(3), as amended by TRA]. For estates of decedents dying after August 7, 1997, if the executor files a timely notice of election and a recapture agreement, but the forms do not contain all the required information or the signatures of all persons required to sign, the executor has a reasonable time (not exceeding 90 days) after being notified by the IRS to provide the missing information.

The Agreement

The "Agreement to Special Use Valuation," which is Part 3 of Schedule A-1 of the Federal estate tax return (see appendix II), 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 is 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 post-death requirements (discussed below) 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 under special use valuation unless the agreement contains a signature that binds the corporation; signatures by shareholders or heirs in their individual capacities are not enough (Technical Advice Memorandum 8602007, September 7, 1985). Similarly, a decedent's interest that passes to a testamentary trust is not eligible for special use valuation unless the trust beneficiaries consent to be personally liable for any recapture tax; the trustee's signature alone is insufficient (Technical Advice Memorandum 8802005, September 29, 1987).

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 valuation 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 decedent's tenancy in common interest was includable in his gross estate and thus subject to the election (Estate of Pullin, M.F., 84 TC 789, CCH Dec. 42,060).

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 forest land, either bare land or standing timber or both may be specially valued. Often, however, it is only by including some or all of the standing timber on the property that both the 50- and 25-percent tests can be met. For a discussion of the procedures applicable to fair market valuation of forested property, see chapter 4.

Alternate Valuation

As discussed above, when an estate elects to use the alternate valuation date of 6 months after the date of the decedent's death (see chapter 3) and also elects special use valuation, the special use value must be determined as of the alternate valuation date. The alternate valuation date also must be used when determining whether the aggregate decrease in value of the qualified property exceeds the statutory dollar limit (Revenue Ruling 88-89, 1988-2 CB 333).

Special Use Valuation of Forest land

Forest land special use valuation procedures must, for the most part, follow the general special use valuation rules applicable to farms, as set out in the IRS regulations. No valuation procedures specifically applicable to forest land 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, less 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 five most recent calendar years ending before the date of the decedent's death.

Forest land in the South sometimes is specially valued under the farm method by using rental payments specified in long-term leases to forest product companies, when the details of such leases for comparable forested properties can be obtained.

Two recent court decisions have addressed using the "farm method" for special use valuation of forest land. Both decisions provide a good discussion and analysis of the statutory requirement that identified leased properties used in the section 2032A valuation process must be comparable to the estate forest land (see *Estate of Thompson, L.S. III v. Commissioner*, TC Memo. 1998-325, 76 TCM 426, and *Estate of Rogers, C.J. et al. v. Commissioner*, TC Memo. 2000-133, 79 TCM 1891).

Historically, the farm method has been used only for specially valuing the underlying land and not the standing timber. Most existing long-term leases encompass only land rental; some, however, provide for rental conjointly of both land and timber. In the Rogers case, above, the Tax Court permitted the farm method of valuation to be applied to both land and timber in the estate because both were the subjects of the leases that were used by the estate. In addition, over IRS objections, the Court allowed the estate to use existing leases that had been initiated many years prior to the decedent's date of death. The IRS position was that only leases entered into during the previous 5 years could be used. The Court noted that this proposed rule would eliminate the use of the farm method of valuation for forest land in Alabama, since virtually no timber leases had been initiated in the State since the early 1970s.

If no comparable land can be identified for which the average annual gross cash rental can be determined, 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 forest land can be documented, the executor may elect to value the property using the multiple factors method. The regulations list the following factors: (1) capitalization 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 sale price; and (5) any other factor which fairly values the farm value of the property. The Tax Court has held that if an estate that has elected special use valuation has not provided all of the necessary documentation to use the farm method, it is deemed to have, by default, elected to use the multiple factors method [*Estate of Wineman, R.A.*, 79 TCM 2189, CCH Dec. 53,925(M), TC Memo. 2000-193]. Although not addressed in the section 2032A regulations, or administratively by the IRS, authors Siegel and Haney have been successful in applying the multiple factors method to standing timber separately from the underlying land.

The IRS has ruled that, when using the multiple factors method, the executor cannot select only one of the factors enumerated above as the exclusive basis of valuation unless none of the other factors is relevant. Each factor relevant to the valuation must be applied, although certain factors can be weighed more heavily than others, depending on circumstances (Revenue Ruling 89-30, 1989-1 CB 274).

Change in method—All special use property in the estate must be valued using either the farm method or the multiple factors method; one segment may not be valued by one method and another segment by the other. The IRS, however, has ruled that an estate that had made a valid special use valuation election could amend the election in order to substitute the farm method of valuation for the multiple factors method that was originally applied. The executor valued the decedent's farm under the multiple factors method because he was unable to obtain the information (rentals for comparable farmland) necessary for computing value under the farm method until after the return was filed. Although the special use valuation election is irrevocable, the IRS did not bar the estate from changing the method of valuation once the election was made. In addition, the IRS noted that a change from the multiple factors method is allowable even where information regarding comparable farmland is available, but the executor nevertheless originally applies the multiple factors method (Revenue Ruling 83-115, 1983-2 CB 155).

Technical advice memorandum 9328004 (March 31, 1993)—The IRS addressed the valuation method for special use valuation purposes for 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 forest land and 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 forest land and how it should be used to specially value forest property.

Forest land 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. The election is designed to eliminate purely speculative and inflationary components of value, even when timber production is the highest and best use. Factors 1, 3, and 4 in the "Multiple Factors Method" section, above, are the most applicable to forest land; of these, income capitalization and property tax values probably are used the most often. Depending on the circumstances and characteristics of the property involved, the multiple factors method of valuation may result in a value lower than the current market value for timber use—a result specifically permitted by the regulations.

Other Valuation Considerations

Applicability of minority discounts—In 1995, the Tenth United States Circuit Court of Appeals, reversing the Tax Court, held that the maximum reduction in value (then $750,000) of qualified real property imposed by section 2032A can be subtracted from the true fair market value of a minority interest in that property when said fair market value is calculated by employing a minority discount factor. The Appeals Court rejected Tax Court and IRS reliance on *Estate of Maddox, F.E.W. v. Commissioner,* [93 TC 228 (1989), CCH Dec. 45,924], noting that *Maddox* did not involve the $750,000 limitation but rather the estate's attempt to reduce further the reported special use value by applying a minority interest discount to it as opposed to the fair market value [*Estate of Hoover, K.C. v. Commissioner*, 102 TC 777, CCH Dec. 49,919; reversed 69 F3d 1044 (CA-10), 95-2 USTC ¶60,217].

Discounts based on the recapture provisions—In a 1999 field service advice, the IRS concluded that the section 2032A recapture provisions (see below) don't apply to reduce the timber's value. In valuing the timber under the multiple factors method, an estate's appraiser estimated no timber income for the first 10 years based on the recapture provisions and took this into account under valuation factors 1 and 5. See IRS Field Service Advice 199924019 (March 17, 1999, http://www.unclefed.com/ForTaxProfs/irs-wd/1999/9924019.pdf).

Postdeath Requirements

Certain requirements must continue to be met during a 10-year recapture period measured from the decedent's date of death. However, the qualified heirs have a maximum 2-year grace period from that date to begin the qualified use and material participation. The 10-year period is extended by whatever portion is used of the 2-year grace period.

Continued Ownership Within the Period

Ownership of the specially valued property must continue solely within the decedent's family, as the term "family members" is defined above. Exceptions apply to 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 a like-kind exchange also must be employed in the same qualified use.

Material Participation

If the qualified heir should die during the 10-year period following the initial decedent's death, at least one member of the initial decedent's family, as defined above, must materially participate in operation of the property during 5 of every 8 years. The less stringent active management test—described in the "Material Participation" section, above—may be used to meet the material participation requirement for the surviving spouse, qualified heirs under the age of 21, full-time students, or disabled persons. If the property 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 compliance with the material participation requirements (Private Letter Ruling 8652005, September 12, 1986).

Qualified Use

The property must continue to be used and managed for the qualified use. As noted above, 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 (see below); 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 (Private Letter Ruling 8652005, September 12, 1986).

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 post-death 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, if 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—the sale of the property.

Special Considerations

Conservation reserve program enrollment—Private Letter Ruling 8745016 (August 7, 1987), 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 crops 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.

Conservation easements—Contribution of a qualified conservation easement does not constitute a discontinuance of qualified use [IRC section 2032A(c)(8)], as amended by TRA. However, the sale of a conservation easement during the recapture period is deemed by the IRS to be a disposition of the specially valued property, which triggers the recapture tax. The IRS holds to this position despite at least one court decision to the contrary.

Lease of qualified property—Under a provision added by TRA, a surviving spouse or lineal descendant of the decedent no longer is treated as failing to use qualified real property in a qualified use solely because the spouse or lineal descendant rents the property to a member of the family of said spouse or descendant on a cash basis [IRC section 2032A(c)(7)(E), as amended by TRA section 504 (a)].

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 of tax that electing special use valuation 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 arms-length sale—exceeds 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, 1981-2 CB 176). If, however, 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 reasons 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 (Private Letter Ruling 8902002, September 26, 1988).

Recapture Lien

A government lien is imposed on all qualified property for which a special use valuation election has been made and applies to the extent of any recapture tax that may be imposed. The lien 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) 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 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 is personally liable for that portion of the recapture tax imposed with respect to his or her interest in the specially valued property. Liability for the recapture tax can be extinguished in three instances: (1) if the recapture period lapses, (2) if the heir dies without converting or disposing of the property, or (3) if the tax benefit is recaptured. 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 from further liability. Even if the second heir has paid full consideration for the property, the special estate tax lien remains.

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. The qualified heir must make written application to the IRS for determination of the maximum additional tax. The IRS, then, is required to notify the heir within 1 year of the date of the application as to the maximum amount.

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 transfer 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 will 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 forest land to be 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 is 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 *[Peek, D.C. v. Commissioner*, TC Memo. 1983-224, 45 TCM 1382, CCH Dec. 40 40,063(M)]. Calculation of the recapture tax with respect to the sale of a tract of farm and forest property is set out in Private Letter Ruling 8741048 (July 14, 1987).

Designation of specially valued timber—In most instances, executors probably will 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 used first for the special use valuation election. The designation should be made on an acreage basis, if possible, to avoid confusion as to just which trees are included. For the same reason, if older timber is to be specially valued, it also would be most feasible to do it on an acreage basis, with a specific description of 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 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 could be 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, however, took the position that the volume breakdown applied to each tree—not to the stand as a whole—and therefore, part of each tree was specially valued. 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 potentially 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 per-acre value 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 by the family, while preserving other property for future liquidation, if desired.