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**An Overview of Special Use Valuation
Under 26 U.S.C.A. § 2032A**

by

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An Overview of Special Use Valuation Under 26 U.S.C.A. § 2032A

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Introduction

The general purpose behind this provision is to allow for special valuation of real property that is used in a closely held business or farming operation. Instead of valuing the property at the fair market value, which values the property at its highest and best use, the special use valuation allows for the property to be valued at its current qualified purpose. Special use valuation under the Internal Revenue Code is one of the more complex provisions found within the Code, therefore special care must be exercised in order to fully comply with the statute. This article covers only the statute and not the case law surrounding each of the issues that arise when applying the statute. It is not intended to be legal advice; instead its purpose is to establish a framework under which to view the statute and to begin the preparation of the estate tax return.

General Requirements

There are numerous steps that must be followed in order to qualify the estate to receive the special use valuation. Each of these requirements must be completely met in order to satisfy the Internal Revenue Service, or the election will fail, and the value saved by the special use provision will be recaptured under § 2032A(c).

The general requirements of § 2032A are that:

- “The decedent (at the time of his death) must be a citizen or resident of the United States.¹”
- Only real property may be valued under this provision and this property must be located in the United States.²
- The executor must timely elect to use this provision on the federal estate tax return,³ commonly called the form 706.
 - a. The “notice of election” must be attached to the estate tax return and must contain the following information:⁴

¹ 26 U.S.C. § 2032A(a)(1)(A).

² 26 U.S.C. § 2032A(b)(1).

³ 26 U.S.C. § 2032A(a)(1)(B).

⁴ 26 C.F.R. § 20.2032A-8(a)(3).

- i. the decedent's name and taxpayer identification number;
- ii. the relevant qualified use (either as a farm or a closely held business);
- iii. the items or real property shown on the estate tax return to be specially valued pursuant to the election;
- iv. the fair market value of the real property to be specially valued and its value based on its qualified use;
- v. the adjusted value of all real property in a "qualified use" and which passes from the decedent to a qualified heir as well as the adjusted value of all real property to be specially valued;
 - Qualified Use – means the devotion of the property to either use as a farm for farming purposes or use in a trade or business other than the trade or business of farming.⁵
- vi. the items of personal property shown on the estate tax return that pass from the decedent to a "qualified heir" and are in a qualified use under § 2032A, as well as the total value of such personal property;⁶
- vii. the adjusted value of the gross estate;
- viii. the method used in determining the special value based on use;
- ix. copies of written appraisals of the fair market value of the real property;
- x. a statement that the decedent and or a member of his family has owned all specially valued real property for at least five years of the eight years immediately preceding the date of the decedent's death, and explaining any period during the eight year period preceding the date of the decedent's death during which the decedent or a member of his or her family did not own the property, use it in a qualified use, or materially participate in the operation of the farm or other business;
- xi. the name, address, taxpayer identification number, and relationship to the decedent of each person taking an interest in each item of specially valued property, and the value of the property interests passing to each such person based on both fair market value and qualified use; and

⁵ 26 U.S.C. § 2032A(b)(2).

⁶ 26 U.S.C. § 2032A(e)(1) and (e)(2) defines the term "qualified heirs" as members of the decedent's family who acquire such property from the decedent and are an ancestor of the decedent, a spouse of the decedent, a lineal descendant of such individual, of such individual's spouse, or of a parent of such individual, or the spouse of any lineal descendant.

- xii. a legal description of the specially valued property.
- The executor must file an agreement signed by each person currently living who has an interest in the real property⁷ (whether possessory or not) that assents to the burdens placed upon them. If that person is an infant or incompetent than a representative may be designated under local law to bind them.⁸
 - a. Qualified heirs are required in the agreement to express consent to personal liability under § 2032A(c) if the property is disposed of early or the qualified use ceases.
 - b. Other parties that have an interest in the property other than qualified heirs must expressly consent to the collection of any additional estate tax imposed under § 2032A(c) from the property.
- The property that the special use valuation will be used for must be meet the criteria for “qualified real property” found in § 2032A(b).
 - a. It must be 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 of a member of the decedent’s family, but only if:
 - i. The decedent, or a member of the decedent’s family, used the real property as a farm for farming purposes or in a trade or business other than farming;⁹ and
 - ii. “Fifty percent or more of the adjusted value of the gross estate consists of the adjusted value of real or personal property which was being used for the qualified use by the decedent and was acquired from or passed from the decedent to a qualified heir of the decedent;”¹⁰ and
 - iii. “At least twenty-five percent or more of the adjusted value of the gross estate consists of the adjusted value of real property;”¹¹ and
 - iv. During an aggregate of five years or more of the eight years before the decedent’s death the decedent, or a member of his

⁷ 26 C.F.R. § 20.2032A-8(c)(2) states that, “An interest in property is an interest which, as of the date of the decedent’s death, can be asserted under applicable local law so as to affect the disposition of the specially valued property by the estate. Any person in being at the death of the decedent who has any such interest in the property, whether present or future, or vested or contingent, must enter into the agreement. Included among such persons are owners of remainder and executory interests, the holders of general or special powers of appointment, beneficiaries of a gift over in default or exercise of any such power, co-tenants, joint tenants and holders of other undivided interests when the decedent held only a joint or undivided interest in the property or when an undivided interest is specially valued, and trustees of trusts holding any interest in the property.”

⁸ 26 C.F.R. § 20.2032A-8(c) and 26 U.S.C. § 2032A(d)(2).

⁹ 26 U.S.C. § 2032A(b)(1)(C) and 26 U.S.C. § 2032A(b)(2).

¹⁰ 26 U.S.C. § 2032A(b)(1)(A).

¹¹ 26 U.S.C. § 2032A(b)(1)(B).

family, must have owned and used the real property in its qualified use.¹²

- Finally the real property must have been owned by the decedent or a family member while being put to a qualified use. There must have also been “material participation” on the part of the decedent before the transfer of the property¹³
 - a. Material Participation – for the purposes of this statute material participation will be determined similarly to 26 U.S.C.A. §1402(a) which deals with net earnings from self-employment.
 - i. Exceptions to Material Participation requirement¹⁴:
 1. Decedents who are retired or disabled – if, on the date of the decedent’s death, the requirement of material participation was not being met and the decedent was:
 - Receiving old-age benefits under Title II of the Social Security Act for a continuous period ending on the decedent’s death, OR
 - Was disabled for a continuous period ending on the decedent’s death,
 - than material participation shall be determined by looking back eight years from the date on which the exception began instead of the date of the decedent’s death.
 2. Surviving Spouse of the decedent – if the qualified real property was passed from the decedent to a surviving spouse (usually the wife), than active management¹⁵ of the farm or other business by the surviving spouse shall be treated as material participation.¹⁶

Ongoing Obligation of Heirs

These criteria must be met in order for an election under § 2032A, but unlike many other code provisions in the Internal Revenue Code this particular provision also requires compliance by the family members of the decedent that will carry on the farm or business. This ongoing obligation makes § 2032A different than other code provisions and essentially creates a binding contract between the Internal Revenue Service and the qualified heirs to keep the farming operation in existence.

¹² 26 U.S.C. § 2032A(b)(1)(C).

¹³ 26 U.S.C. § 2032A(b)(1)(C).

¹⁴ 26 U.S.C. § 2032A(b)(4).

¹⁵ 26 U.S.C. § 2032A(c)(7).

¹⁶ 26 U.S.C. § 2032A(b)(5).

Recapture of Value: Burden of the Qualified Heirs

There are two basic triggers under which the IRS will attempt to recapture the tax difference obtained by the special use valuation for actions by the qualified heirs. If, within 10 years after the decedent's death and before the death of the qualified heir:

- The qualified heir disposes of any interest in the qualified real property other than by a disposition to a recognized member of the family as pursuant to §2032A(e)(2); *or*
 - Partial dispositions (or cessations of use) – are to be reduced pro rata under the formula found in 26 U.S.C. § 2032A(c)(2)(D).
 - Special Rule for Disposition of Timber - 26 U.S.C. § 2032A(c)(2)(E).
- The qualified heir “ceases to use” for the qualified use the qualified real property which was acquired or passed from the decedent than an additional estate tax will be imposed.¹⁷
 - Cessation of Use – real property shall cease to be used for the qualified use if the property ceases to be used for the qualified uses under which it was qualified (farm or business).¹⁸
 - The qualified heirs have two years from the decedent's death to begin qualified use. The ten year time period in which the qualified heirs must continue to use the real property for its qualified use does not begin until the qualified use of the heirs has started.¹⁹

Conclusion

For farms and closely held businesses owned and operated by decedents who qualify for special use valuation and have a significant portion of their estate's value tied up in real property, §2032A can be a valuable tool. It can work to lower estate taxes by a significant amount (currently up to about \$1,000,000) and preserve the family business or farm for the next generation. However, because of the complex and strict requirements for both applying for, and continuing to maintain, eligibility for this statutory provision it should be researched carefully before being implemented. If the qualified heirs are not firm in their commitment to continue the decedent's business or farming operation pursuant to the statutory requirements than this provision should not be used because of the recapture consequences. Additionally since the amount that can be saved is capped by the statute it may be important to include only portions of the real property that are either necessary for the continuation of the business or left to qualified heirs that are certain in their ability to meet the continuing obligation imposed by the statute. To determine whether this valuation provision is right for your estate one should contact their attorney and accountant.

¹⁷ 26 U.S.C. § 2032A(c).

¹⁸ 26 U.S.C. § 2032A(c)(6).

¹⁹ 26 U.S.C. § 2032A(c)(7)(A).