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District Court Tells Treasury That Its Special Use Valuation Regulation Is Invalid – Again

2321 N. Loop Drive, Ste 200 • Ames, Iowa 50010 www.calt.iastate.edu

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- by Roger McEowen*

Overview

The Tax Reform Act of 1976 provided a legislative solution to the perceived problem facing rural landowners of having their estates taxed on the basis of fair market value, and the ability of the Internal Revenue Service (IRS) to use fluctuating values in agricultural land markets to their advantage. That solution, in the form of the enactment of I.R.C. §2032A (special use valuation) allows the executor of a decedent's estate to value farmland in the estate at its value for agricultural purposes rather than fair market value. In recent months, the rapid increase in farmland values in many parts of the country and the uncertainly over the future level of the federal estate tax exemption has increased interest in the utilization of special use valuation.

Because of the significant tax benefits that can be derived by a decedent's estate making an election to value qualified elected land under a special use valuation election, numerous requirements must be satisfied.[1] Two of those requirements focus on the amount of farmland and farm personal property that a decedent's estate must contain. Statutorily, one of those requirements (discussed further below) requires that the real estate eligible for a special use valuation election must make up at least 25 percent of the adjusted value of the decedent's gross estate.[2] But, must the 25 percent test be satisfied only with property that is subject to a special use valuation election? IRS thinks so,[3] and has adopted a regulation that specifies just that.[4] In 1988, however, the Federal District Court for the Central District of Illinois invalidated the regulation.[5] Apparently, IRS didn't get the message. The same court has now, 24 years later, again instructed the IRS that the court meant what it said in 1988.[6]

I.R.C. §2032A

Most assets are valued at fair market value as of the date of the decedent's death.[7] The only major exception to the willing buyer/willing seller test is special use valuation of land used in a farming or ranching business.[8] The executor of an estate may elect to value real property devoted to farming or ranching (or other closely-held businesses) at its special use or "use" value rather than its fair market value.[9] For deaths in 2012, however, the election cannot reduce the gross estate by more than $1,040,000.[10] But, even with that valuation reduction limitation, a special use valuation election has the potential to easily trim over $100,000 off the estate's federal estate tax bill with the right set of facts.[11] The determination of the special use valuation of land is generally based upon the capitalization of cash rents on comparable land.[12]

Eligibility for the Election – Pre-Death Requirements

In order for an estate to utilize special use valuation, certain pre-death requirements must be satisfied. In many respects the primary reason for the satisfaction of the eligibility requirements is to ensure that the election is utilized by truly farm estates where the intent is to keep the farmland in the decedent's family and operated as a farm for a certain period of time after the decedent's death.

The 50 percent test. A special use valuation election can be made only if farming or ranching property is a significant part of the estate. The real estate used in farming together with the farm personal property must make up at least 50 percent of the adjusted value of the gross estate, using fair market value figures, and that amount or more must pass to qualified heirs.[13]

The 25 percent test. Under this test, the decedent's farmland must make up at least 25 percent of the gross estate less secured indebtedness.[14]

The qualified use test. This test requires that the decedent or a member of the decedent's family must have had an equity interest in the farm operation at the time of death and for five or more of the last eight years before death.[15]

The "ownership" test. The real estate must have been owned by the decedent or a member of the family and held for a qualified use during five or more years in the eight year period ending with the decedent's death.[16]

The "material participation" test. The decedent or a member of the decedent's family must have materially participated in the farming operation for at least five out of the eight years immediately preceding the earlier of the decedent's death, disability or retirement.[17]

The "passing" test. The farmland and personal property used in farming must have been "acquired from the decedent to a qualified heir or passed from the decedent" to a qualified heir.[18] (defined in terms of a member of the decedent's family).

Rules for partnerships and corporations. For land owned by a partnership, the decedent must have had an interest in a closely-held business.[19] This requires 20 percent or more of the partnership's total capital interest to be in the decedent's estate or the partnership must have had 15 or fewer partners. A similar rule applies to corporations.[20] Twenty percent or more of the corporation's voting stock must be in the estate or the corporation must have had 15 or fewer shareholders. In addition, the 50 percent test must be satisfied. For partnerships and corporations, this requires a look through the partnership or corporation entity to see what it owns. Farm real estate or farm personal property must equal 50 percent or more of the gross estate less secured indebtedness and must pass to qualified heirs. The farmland that the entity owns must also satisfy the qualified use test.

Facts of *Finfrock v. United States*[21]

At death, the decedent owned 61.05 percent of the stock of Finfrock Farms, Inc. The corporation owned four tracts of real estate – tracts of 40 acres, 122.5 acres, 377.21 acres and 165 acres. There was no question that the ownership test was satisfied, or that the 50 percent or 25 percent tests were satisfied. Indeed, the adjusted value of the gross estate was $2,608,848 including the farmland which was valued at 1,775,000. For the entire eight-year period preceding the decedent's death, a son farmed the land, and upon the decedent's death the ownership of the corporation passed to qualified members of the decedent's family. The estate elected special use valuation as to the fourth tract of farmland because that was the only tract that the family wished to continue to farm. The other tracts were sold to unrelated persons shortly after the decedent died. The fair market value of the fourth tract was $402,930, or about 15 percent of the estate's adjusted value. The special use value election on that tract dropped its value reported on the estate tax return to $227,233.00. On audit, the IRS denied the election *because the land subject to the election* did not exceed 25 percent of the adjusted value of the gross estate.

The IRS Position

As noted above, both the 50 percent and 25 percent tests must be satisfied as prerequisites for an estate to be eligible to make a special use valuation election.[22] IRS has stated that land that is not subject to a special use valuation election can count toward the 50 percent test,[23] but has adopted a regulation requiring that the 25 percent test can be satisfied *only from property that is subject to a special use valuation election.*[24] In other words, according to the IRS, not only must the estate satisfy the 25 percent test to be eligible to make a special use valuation election, the election must be made applicable to at least 25 percent of the value of farmland that is included in the estate (using fair market value figures).

The Treasury Regulation at issue in *Finfrock* had previously been invalidated in 1988 by the same court in *Miller v. United States.*[25] In *Miller*, the court held Treas. Reg. §20.2032A-8(a)(2) invalid insofar as it attempted to impose a non-statutory requirement that 25 percent of the adjusted value of the gross estate must consist of farmland subject to the special use valuation election. The court determined that the regulation was not simply interpretative of the statute, but was legislative in nature because it imposed a requirement that the statute did not contain. So, the regulation was invalid to the extent it went beyond merely procedural matters (e.g., the proper form to file or information to include on prescribed forms).[26]

After *Miller*, it was believed that the IRS no longer enforced the regulation against estates. Obviously, that wasn't the case in *Finfrock*, where the IRS again asserted the application of the regulation. The estate pointed to the 1988 *Miller* decision, and argued that the statute was clear and unambiguous in that the 25 percent requirement only meant that 25 percent of the adjusted value of the gross estate had to be comprised of farmland, not that the election must also be on at least 25 percent of the farmland in the estate.[27] The IRS argued that the statute was silent on the matter, and that the regulation merely clarified the statutory ambiguity. But, the court disagreed, noting that the statute's plain language did not require that the property constituting 25 percent or more of the adjusted value of the gross estate also be subject to the election. The court held that the statute unambiguously allows an executor to make the election on land comprising less than 25 percent of the adjusted value of the gross estate, and that the regulation impermissibly imposed a requirement in addition to the statute's plain meaning. Because the statute was neither silent nor ambiguous, the issue of whether the regulation was a reasonable interpretation of the statute was not in issue.[28]

Ultimately, however, two additional matters prevented the court from fully resolving the case.[29]

Planning Implications

Finfrock reasserts the point that any attempt by the Treasury to limit the scope of a special use valuation election beyond the statute is impermissible. That's a key point, particularly when the issue involves the amount of land that must be subjected to a special use value election. When an election is made, an amount equal to the adjusted tax difference becomes a lien in favor of the United States.[30] The lien applies "on the property in which such interest exists."[31] The lien arises at the time the election is filed and continues until liability for the tax ceases or the recapture tax has been paid.[32] The ability to limit the amount of property subject to the lien allows for tailoring of the special use valuation election. Such tailoring can aid in minimizing the potential for recapture tax being triggered during the ten-year period following the date of the decedent's death by restricting the election to the land most likely to be continued in farm use during the recapture period.

Conclusion

The IRS tactic of ignoring Federal District Court opinions that are opposed to their litigating position and continuing to subject taxpayers in different jurisdictions to their judicially-rejected positions is not new. The new twist is for the IRS to return to the same court 24 years after that court rejected their position. Maybe in *Finfrock* they were hoping that the court had forgotten about its previous ruling. The court hadn't. The regulation was invalid even under a more deferential standard.

*Leonard Dolezal Professor in Agricultural Law, Iowa State University, Ames, Iowa, and Director of the ISU Center for Agricultural Law and Taxation. Member of the Iowa and Kansas Bar Associations and licensed to practice in Nebraska.

[1] Under I.R.C. §2032A(c) an additional tax, known as a "recapture" tax is imposed if the property subject to the election fails to continue to be used by the decedent's family for farming purposes during the ten year period after the decedent's death.

[2] I.R.C. §2032A(b)(1)(B).

[3] Priv. Ltr. Rul. 8042009 (Jun. 30, 1980).

[4] Treas. Reg. §20.2032A-8(a)(2).

[5] Miller v. United States, 680 F. Supp. 1269 (C.D. Ill. 1988).

[6] Finfrock v. United States, No. 11-3052 2012 WL 951268 (C.D. Ill. Mar. 20, 2012).

[7] The Internal Revenue Service defines fair market value as the price at which a willing buyer and a willing seller would exchange the property, neither being under any compulsion to buy or sell and each having full knowledge of all relevant facts. Treas. Reg. §1.170A-1(c)(2)(1990).

[8] I.R.C. § 2032A.

[9] The purpose of the election is to eliminate speculative and inflationary components to value such as the potential for residential or commercial development of agricultural land caused by "urban-sprawl."

[10] The amount was originally $750,000, but was indexed for inflation for deaths after 1998.

[11] Theoretically, the maximum saving is $364,000 (35 percent of $1,040,000) in 2012.

[12] But, two approaches to arrive at special use value are available. An election can be made to value qualified land under either the "farm value" method of I.R.C. §2032A(e)(7) or the "multiple factor" method of I.R.C. §2032A(e)(8).

[13] I.R.C. § 2032A(b)(1)(A). "Adjusted value" of real or personal property is defined as the fair market value less allowable indebtedness attributable to the property. The farm residence is eligible real property if it is occupied on a regular basis by the owner, tenant or an employee of the owner or tenant for the purpose of "operating or maintaining such real property." Personal property may be considered in

meeting the 50 percent test only if it is used together with the real property that is to be specially valued.

[14] I.R.C. §2032A(b)(1)(B).

[15] I.R.C. §2032A(a)(1), (b)(1)(C)(i).

[16] I.R.C. §2032A(b)(1)(C)(i).

[17] I.R.C. §2032A(b)(1)(C)(ii). Surviving spouses only need to provide active management.

[18] I.R.C. 2032A(e)(9). A "qualified heir" is defined in terms of relationship to the decedent. I.R.C. §2032A(e)(1).

[19] I.R.C. § 2032A(g); 6166(b)(1)(B).

[20] I.R.C. § 2032A(g); 6166(b)(1)(C).

[21] Finfrock v. United States, No. 11-3052, 2012 WL 951268 (C.D. Ill. Mar. 20, 2012).

[22] Adjusted taxable gifts are taken into account when determining whether the 25 percent or 50 percent tests are satisfied, but they do add to the taxable estate when computing the estate tax base.

[23] Priv. Ltr. Rul. 8041016 (Jun. 30, 1980).

[24] Treas. Reg. §20.2032A-8(a)(2).

[25] 680 F. Supp. 1269 (C.D. Ill. 1988)

[26] See I.R.C. §7805. The court also cited *Estate of Davis v. Comr., 86 T.C. 1156 (1986)* in support of its holding that the Congress had delegated only procedural rulemaking to the Treasury, and not the power to adopt substantive requirements that were not statutorily authorized.

[27] The statute at issue, I.R.C. §2032A(b)(1)(B), specifies that "For purposes of this section, the term "qualified real property" means real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and which, on the date of the decedent's death, was being used for a qualified use by the decedent or a member of the decedent's family, but only if - ….25 percent or more of the adjusted value of the gross estate consists of the adjusted value of real property which meets the requirements of subparagraphs (A)(ii) and (C)."

[28] The court determined that the regulation was invalid even under the highly deferential standard set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).* In *Swallows Holding, Ltd. v. Comr., 515 F.3d 162 (3d Cir. 2008),* the court noted that *Chevron* deference is appropriate for complex, technical regulatory schemes like tax laws, and that the IRS is in the best position to make judgments about tax law administration. Previously, the regulation had been invalidated under a standard that was less deferential.

[29] First, the IRS argued for the first time in its motion for summary judgment that the estate's election was invalid because the corporation did not have a formal written agreement with the decedent's son to farm the land before the decedent's death. See Treas. Reg. §20.2032A-3(f) which states that for indirectly owned land, there must be an "arrangement" calling for material participation in the business by the decedent owner or a family member. While no formal agreement was present, the parties stipulated that the decedent's son farmed the land for the entire eight-year period before the decedent's death. The IRS later conceded that an oral agreement could satisfy the material participation requirement, and requested additional information from the estate on this point. The IRS is to inform the court by March 29, 2012, whether the matter has been resolved or whether additional briefing is necessary. Second, the parties stipulated that they would attempt to determine the proper amount of estate tax to be refunded if the court ruled in the estate's favor. This issue, in turn, is dependent on the outcome of the first unresolved issue.

[30] I.R.C. §6324B(a).

[31] *Id.*

[32] I.R.C. §6324B(b). As noted above, while a decedent may own as little as 20 percent of the ownership interests in a corporation or partnership and the estate can qualify for special use valuation, the corporate ownership of the land cannot be segregated from the indirect ownership of the decedent for purposes of the lien. Apparently, the practice of the IRS is to file the lien against all of the elected corporate land rather than to file it against the decedent's stock interest. This issue was not addressed in *Finfrock.*