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9th Annual Mid-South Conference Materials

Estate Planning & Taxation: Latest Updates, Pitfalls, & Pointers

Lucas Haley

Ninth Annual Mid-South Agricultural and Environmental Law Conference

Estate Planning & Taxation: Latest Updates, Pitfalls, & Pointers

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*The Greater Mississippi River system includes over thirteen thousand miles of naturally navigable, interconnected waterways—**more than the combined total of all the world's non-American internal river systems**—and it almost perfectly overlaps the largest contiguous piece of arable, flat, temperate-zone land under a single political authority in the world.*

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- Smattering of topics – This is a brainstorming session.
- These ideas will not always work with clients, some are obstinate, too resistant to change and unwilling to solve a future problem today.
- My view is that part of our role is to provide all clients with good ideas and options for setting things up the most optimal way. They can choose not to, but you earned your fee by making them think through the process and imagine the possibilities.
- These are concepts that are readily embraced by the best client, who are usually also the best business operators, and are rejected by other clients, who usually are not the best business operators.

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Legacy

- All farmers and landowners love to talk about legacy.
- Many think they are leaving a legacy with the land when in fact they are leaving a legacy of conflict.
- How to avoid establishing a family legacy of conflict?
- Information, information, information is key.

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Scenario

- Mom and Dad have built significant farmland holdings and farming operation.
- Son works on the farm with Dad and rents some land on his own on the side. They share equipment.
- Sister is not involved in the farming operation, lives in the City, has no understanding of farming economics, but does feel strong attachment to the family farm and family legacy.
- This is a very common scenario and it is a disaster waiting to happen.
- Everyone is this room has likely made a lot of money on disputes that have these basic facts.

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- **Point 1** – No unnatural business partnerships.
  - Do not force people to be business partners under a vague operating structure, particularly if they would not be natural business partners.
  - If they do not get along or have strongly different opinions and outlooks on life, they will not make good business partners.
  - You would not go into business yourself with someone who did not feel like a partner, so why force your kids to?

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- **<u>Practice tip</u>** - Present the option of splitting the farm into separate 100% owned tracts, as opposed to undivided interests, as a normal and common sense path.
- Most people fall back to undivided interests because it is easy, but often it is not the right answer.
- This is easier said than done, however, getting at least some portion of the land into separately owned tracts can be beneficial for Son and Daughter.
- Pros –
    a. Provides Son with land he can use as collateral to buy more land and grow his business operation.
    b. Provides Daughter with feeling of control over her inheritance and gives collateral base for buying beach house.
    c. Structure should be flexible enough to allow best use of the assets – not so rigid that the farm earns a 3-4% return each year and the real value sits unutilized.
    d. Trust terms at time of distribution can still provide Son with right of first refusal to purchase family land.

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Point 2 – No surprises.

- Provide a bullet point list of trust terms, lease terms, buy-out rights, etc. to all children.
- Surprises or unmet expectations are never good. *Do not allow your clients to provide the spark that starts a fire between their children.*
- Many families want to provide Son with opportunity to continue farming the land after Mom/Dad die. If they choose to go this route, then make sure the lease provisions and farm operations are transparent enough to avoid a dispute.
- You would not expect someone to be a co-owner in any other type of business and not have full access to the corporate books and records and input on major decisions.
- Why treat the farm differently?

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Practice Tip

- Farm lease terms can provide for semi-annual reports on the farm, crops planted, improvements made, on farm yields, county average yields, contract prices, input prices, real estate taxes, etc.
- Essentially providing a balance sheet and income statement for the farm to the Sister.
- She may never look at it, but the point is that she can if she chooses.
- More problems and suspicions arise from lack of clarity than from answers in black and white.
- Information and communication on the decision making process will build trust between business partners. If it does not, then it is never going to work anyway.

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Point 3 – Liquidity

- Many clients want to force the family to hold the farm perpetually and restrict their ability to sell, exchange, transfer or mortgage the property.
- Predicting the future is a fool's errand. The combination of crop prices, specialty crop operations, solar leases, wind farms, hunting sites, etc. should give anyone pause before restricting land uses for decades/generations.
- Allowing the land to be sold, exchanged, or mortgaged provides flexibility for future generations and often times actually ends up with the land being kept longer than in a "forced hold" scenario.
- One of the major complaints of the siblings who do not farm is that the cash flow from the farm versus the asset value are mismatched. Allowing flexibility of using the land as collateral for other purchases, whether investments or strictly recreational, allows the farm to remain a central part of the family legacy, but allows everyone to enjoy it in their own way.

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Practice Tip

- Consider an entity structure that provides for perpetual management of the family land and assets, but leaves the actual decision making to the next generation.
- A family trust or LLC can provide for different levels of voting for different types of decisions.
- Categories can range from simple majority vote for basic decisions, 2/3rds or 3/4ths supermajority vote on a list of “Major Decisions”. This would include land sales, acquisitions, exchanges, loans over a certain amount, and farm leases.

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- **<u>Blended Families</u>**. All of the above issues become even more complex with blended families. Opportunities for creative planning abound in this area.

  A. **Scenario 1 –** Wife's family owns farmland. Wife wants to ensure husband has income stream from land if she dies first, but also wants to ensure land is ultimately distributed to her children.

     1. Husband and Wife's Revocable Trust can provide at Wife's death (assuming she is first spouse to die), the farmland is transferred to an irrevocable sub-trust, providing for income to be distributed each year to Husband, no principal distributions of farmland, and termination of Husband's income rights upon remarriage or cohabitation.
     2. Trust can also provide a cap on income amount to Husband, with remainder being distributed to children. Examples would be: income not to exceed $100,000 annually or provide for 60% of income to Husband remaining 40% equally between children.
     3. Remainder of joint assets of Husband and wife remain in the Revocable Trust, which is revocable and can be amended by surviving spouse.

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B. Scenario 2 – Parents own farmland.

- They want to ultimate ownership of land to remain in the bloodline, but also want to provide for income to spouses of children.
- At parent’s death, land is transferred into an irrevocable trust for the benefit of child.
- At child’s death, then income is split between surviving spouse and children in a manner similar to above example.
- Provide child with limited power of appointment so they can alter trust terms and income distributions between surviving spouse and children or exclude spouse completely.

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- **<u>Estate Tax Planning</u>**. As of now exemption levels are high and cover a significant amount of assets, but land values are increasing quickly and many families are now in the danger zone of being over the exemption amount. There is no predicting what will happen between now and 2025, when the current exemption is to sunset, however, there are options:
  - **a. <u>Typical Family LP/LLC Gifting Strategy</u>** – Transfer land into an LP/LLC. Create voting and non-voting shares. Parents retain voting shares and transfer some portion of non-voting shares to children or trusts created for children. This does many things:
    1. Gifts land to next generation at a discount to the current market value (marketability/minority interest discount);
    2. Freezes the value of the land made at the time of the gift for estate tax purposes;
    3. Lowers the value of the remaining interest held by parents;
    4. Allows parents to retain voting control over the assets during their lifetime;
    5. Transfers the income stream from the assets to the next generation, which prevents parents' estate from growing larger each year due to income.

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b. **Section 6166** – the "Last Resort Plan" – IRC Section 6166 is a little known estate tax mechanism.

- The basic rules allow the Estate to pay estate tax arising from "family owned businesses" over a period of up to 14 years, instead of being due 9 months after the decedent's date of death.
- The first 4 years of the 14 years can be paid interest only, with regular payments of principal and interest beginning in year 5.
- The interest rate is set at 2% on the tax due for the first $1 Million of the estate and the remainder is set at a rate of 45% of the Section 6621 interest rate. As of now that interest rate is around 4%.
- The interest only period can give the family sufficient time to settle out the Estate, normalize farm income, and complete the transition to the next generation before being required to make principal payments.
- Longer amortization terms may favor bank loans over this option, but the interest rate differential must also be factored in.

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Section 6166 – Additional Requirements

- The “family owned business” must represent at least 35% of the value of the Estate.
- The decedent must have been an “active participant” in the family owned business. Farming operations, including the value of the land, qualify for this, and in addition, crop share landlords who are “material participants” in the farming operation also qualify as “active participants”.
- Land leased on a cash rent basis is not deemed to be a family owned business and does not quality for the payment extension. This can be a very costly and important distinction.
- The Estate must be at least a 20% owner in the business.
- **<u>Practice Tip</u>** – Include terms in written farms leases that specify the landlord is a “material participant” in the farming operation.

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Section 2032A – Special Use Valuation

- More commonly used than Section 6166
- This Section allows the market value of an asset to be adjusted down to the value attributed to the cash flow it produces as opposed to the value of the land itself.
- Calculation provides for the cash rent value of the land divided by the average annual interest rate on Federal Land Bank loans.
- Example: $200/acre cash rent divided by 4% = $5,000 per acre valuation on land.
- In some areas the interest rate is higher than the current rental income on farmland. This is essentially a “cap rate” valuation metric.
- The maximum discount in value that can be claimed from 2032A election is $1,230,000 for 2022. Adjusted for inflation, with a large increase expected for 2022.
- $1,230,000 discount in value at a 40% estate tax rate equates to a maximum of $492,000 in tax savings.
- This tool will not cure a large estate tax problem, but can certainly help smaller estates that are near or slightly over the estate tax limit.

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- Short list of requirements for the election:
  - 25% of the "adjusted value" of the Estate must consist of real estate passed on to a "qualified heir";
  - Real estate must have been a "qualified use" for five out of prior eight years before decedent's death;
  - Decedent or family member must have "materially participated" in the qualified use for five out of last eight years;
  - In addition, 50% of the "adjusted value of the Estate must consist of property that was used for a "qualified use" by decedent or family member and passed on to a "qualified heir".
  - Several more defined terms and exceptions through 2032A – limited application but impactful when it is available.

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I. Section 6166 — Deferral of Estate Tax on Business Assets

B. General Rules of §6166

The general rules of §6166 are set forth in §6166(a) and §6166(d).

1. **Qualification — §6166(a)(1) and §6166(a)(2)** —

If the gross estate of a U.S. citizen or resident includes an interest in a closely held business valued at more than 35% of the adjusted gross estate, the executor may elect to pay part or all of the estate tax in two or more (but not more than 10) equal installments.[17] In general, such an estate may defer that portion of the estate tax, as reduced by the credits against the estate tax, in the proportion that the amount of the interest in the closely held business bears to the adjusted gross estate.[18]

[17] §6166(a)(1). The IRS will usually not issue a ruling on an estate's qualification under §6166 until after the decedent's death. Rev. Proc. 2022-3, §3.01(139).

[18] §6166(a)(2). *See also* Keith Schiller, *Estate Planning at the Movies — Art of the Estate Tax Return*, ch. 27 (Bloomberg BNA 2d ed. 2014 & 2015 Supp.).

Example: The decedent (D) died in 2022, a year in which the unified credit exempted $12,060,000 from estate tax. D's gross estate had a date of death value of $15,000,000, including her 100% ownership of a closely held business that was valued at $7,000,000. D's funeral and administration expenses were $150,000. D's estate had deductible uninsured losses of $50,000. D's estate qualifies for §6166 deferral because the value of D's interest in the closely held business exceeds 35% of D's adjusted gross estate (i.e., $700,000). D's estate may defer 45% ($900,000/$2,000,000) of the estate tax liability. The following illustrates the computation of the amount of estate tax that D's estate will be permitted to defer under §6166:

(1) Gross estate	$15,000,000
(2) Deductible §2053 administration and funeral expenses	<150,000>
(3) Deductible §2054 uninsured losses	<50,000>
(4) Adjusted gross estate	$14,800,000

(5) Federal estate tax due	5,865,000
(6) Unified credit under §2010	4,717,800
(7) Total credits under §§2011–2015	0
(8) Federal estate tax reduced by allowable credits (780,800 – 345, 800)	1,148,000
(9) Closely held business amount	7,000,000
(10) Percentage of estate tax to be deferred	47.3%
(11) Amount of estate tax to be paid upon filing the return	604,996
(12) Amount of estate to be deferred	543,004
(13) Amount of each of 10 equal annual installments	54,300

Interest on the $543,004 of estate tax is payable at 2% and is not deductible for estate or income tax purposes.[19]

[19] *See* §6601(j), §2053(c)(1)(D), §163(k). See E. and G., below, for a discussion of the interest rate applicable to the deferred estate tax.

In CCA 200141015, the IRS Chief Counsel determined that an estate would qualify for deferral under §6166, even though it was legally bound under a buy-sell agreement to redeem its remaining stock in a closely held corporation. The value of the closely held stock owned by the estate met the 35% threshold limitation. Following an initial redemption funded with insurance proceeds, the corporation was obligated to redeem the remaining stock from the estate over a period of no more than 10 years. The buy-sell agreement provided that any stock that was not redeemed during the 10-year period would not be considered sold and would remain property of the estate until redeemed. According to CCA 200141015, "although certain events will terminate the §6166 deferral, those events are only relevant after the election has been granted; the fact that acceleration may occur at a future date is not taken into account when determining whether an estate qualifies for the §6166 installment privilege." Although the buy-sell agreement required the estate to eventually redeem its stock, the IRS ruled that the sales after death were not relevant for purposes of determining if the estate initially qualified for the benefits of §6166 deferral.

Inter vivos estate planning for an individual who owns an interest in a closely held business should consider the potential qualification of the individual's estate for deferral under §6166. For instance, in one common estate planning technique, an individual (i.e., the grantor) sells all or a portion of his or her interest in a closely held business to a wholly owned grantor trust in exchange for an installment note of equal value to the property sold. Following this transaction, the grantor's estate may no longer qualify for deferral because the estate would not meet the threshold limitations under §6166. Nevertheless, the transaction may leave the estate with an asset (an installment note) subject to estate tax and not eligible for deferral under §6166. An estate could also fail to qualify for deferral under §6166 because of a variety of inter vivos estate planning techniques, including the use of an outright gift of an interest in a closely held business. Use of appropriate inter vivos estate planning strategies, may enable an estate to qualify for deferral under §6166. For example, a gift of nonbusiness assets may cause an individual's interest in a closely held business to exceed the threshold limitations under §6166.

Comment: An election to use alternate valuation under §2032 or special use valuation under §2032A could affect the availability of estate tax deferral under §6166. See the discussion at E. and I., below.

2. **Payment Dates — §6166(a)(3)** —

The first installment payment of estate tax may be made on or before a date selected by the executor; however, the date selected cannot be more than five years after the date prescribed by §6151(a) for payment of the estate tax. Section 6151(a) prescribes the due date for the payment of estate tax as the date the estate tax return is required to be filed determined without regard to any extensions of time for filing that return. Each succeeding installment payment must be made on or before the next anniversary of the initial payment date selected by the executor.[20]

[20] §6166(a)(3). For certain extensions related to the coronavirus (COVID-19) pandemic, see Notice 2020-23, *amplifying* Notice 2020-20.

Comment: In practice, executors generally elect to maximize the deferral benefit available under §6166; therefore, most executors elect to make the first payment of the 10 equal annual installments on the fifth anniversary of the due date for the estate tax return. The deferred estate tax can always be prepaid without penalty at any time before it is due. If an election is made for a period that is less than the maximum allowable deferral period (i.e., five years), however, a longer period cannot be elected after the date for making the election has passed.

The IRS takes the position that estate tax payments made by an estate electing §6166 deferral are allocated in the following order: (1) first to the nondeferred portion of the estate tax (that is the estate tax attributable to property that does not qualify for the §6166 election); (2) next to the interest accrued on both the nondeferred and deferred taxes; and (3) finally to the tax deferred under §6166.[21]

[21] *See* TAM 9046003, TAM 9046002. In TAM 200648028, the National Office addressed whether an estate had the right to reallocate to §6166 interest installments a remittance sent to the IRS before the estate made the §6166 election. Because the estate asked the IRS to change the estate's original designation of the payment, which had been for estate and GST taxes, to the §6166 interest installments and then to outstanding gift taxes, the National Office advised that the IRS could treat the remittance as an undesignated voluntary payment. The National Office advised that the estate had no legal right to force the IRS to reallocate the payment because the IRS has complete discretion to allocate undesignated payments against any matured tax liabilities.

The estate's payment of the first required installment five years after the decedent's death is allocated proportionately in the following order: (1) first to the required installments of deferred tax; (2) next to the interest on the deferred tax; and (3) finally to any unpaid balance of the deferred tax.[22]

[22] *See* TAM 9046003, TAM 9046002.

3. **The Election — §6166(d)** —

An election under §6166 must be made no later than the date prescribed by §6075(a) for filing the estate tax return, including extensions. While Form 4768, *Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes,* does not contain any reference to the §6166 election itself and a §6166 election is not actually made until the estate tax return is filed (since where a §6166 is anticipated less than all tax shown as due will be paid with Form 4768), it may be advisable to include a written statement with Form 4768 notifying the IRS of the intention to make the §6166 election. For a sample Form 4768 with such a written statement, see the Worksheets.

However, §6166(h) and Reg. §20.6166-1(c)(1) provide that where no election, including a protective election, has been made under §6166(a) and a deficiency is then assessed, the estate may subsequently make a §6166 election. The estate tax deferral is available only with respect to the portion of the deficiency attributable to the decedent's interest in the closely held business. The election must be made within 60 days of the notice and demand for payment from the IRS, and must contain the same information as required with respect to a notice of election filed with the original estate tax return.[23] However, an executor may not elect to pay a deficiency in installments if the deficiency is due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax.[24]

[23] Reg. §20.6166-1(b), §20.6166-1(c)(1).

[24] §6166(h). *See also* CCA 200909047.

Requests for extension of time under Reg. §301.9100-3 will be denied because the §6166 election is a statutory election.[25] Furthermore, the election must be made as prescribed in the regulations. When an election is made, all the provisions of Subtitle F — "Procedure and Administration" — apply "as though" the time of payment of the tax was extended.[26]

[25] *See* §6166(d), §6075(a); PLR 201015003 (§6166 was a statutory election that must be made by date prescribed by statute; therefore, IRS denied extension of time to file); CCA 200848004 (§6166 election may not be made on late-filed return; taxpayer's statement on timely extension request of intent to make election did not qualify); PLR 200721006 (request for extension of time under Reg. §301.9100-3 to file §6166 election was denied because Reg. §301.9100-3 applied only to regulatory elections, and §6166 election was statutory). *See also Estate of Woodbury v. Commissioner*, T.C. Memo 2014-66 (estate denied election because (1) in its statement on timely extension to file request, estate failed to substantially comply with election regulatory requirements by not providing specific information on closely held business interests, and (2) although estate did substantially comply with election requirements on return, return was not timely filed). For estates of decedents dying after 2009 and before December 17, 2010, a non-Code provision in the 2010 Tax Relief Act, Pub. L. No. 111-312, §301(d)(1), extended for at least nine months after December 17, 2010, the due dates for: (1) filing an estate tax return (including any elections required to be made on such returns) under §6018, as in effect without EGTRRA, Pub. L. No. 107-16, §542(b)(1), amendments, and without regard to the election available (under the 2010 Tax Relief Act, Pub. L. No. 111-312, §301(c)) to such decedents to apply the §1022 modified carryover basis rules rather than the reinstated estate tax regime; and (2) making any estate tax payments. For any extensions related to the coronavirus (COVID-19 pandemic), see Notice 2020-23, *amplifying* Notice 2020-20.

[26] §6166(d). In CCA 200628042, the Chief Counsel's Office advised that there was no reasonable cause exception for a denial of a §6166 election where the estate made the election on a late-filed return. The Chief Counsel noted, apparently incorrectly, that the estate may be able to seek relief under Reg. §301.9100-3. *See also Bank of the West v. Commissioner*, 93 T.C. 462 (1989) ("Petitioner concedes that the estate tax return was not timely filed; therefore, the purported election to pay the tax in installments was ineffectual as a matter of law"); *Estate of Hinz v. Commissioner*, T.C. Memo 2000-6 (citing *Estate of La Meres v. Commissioner*, 98 T.C. 294 (1992) as follows: "Petitioner did not timely pay the estate tax shown on the return because it elected to defer payment under section 6166. The section 6166 election was invalid because it was made in a return which was not timely filed."); CCA 200848004 (§6166 election made on late-filed return is not eligible for Reg. §301.9100-3 relief); PLR 200721006 (request for extension of time under Reg. §301.9100-3 to file §6166 election was denied).

Practice Point: In many estates consisting of closely held business interests, an executor will not know if the IRS will accept the valuations originally set forth in an estate tax return. These returns typically have a high probability of audit because such estates consist of substantial interests in one or more closely held businesses. Any adjustment by the IRS in the value originally reported on an estate tax return could affect the ability of an estate to qualify for §6166 deferral. Thus, if the IRS increases the value of a closely held business interest it will increase the likelihood that the interest will qualify under the 35% of adjusted gross estate limitation previously discussed. On the other hand, if the IRS adds excluded assets to an estate (i.e., a transfer with retained interests (under §2036–§2038)), it could decrease the likelihood that the closely held business interest will satisfy the 35% threshold. Similarly, an adjustment to the value of another estate asset (i.e., an interest in a limited partnership consisting of marketable securities and cash) could also decrease the likelihood that a closely held business interest will satisfy the 35% threshold.

Under Reg. §20.6166A-1(e)(3),[27] an executor may make a protective election to defer estate tax payments under §6166 if the values originally reported on an estate tax return do not qualify under the threshold 35% limitation or the estate tax return as originally filed shows that no tax is due.

[27] *See also* Reg. §20.6166-1(d). In CCA 201302037, an estate would have been eligible to make an election under §6166(a) at the time its original return was filed. However, the estate paid the tax in full. Later, the IRS determined that there was a deficiency. The Chief Counsel's Office advised that only that portion of the deficiency attributable to a closely held business may qualify for the §6166(h) election, even though the estate could have elected a larger deferral had it done so with the original filed return.

The IRS[28] decides in examination whether an election meets the requirements of §6166.[29] If the election is rejected, the executor may request consideration by the Appeals Office. The appellate determination will be regarded as the IRS's final decision.[30]

[28] Reg. §20.6166A-1(e) refers to the "district director," a position eliminated from the IRS in its restructuring pursuant to the 1998 IRS Restructuring and Reform Act.

[29] Following receipt of an election, the IRS will make a preliminary determination if the estate qualifies for §6166. If the estate qualifies, the IRS will prepare and issue Letter 2568C, indicating the installment amounts and notifying the estate that the election has been received, but that it is subject to examination. Thereafter, the IRS will issue an annual Letter 249C approximately 30 days prior to each installment's due date.

[30] Rev. Proc. 79-55, *modifying* Rev. Proc. 60-33. *See* TAM 8512003 (§6166 election was not valid because it was not attached to the estate tax return even though election, with full information, had been attached to two prior, timely filed applications for extension of time to file the return).

While the election is under consideration in examination or Appeals, an executor may request that the case be referred to the National Office for technical advice, either because a lack of uniformity exists as to the disposition of the issue or the issue is so unusual or complex as to warrant review by the National Office.[31]

[31] Rev. Proc. 79-55.

a. **Form of the Election** —

The IRS has not issued a form to make a §6166 election, although the executor should check the election box on the estate tax return (Form 706, Part 3). The election may be made in any style. For example, the election could be made by attaching a notice to the estate tax return. A sample election statement is available at *Deferral of Estate and Generation-Skipping Transfer Tax on Closely Held Businesses (§6166)* in the Bloomberg Tax & Accounting Election and Compliance Statements Library.

Nevertheless, the following information must be included with the election:

(1) the decedent's name and taxpayer identification number as each appears on the estate tax return;

(2) the amount of the estate tax to be paid in installments;

(3) the date selected for the payment of the first installment;

(4) the number of annual installments, including the first installment, in which the tax is to be paid;

(5) the property shown on the estate tax return that constitutes a closely held business, identified by schedule and item number; and

(6) the facts that serve as the basis for the executor's conclusion that the estate qualifies for payment of the estate tax in installments.[32]

[32] Reg. §20.6166-1(b). *See also* Worksheet 5. For additional discussion of the mechanics of §6166, see Elizabeth Carrott Minnigh, *So You Think You Can Read,* BNA Fin. Planning J. (May 14, 2014).

If the notice of the §6166 election omits the amount of estate tax to be paid in installments, the date selected for payment of the first installment, or the number of installments, the election will be presumed to be for the maximum amount payable in installments with such payment to be made in 10 equal installments, the first of which is due five years after due date for the estate tax return prescribed in §6151(a).[33]

[33] Reg. §20.6166-1(b). *See, e.g.,* TAM 8142015, TAM 8142014 (where authorized representative's letter making §6166 election excluded certain information, maximum amount of tax payable on estate tax return was to be paid in 10 equal installments beginning five years after return was filed). *See also* TAM 8331006 (where second Form 706 was filed by due date to elect payments under §6166, but first Form 706 excluded such election, filing second estate tax return by due date was valid §6166 election).

Practice Tip: If the notice of a §6166 election for a lending and finance company does not contain the required information, presumably it will be assumed that the election is for the maximum amount of estate tax payable in installments with such payment to be made in five equal installments, the first of which is due on the estate tax return due date prescribed in §6151(a). Furthermore, for a holding company that has operating subsidiaries with stock that is not “non-readily tradable” stock, presumably it will be assumed that the §6166 election is for the maximum amount of the estate tax that is payable in installments also with such payment to be made in five equal installments, the first of which is due on the due date for the estate tax return prescribed in §6151(a).[34]

[34] *See* §6166(b)(8), §6166(b)(10)(A).

b. **Late Election Allowed for Certain Deficiency Determinations — §6166(h)** —

If an executor did not previously make an election under §6166, but the estate qualifies under §6166(a)(1) after a deficiency in the estate tax is assessed, the executor may elect to pay the deficiency in installments under §6166(h)(1). The deficiency, however, cannot be due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax. (These are the same rules that apply to prorating deficiencies to installments where an election to defer tax had been made before determination of the deficiency under §6166(e). See I.B., above.) This election must be made no later than 60 days after the Secretary issues notice and demand for payment of the deficiency, and it is made as prescribed by regulations.[35] For a sample election statement, see *Deferral of Deficiency of Estate and Generation-Skipping Transfer Tax on Closely Held Businesses if Deferral Was Not Elected on Original Return (§6166(h))* in the Bloomberg Tax & Accounting Election & Compliance Statement Library. The portion of the deficiency eligible for payment in installments is paid on the due date for the installments due after the date of election. For this purpose, the due dates are determined as if a timely §6166 election had been made upon filing the estate tax return. The portion of the deficiency attributable to any installment that would have been due when the election is made under §6166(h)(1) must be paid at the time of the election.[36]

[35] §6166(h)(2).

[36] §6166(h)(3).

Comment: In TAM 8846001, the IRS increased the value of an interest in a closely held business during an audit to 74% of the adjusted gross estate. Pursuant to §6166(h)(1), the estate elected to pay the deficiency in installments under §6166, however, the IRS limited the amount that the estate could defer to 74% of the deficiency. This is an inequitable interpretation of §6166(h)(3), which is a relief provision. Section 6166(h)(3) states that "the deficiency shall (subject to the limitation provided by [§6166](a)(2)) be prorated to the installments which would have been due if an election had been timely made . . ." Nonetheless, §6166(a)(2) provides only a ceiling amount that a deficiency attributable to the business asset cannot exceed. Therefore, the entire deficiency should be deferrable under §6166 .

4. **Challenging IRS §6166 Determinations**

a. **Section 7479 Declaratory Judgments** —

To limit the potential hardship caused by an erroneous denial of a §6166 election, a declaratory judgment remedy was added under §7479 by the 1997 Act.[37]

[37] Until the enactment of the 1997 Taxpayer Relief Act (TRA), the Tax Court had no jurisdiction to resolve disputes between an estate and the IRS regarding an estate's qualification for §6166 deferral. This was because the denial of an installment election did not create a "deficiency." Before the 1997 TRA, a deficiency was necessary to confer jurisdiction on the Tax Court. Even a reference to a §6166 issue in a deficiency notice that raised other issues over which the Tax Court had jurisdiction would not give the Tax Court jurisdiction to review this issue. *See Estate of Meyer v. Commissioner*, 84 T.C. 560 (1985) (court had jurisdiction over deduction of interest under §2053, but not over right to defer estate tax under §6166); *Estate of Sherrod v. Commissioner*, 82 T.C. 523 (1984), *rev'd on other grounds*, 774 F.2d 1057 (11th Cir. 1985); *Estate of Bell v. Commissioner*, 92 T.C. 714 (1989), *aff'd*, 928 F.2d 901 (9th Cir. 1991). *But see Estate of Baumgardner v. Commissioner* , 85 T.C. 445 (1985), *acq.,* 1986-2 C.B. 1 (Tax Court had jurisdiction to determine overpayment of interest paid on estate tax installments as part of its jurisdiction to determine overpayment of tax).

Section 7479 grants an estate the ability to petition the Tax Court to resolve a dispute concerning initial or continuing eligibility for §6166 deferral without first requiring the estate to pay the full amount of estate tax the IRS asserts is due. According to its legislative history, §7479 was enacted because requiring full payment of the estate tax before allowing an estate to seek judicial review of §6166 issues might require an estate to liquidate the assets that §6166 was designed to protect.[38]

[38] H.R. Rep. No. 148, 105th Cong., 1st Sess. 83 (1997); S. Rep. No. 33, 105th Cong., 1st Sess. 48 (1997).

Under §7479, the Tax Court may grant a declaratory judgment in an actual controversy involving an IRS determination (or failure to make a determination) with respect to an estate's eligibility to make a §6166 election or whether an estate will cease to qualify for §6166 deferral.[39] The 1998 Act made technical corrections to §7479(a) which clarified that the Tax Court's declaratory judgment jurisdiction extends to the determination of whether particular property qualifies for §6166 deferral. The purpose of the amendment was to clarify that an estate may seek a declaratory judgment as to the qualification of particular property, even if the estate already qualifies for the

§6166 election on the basis of other property included in the estate.[40]

[39] §7479(a). See I.G., below, for a discussion of the loss of §6166 deferral.

[40] H.R. Rep. No. 148, 105th Cong., 1st Sess. 83 (1997); S. Rep. No. 33, 105th Cong., 1st Sess. 48 (1997). *See also* CCA 201226027 (Tax Court had jurisdiction under §7479 to review IRS Appeal's determination that amount of deferred payment of estate tax should be reduced).

The Tax Court's declaration has the full force and effect of a Tax Court decision and is reviewable.[41]

[41] §7479(a).

Either the executor of the estate or the person who has assumed an obligation to make the deferred tax payments (the petitioner) may bring the action under §7479; however, if more than one person has the obligation to make the payments, all such persons must be joined as parties in the case.[42] A petitioner is required to exhaust all available administrative remedies within the IRS before an action may be brought under §7479.[43] Failure by the IRS to make a determination within 180 days after a request has been made will satisfy this requirement if the petitioner has taken all reasonable steps in a timely manner to secure the IRS determination.[44]

[42] §7479(b)(1).

[43] §7479(b)(2). Rev. Proc. 2005-33 provides guidance as to exhausting all administrative remedies prior to seeking a declaratory judgment.

[44] §7479(b)(2).

The Tax Court action must be filed before the 91st day after the IRS mails notice by certified or registered mail of a determination to deny initial or continuing §6166 eligibility.[45]

[45] §7479(b)(3). See 630 T.M., *Tax Court Litigation* (U.S. Income Series), and 460 T.M., *Tax-Exempt Organizations — Declaratory Judgments (Section 7428),* for further discussion of Tax Court procedures.

b. **Section 7422 Refund Actions** —

The 1998 IRS Restructuring and Reform Act created an additional remedy under §7422(j).[46] Section 7422(j) allows an estate that made the §6166 election to file an estate tax refund claim in federal district court or the Court of Federal Claims before the entire estate tax has been paid. Section 7422(j) overrules prior cases that held that an estate must wait until it had made the final deferred payment before filing a refund claim.[47]

[46] Until the enactment of the 1998 IRS Restructuring and Reform Act, an estate incurred significant obstacles in attempting to challenge a late rejection of a §6166 election in court or a dispute arising during the §6166 deferral period. To gain access to court to file a refund claim, the estate first had to pay the entire estate tax liability. The payment of all installments due prior to bringing the action was insufficient to invoke jurisdiction. *See, e.g., Flora v. United States*, 357 U.S. 63 (1958), *aff'd on reh'g*, 362 U.S. 145 (1960); *Rocovich v. United States*, 18 Cl. Ct. 418, 89-2 USTC ¶13,819 (Cl. Ct. 1989), *aff'd*, 933 F.2d 991 (Fed. Cir. 1991); *Abruzzo v. United States*, 24 Cl. Ct. 668 (1991).

[47] *See* H.R. Rep. No. 364, 105th Cong., 2d Sess. (1998); S. Rep. No. 174, 105th Cong., 2d Sess. (1998).

Section 7422(j) provides that an estate may file a refund suit if the following requirements are met:

- no portion of the §6166 payments has been accelerated;

- all installments due as of the date of filing have been paid;

- there is no Tax Court case pending with respect to the estate tax liability; and

- the estate has not filed a §7479 declaratory judgment action with respect to its eligibility for the §6166 election.

In *Hansen v. United States* [48] the first decision to address §7422(j), the court held that a decedent's estate was jurisdictionally barred from bringing suit for a redetermination of estate taxes under §7422(j) where the estate had not paid all installments due before the suit was filed, installments due during the litigation, or the full amount of its tax liability after acceleration by the IRS. The court stated that to allow an estate to withhold payment and still bring suit for a redetermination of taxes would be "contrary to the carefully structured system of tax litigation and limited waiver of sovereign immunity envisioned by Congress."[49]

[48] *Hansen v. United States*, 248 F.3d 761 (8th Cir. 2001).

[49] *Hansen v. United States*, 248 F.3d 761 ("district court pointed out '[t]he Estate's argument, however, ignores completely the jurisdictional preconditions listed in §7422(j) that are pertinent to this case. First, §7422(j)(2)(B) requires that all installments are paid in full at the time of the taxpayer suit. I.R.C. §7422(j)(2)(B). Since the Estate was admittedly not current in its installment payments when it filed suit in this Court, the Estate is jurisdictionally barred from litigating this action in federal court.'").

Practice Tip: Practitioners should note that §7422(j) does not alter the generally applicable statute of limitations for refund claims[50] and the refund will be limited to the tax (including interest) paid within the limitations period.

[50] *See, e.g.,* TAM 9843001–TAM 9843005 (refund allowed only for §2032A recapture tax and interest paid during two years before refund claim was filed; refund of earlier payments barred by statute of limitations), TAM 9828002 (where estate sought deductions for interest paid during deferral period and claimed refund of resulting overpayment of estate tax, IRS advised that estate was entitled to refund of only final deferred payment because it was only one that was paid within two years of refund claim (i.e., period specified in §6511(b)(2)(B) for refunds)).

In CCA 200141013, an estate applied for and received an extension of time to file its estate tax return and pay the estate tax that was due. The estate also remitted a payment of the estimated estate tax with its extension request. The estate filed its estate tax return within the extended due date. The return included an election under §6166 to pay the estate tax attributable to the decedent's interest in a closely held business in installments and a claim for refund because the estate's initial payment of the estimated tax was more than the tax due on the portion of the estate that was not eligible for deferral. Following an examination of the return it was determined that the estate's initial payment was still greater than the tax that was due on the portion of the estate that was not eligible for deferral under §6166. The Chief Counsel advised that the estate should not receive a refund of the difference between the amount paid and the minimum amount of tax that was due on the portion of the estate not eligible for deferral. Chief Counsel stated that §7422(j) "does not change the fact that there must be an overpayment of the entire estate tax liability in order to obtain a refund," and does not permit "payment of a refund merely because one or more estate tax installments have been overpaid or because the amount not eligible for deferral has been overpaid." Thus, Chief Counsel concluded that the IRS could not issue a refund because there was no overpayment of the entire estate tax liability.[51]

[51] CCA 200141013 (citing *Estate of Baumgardner v. Commissioner*, 85 T.C. 445, 461 (1985), which provided that "an overpayment of an installment is not an 'overpayment of tax' until the entire amount of the tax has been paid"). *See also Estate of Shapiro v. Commissioner*, 111 F.3d 1010 (2d Cir. 1997) ("when the overpayment of a §6166 installment is voluntarily made (e.g., is the result of a mistake on the part of the taxpayer), it will be credited against outstanding installments under §6403, but when the overpayment is both the result of erroneous or wrongful conduct on the part of the government and made under protest by the taxpayer, it will be refunded to the taxpayer in order to preserve the taxpayer's statutory right to defer payment under §6166").

In CCA 201226027, an estate timely filed an *application for extension of time to file* and to pay the estate tax, and the estate attached a letter stating it would be making an election under §6166 and that the payment enclosed was to be applied to the nondeferred portion of the estate tax. The estate tax return was filed timely. Because the nondeferred portion of the tax was much less than the amount remitted, the estate requested a refund for the overpayment of the nondeferred tax. Citing §6403, the IRS responded that the overpayment had to be applied to the deferred tax and would not be refunded. The Chief Counsel's Office advised that before the IRS is permitted to refund an amount of tax paid, §6402 requires that there be an overpayment. According to the Chief Counsel's Office, an overpayment exists when the amount of tax paid exceeds the amount of tax properly due. The Chief Counsel's Office stated that the estate may have overpaid the nondeferred portion of the estate tax, but the estate did not overpay its total estate tax liability. Although §6403 provides an exception to §6402, that exception is inapplicable in these circumstances because §6403 is only applicable when a §6166 election has been made and the payment is submitted as an installment payment. Because the §6166 election had not been made and the payment was not submitted as an installment payment, the Chief Counsel's Office advised that none of the payment could be treated as an installment payment under §6403 and there was no overpayment of tax that could be refunded.[52]

[52] Chief Counsel's conclusions were effectively affirmed in *Estate of McNeely v. United States*, No. 0:12-CV-01973, 2014 BL 165515 (D. Minn. June 12, 2014). The facts of *Estate of McNeely* were identical to those in CCA 201226027 (it is likely that the McNeely estate was the impetus for the issuance of the CCA). The district court concluded that §6402 and §6403 both gave the IRS discretion to credit overpayments against other tax liability, and there was no indication that Congress provided for or intended an exception from those provisions for taxpayers electing under §6166. *Estate of McNeely v. United States*, 2014 BL 165515 at *5–7. The court also held that, because the estimated payment made with the request for an extension was a voluntary overpayment, it was governed by §6402 and the IRS was not required to give effect to any attempt by the estate to designate the taxes to which it would be applied. *Estate of McNeely v. United States*, 2014 BL 165515 at *8–9.

In *Estate of Adell v. Commissioner*,[53] the taxpayer timely filed its estate tax return and made a §6166 election. Included in the assets of the taxpayer was a loan receivable due from the deceased's son as a result of the deceased paying a legal judgment entered against the son. The estate tax return listed this loan amount as an asset. In filing its estate tax return, the taxpayer paid a portion of the tax due (i.e., the portion which was ineligible for deferral), which included an amount as a result of the aforementioned loan. A year later, the taxpayer filed an amended estate tax return reclassifying the loan as a gift, and a gift tax return showing an amount due as a result of the gift. Almost two years later, the IRS assessed the gift tax shown on the return, together with interest and penalties. The taxpayer argued that its overpayment of estate tax on its original return (which was the result of including the loan as an asset of the estate) should be applied towards its outstanding gift tax liability. The Tax Court, citing §6403, held that the overpayment on the nondeferred portion of estate tax must first be credited against the taxpayer's deferred portion of the estate tax, rather than the gift tax liability. Because the overpayment did not exceed the deferred portion of the estate tax owed, the court allowed the IRS to proceed with its collection action on the gift tax liability.

[53] *Estate of Adell v. Commissioner*, T.C. Memo 2014-89.

Editor's Note: The majority of cases addressing the issue of refunds on overpayments of installments cited *Estate of Bell* [54] for the notion that any overpayment of an installment must be applied first to any unpaid installments and may be credited or refunded if the overpayment exceeds the full amount of tax due. Furthermore, any overpayment of the nondeferred portion must be applied to the deferred portion before any credit or refund may be permitted.

[54] *Estate of Bell v. Commissioner*, 92 T.C. 714 (1989), *aff'd*, 928 F.2d 901 (9th Cir. 1991).

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II. Eligibility Criteria

Special use valuation is only available to certain estates, and only for certain real property owned by these estates. While the narrow congressional targeting of the benefits of special use valuation can be broadly summarized in terms of a substantiality threshold, historical usage requirements, and future usage limitations, applying these eligibility criteria to the estates of actual decedents can be daunting, even for the seasoned practitioner. As far back as 1984, Professor Neil Harl declared that "Special use valuation is on its way to becoming the most complex section in the entire Internal Revenue Code."[37] More recently, the authors of a noted treatise remarked that, as one "becomes submerged in the intricacies of §2032A, one may begin to wonder whether the game is worth the candle,"[38] and others have observed that "farm special use valuation, which began its existence visualized as a panacea for the ills of agricultural land valuation, proved to be instead a Pandora's box of troubles."[39] Of course, not all reviews are unfavorable: in 1990, Professor Martin Begleiter attributed his achieving tenure to the §2032A material participation requirements.[40]

[37] Neil E. Harl, *Special Use Valuation: The Complexities of Economic Engineering,* 60 N.D. L. Rev. 7, 43 (1984).

[38] Richard Stephens, Guy Maxfield, Dennis Calfee, Stephen Lind, *Federal Estate and Gift Taxation* ¶4.04[3][b], n. 79 (8th ed. 2002). For an argument that "the game may not be worth the candle," see XIII.B., below.

[39] Donald H. Kelley & Burnell E. Steinmeyer, Jr., *Estate Planning for Farmers and Ranchers,* 3d ed. 2008.

[40] Martin D. Begleiter, *Material Participation Under Section 2032A: It Didn't Save the Family Farm but It Sure Got Me Tenure,* 94 Dick. L. Rev. 561 (1990).

In part, the complexity of §2032A is due to the statutory scheme where only certain estates may elect special use valuation for certain real property. After determining whether the estate is eligible under the citizen/resident, 25%, and 50% tests, it is next necessary to determine whether specific parcels of real property qualify for the election. Further complexity results from the unique language of the §2032A eligibility criteria.[41] In order to understand the section, one must thoroughly understand such concepts as "material participation," "active management," "qualified use," "member of the family," "acquired from or passed from," "qualified heir," and "qualified real property." These concepts are merely introduced in this section with detailed developments of each concept to follow in III., below.

[41] Perhaps unfortunately for practitioners, the "language" of §2032A spread. "Material participation" was picked up and expanded upon for purposes of the §469 passive activity rules, and former §2057 heavily cross-references the qualifying requirements of §2032A for purposes of the (pre-2004) Family-Owned Business Deduction. *But see* Reg. §1.469-5T(b)(2)(i). Both §501(c)(15) (tax exemption for certain insurance companies) and §664(g) (charitable remainder trusts) use the §2032A definition of "family," and §170 (charitable contributions), §453 (installment method) and regulations for §45D (New Markets Tax Credit) incorporate the §2032A definition of "farming."

For real property to qualify for §2032A use valuation, three eligibility criteria for the estate and four eligibility criteria for the property must be met. If eligible, §2032A can be invoked by the executor's election on the decedent's estate tax return, along with the submission of an agreement by all parties with an interest in the property consenting to recapture tax.

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A. Eligibility Criteria for the Estate

To elect special use valuation, an estate must meet the citizen or resident requirement, as well as the 25% test and 50% test, each as explained below.

1. **Citizen or Resident** —

At the time of death, the decedent was a citizen or resident of the United States.[42]

[42] §2032A(a)(1)(A).

2. **Twenty-Five Percent Test** —

Twenty-five percent or more of the "adjusted value" of the decedent's gross estate must consist of real property:

- that "was acquired from or passed from" the decedent to a "qualified heir";
- that was owned and used for a "qualified use" by the decedent or a member of the decedent's family for five or more years of the eight-year period before death; and
- for which there was "material participation" by the decedent or a member of the decedent's family during five or more years of the eight-year period before retirement, disability or death.[43]

[43] §2032A(b)(1)(B).

As discussed more fully below, “qualified use” refers to either use as a farm for farming purposes or use in a trade or business other than farming. “Material participation” requires a threshold amount of active involvement in the business. See XIII.F. and *XIII.W.*, below, for a discussion of planning considerations relating to the 25% test.

3. **Fifty Percent Test** —

Fifty percent or more of the “adjusted value” of the decedent's gross estate must consist of the “adjusted value” of real or personal property that was:

- used for a “qualified use” by the decedent or a “member of the decedent's family” on the date of death; and
- “acquired from or passed from” the decedent to a “qualified heir.”[44]

[44] §2032A(b)(1)(A).

For purposes of §2032A, the “value of the gross estate” includes the value of property gifted by the decedent within three years of death other than gifts subject to the annual gift tax exclusion, the medical-educational exclusion, or the charitable deduction.[45] In certain circumstances (including interspousal transfers qualifying for the marital deduction), this provision would prevent the decedent from decreasing the percentage of ineligible property in his or her estate by making deathbed gifts. However, this provision could also *increase* the percentage of eligible property by pulling back property that was gifted to qualified heirs and that continues to be used in the farm or other closely held business into the estate.[46]

[45] §2035(c)(1)(B), §2035(c)(3), §6019.

[46] Section 2032A(e)(9)(A) relies on the §1014(b) definition of “property acquired from the decedent,” which includes property deemed part of the gross estate under §2035. In PLR 8514032, the IRS agreed that otherwise qualifying property transferred within three years of death could be used to satisfy the materiality thresholds.

When applying the 25% and 50% tests, the “adjusted value of the gross estate” is the “value of the gross estate” less allowable deductions under §2053(a)(4) (mortgages or indebtedness with respect to the property).[47] The “adjusted value” of the real and personal property is the value (at its highest and best use) of the property less §2053(a)(4) deductions with respect to the property.[48] Because the §2053(a)(4) deduction is for mortgages or any “indebtedness in respect of” property, unsecured indebtedness is not deducted in determining either the “adjusted value of the gross estate” or the “adjusted value of the real and personal property.”

[47] §2032A(b)(3)(A).

[48] §2032A(b)(3)(B).

An issue left unresolved by the Code and regulations is whether cash or liquid assets such as inventory are included as part of the personal property used in the trade or business for purposes of the 50% test. Given that maintaining a supply of working capital is an essential aspect of any business, it would seem that cash reserves for the reasonable needs of operating the farm or other business should be included as the business's personalty that can be applied toward satisfying the 50% test. In the context of installment payments of tax, the §6166 regulations support this view, providing that if a bank account is shown to be a part of a closely held business's working capital, the account is considered part of the business.[49] However, where a bank account commingled funds used for a qualified use with other funds, the Tax Court held that only the funds actually used for a qualified use counted toward the 50% test.[50]

[49] Reg. §20.6166A-2(c)(2). The IRS itself apparently acknowledged it applied this regulation to the §2032A 50% test. *See Estate of Mapes v. Commissioner*, 99 T.C. 511, 519 (1992).

[50] *Estate of Mapes*, 99 T.C. 511.

Like cash reserves, inventory should be personal property. In a Technical Advice Memorandum, the National Office advised that grain stored on the farm as well as grain stored at the local elevator were property included as an interest in a wheat farming proprietorship for purposes of §6166 installment payments of federal estate tax.[51] In contrast, if substantial amounts of grain inventory have been carried over from prior crop years, it might be determined that the excess inventory would not be needed as part of the trade or business and, therefore, could not be counted for purposes of the 50% test.

[51] TAM 8251015.

Not only are there issues regarding which assets may be included as part of the trade or business for purposes of the 25% and 50% tests, there is also an issue as to whether assets from two different trades or businesses may be aggregated to satisfy the tests. In Rev. Rul. 85-168, the IRS cited the §2032A(b)(2) "qualified use" section to hold that the adjusted value of a building used in a nonfarm business could be combined with both the adjusted value of real property used as a farm for purposes of satisfying the 25% test, and with the adjusted value of personal property used for the farm for purposes of satisfying the 50% test.[52] However, in *Estate of Geiger v. Commissioner*,[53] the Tax Court held that where personal property was used in a separate trade or business and was not connected with real property that satisfied the requirements of §2032A(b)(1)(A), the adjusted value of such personal property could not be applied to satisfy the 50% test. The Tax Court reasoned that:

[52] *See also* PLR 8843023 (allowing closely held banking business interest's aggregation with farm assets for purposes of 50% test); TAM 8433006.

[53] 80 T.C. 484 (1983).

> where personal property is not a part of a business in danger of being "over valued" in the context of an existing use because real property connected with that business has been valued on the basis of another alternative possible use, the family business is not penalized and its continuance is not threatened.[54]

[54] 80 T.C. 484, 488.

The Eleventh Circuit, in *Estate of Sherrod v. Commissioner*,[55] held that neither unused land nor cropland leased pursuant to a cash rent lease were used for a "qualified use" and, therefore, the value of neither parcel could be included for purposes of satisfying the 50% test. As a result, there was insufficient property to satisfy the 50% test and the estate was not permitted to elect special use valuation. The estate argued that because the land in question was part of a tract of timberland that otherwise qualified for special use valuation, the adjoining property should also qualify. It was the court's view, however, that because the land was not "functionally related" to the qualifying timberland as required by §2032A(e)(3), it would not satisfy the qualified use test.[56]

[55] 774 F.2d 1057 (11th Cir. 1985), *rev'g* 82 T.C. 523 (1984).

[56] For further discussion of the rationale for excluding the pastureland and cropland in *Sherrod*, see III.C.6.b., below.

Practice Tip: The citizen/resident, 25%, and 50% tests are threshold tests, limiting the benefits of a special use election to certain decedents' estates that are substantially comprised of farming or closely held business operations. These threshold tests must be met before determining whether specific parcels of real estate qualify for special use valuation.

B. Eligibility Criteria for the Property

After determining whether the estate meets the estate-level tests for §2032A eligibility, the estate determines whether specific real property parcels qualify for the election.

1. **Real Property** —

Only real property is eligible for special use valuation.

2. **Qualified Real Property** —

The real property must be “qualified real property,” which means the real property is:

- located in the United States;[57]
- “acquired from or passed from” the decedent to a “qualified heir”; and
- used for a “qualified use” at the time of death by the decedent or by a “member of the decedent's family.”[58]

[57] Curiously, while “qualified real property” must be in the United States, the language of the statute does not prevent foreign real property from being used to meet the 25% and 50% tests. *Compare* §2032A(b)(1) *with* §2032A(b)(1)(A)(i).

[58] §2032A(b)(1).

If there are successive interests in the “qualified real property,” all successive interests must be received by “qualified heirs.” A remainder interest by itself will not qualify for special use valuation.[59] *See* III.G., below.

[59] Reg. §20.2032A-8(a)(2); TAM 8223004, TAM 8045018, TAM 8020011.

3. **Qualified Use in Five of Eight Years** —

The real property for which an election is made must have been owned and used for a “qualified use” by the decedent or a “member of the decedent's family” for a period aggregating five years or more during the eight-year period ending on the decedent's date of death.[60]

[60] §2032A(b)(1)(C)(i).

4. **Material Participation in Five of Eight Years** —

The real property for which an election is made must have been used in a farm or business in which the decedent or a “member of the decedent's family” “materially participated” for a period aggregating five years or more during the eight-year period ending on the earlier of the date of death or the date of retirement or disability, provided that such retirement or disability continues to the date of death.[61] For this purpose, retirement or disability begins on the date the decedent began receiving Social Security retirement benefits or became disabled.[62] An individual is considered disabled if he or she has a mental or physical impairment that makes him or her unable to materially participate.[63]

[61] §2032A(b)(1)(C)(ii), §2032A(b)(4).

[62] §2032A(b)(4)(A).

[63] §2032A(b)(4)(B).

Practice Tip: If a surviving spouse acquired qualified real property from a deceased spouse, the surviving spouse may demonstrate more limited “active management” rather than “material participation” prior to the surviving spouse's death, preserving the ability to elect special use valuation in the estate of the second-to-die spouse.[64]

[64] §2032A(b)(5); see III.B., below.

While the existence (or lack thereof) of “material participation” in the pre-death period is generally fixed at death, a decedent's estate was able to satisfy the five-of-eight-year material participation requirement when the decedent's brother timely adopted a stepdaughter whose spouse was farming the decedent's land.[65]

[65] PLR 8610073.

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II. Eligibility Criteria

C. Election and Agreement

After the executor determines (1) that the decedent's estate is eligible to invoke §2032A valuation, and (2) what property qualifies for a special use election, the executor must submit an election notice with the decedent's estate tax return.[66] While an executor does not need to elect special use valuation for all eligible real property, Reg. §20.2032A-8(a)(2) requires an electing estate to apply special use valuation to at least 25% of the adjusted value of the gross estate even though such a requirement does not seem supportable by the plain language of the statute. In *Miller v. United States* and *Finfrock v. United States*,[67] decided 24 years apart, the same district court held this minimum election requirement to be an invalid extension of §2032A(b)(1)(B). Nevertheless, Reg. §20.2032A-8(a)(2) remains on the books and, to the knowledge of the authors, continues to be applied by the IRS.[68]

[66] §2032A(a)(1)(B), §2032A(d)(1); Reg. §20.2032A-8(a).

[67] *Miller v. United States*, 680 F. Supp. 1269 (C.D. Ill. 1988); *Finfrock v. United States*, 860 F. Supp. 2d 651 (C.D. Ill. 2012); *see* VII.D., below.

[68] The courts also attacked this regulation's position on successive interests. *See* III.G.2., below.

Contemporaneously with the election, all persons with an interest in the “qualified real property” for which an election is made must sign and attach to the return an agreement pursuant to which all “qualified heirs” with an interest in the property consent to personal liability for the additional estate tax (recapture tax) imposed by §2032A(c). Other parties with an interest in the property who are not qualified heirs must consent to collecting the additional estate tax from the “qualified real property.”[69]

[69] §2032A(a)(1)(B), §2032A(d)(2); Reg. §20.2032A-8(c).

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A. Material Participation

1. **In General** —

Both the historical usage requirements for electing special use valuation and the future usage requirements for avoiding the §2032A recapture tax require the property owner (or a family member) to materially participate in a qualified use of the property. As such, the dual requirements of material participation and qualified use (discussed at III.C., below) are the principal devices by which Congress limited access to the benefits of §2032A.

Material participation plays two key roles in defining and limiting the beneficiaries of special use valuation. First, to qualify for special use valuation, the decedent or a member of the decedent's family must materially participate for five or more of the eight years prior to the decedent's (i) death, (ii) disability, or (iii) retirement.[70] Second, to avoid the post-death recapture of tax benefits, there must not be periods aggregating more than three years during any eight-year period ending after the decedent's death during which there was not material participation by the decedent or member of the decedent's family (in the pre-death period) or by the qualified heir or a member of the qualified heir's family (in the post-death period).[71]

[70] §2032A(b)(1)(C)(ii), §2032A(b)(4). For surviving spouses, material participation can also be achieved through "active management." *See* III.B., below.

[71] §2032A(c)(6)(B).

Congress's intent in promulgating these requirements was to make a distinction for §2032A purposes between those decedents and heirs who are actively involved in the farm operation or the trade or business and those individuals who hold real property merely as a passive investment. Rather than imposing a new framework for making this distinction, §2032A made use of the "material participation" concept already existing for self-employment tax. Mechanically, this occurs under §2032A(e)(6), which provides that, for purposes of §2032A, material participation is determined in a manner similar to that in §1402(a)(1).

Section 1402(a) defines net earnings from self-employment for purposes of the §1401 self-employment tax. In turn, §1402(a)(1) provides that rental income does not generally qualify as net earnings from self-employment. However, §1402(a)(1) provides that if income is produced pursuant to an arrangement to produce agricultural or horticultural commodities and the arrangement requires "material participation," the income will be deemed net earnings from self-employment without regard to its classification as rental income. Thus, the cross-reference from §2032A to §1402 creates a double-edged sword for the commodity grower where it will not be possible to implement a plan that both avoids self-employment tax and nevertheless qualifies the property for special use valuation.

Complexity results, however, from the existence of the term and concept of material participation in other contexts. First, § 211(a)(1) of the Social Security Act (SSA) also utilizes the concept of material participation.[72] Cases and rulings under this provision may be highly precedential in the §2032A context, as the definition of "net earnings from self-employment" found at SSA §211(a)(1) closely parallels that in §1402(a)(1).[73] Although §1402(a)(1) was promulgated as part of the Self-Employment Contributions Act of 1954 (also known as the Social Security Amendments of 1954)[74] and §211(a)(1) is part of the Social Security Act, the complementary nature of the two statutes suggests that the concept of material participation in each Act would be interpreted similarly, as was indeed done in the Eighth Circuit.[75]

[72] 42 U.S.C. §411.

[73] 42 U.S.C. §411.

[74] Pub. L. No. 83-761.

[75] See the discussions of *Mangels v. United States*, 828 F.2d 1324 (8th Cir. 1987), *rev'g* 632 F. Supp. 1555 (S.D. Iowa 1986), in III.A.3.b., and III.A.6.c., below.

Additionally, the enactment of §469 as part of the Tax Reform Act of 1986 (TRA 1986)[76] introduced the concept of "material participation" into yet another context. Section 469 imposes limitations on the deduction for losses from "passive activities." Absence of "material participation" by the taxpayer in a trade or business activity is one of the elements that causes the trade or business activity to be characterized as "passive." Further complicating matters, §1411 imposes a tax on "net investment income" above certain threshold amounts by cross-referencing the §469 passive activity rules in determining whether income from a trade or business is subject to the §1411 tax.[77]

[76] Pub. L. No. 99-514.

[77] §1411(c). The Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §1402, enacted §1411.

More directly analogous to §2032A, and therefore of more precedential value, may be cases and rulings under former §2057, which provided a deduction from the gross estate for certain "qualified family-owned business interests" of decedents dying before 2004. This section closely paralleled §2032A by imposing similar historical and future usage material participation requirements. Former §2057 explicitly cross-referenced §2032A in defining "material participation."

Finally, the IRS issued regulations for §2032A setting forth activities constituting material participation and the factors considered in determining the presence of material participation.[78] While these regulations are detailed, they clearly envision a facts-and-circumstances inquiry, stating that no single factor is determinative of the presence of material participation.[79] For this reason, valuable guidance may be available by a thorough review of material participation as it was defined in each of the above discussed areas. Thus, the following discussion analyzes material participation in five contexts: (i) §1402(a)(1) self-employment tax, (ii) §211(a)(1) of the Social Security Act, (iii) §469 passive activity loss rules, (iv) former §2057 and former §2033 family-owned business deduction/credit, and (v) the §2032A regulations.

[78] Reg. §20.2032A-3(e).

[79] Reg. §20.2032A-3(e)(2).

2. **Section 1402(a)(1) Material Participation** —

Section 1402(a) defines net earnings from self-employment used to calculate the tax on self-employment income. As noted above, self-employment income generally excludes rental income. Nevertheless, income from an arrangement between the owner or tenant and another individual will be taxable self-employment income (without regard to its characterization as "rental income" by the parties) if: (i) the arrangement provides that the other individual shall produce agricultural or horticultural commodities, and (ii) the owner or tenant materially participates in producing the agricultural or horticultural commodities. Thus, material participation by the owner or tenant is significant because it causes certain otherwise-excludible rental income to be characterized as earnings from self-employment and, therefore, subject to the tax imposed by §1401.

Section 1402 and its regulations further provide that it is not possible to establish material participation through services performed by employees or agents.[80] Consequently, an individual cannot satisfy the §2032A material participation requirements by using an agent or employee to carry out production or management. Nonetheless, while the activities of an agent will not be *helpful* in determining whether material participation exists, such activities need not be *fatal* to the inquiry. Instead, both the Code and the regulations clearly contemplate the existence of agents or employees in conjunction with materially participating owners. As an example, the §2032A regulations set forth an attorney who has a farm manager but nevertheless materially participates in the farm operation.[81] Furthermore, if a family member is acting in the role of agent, family member status is controlling.[82] Thus, the material participation limitation restricts access to §2032A to families who are personally involved in the business and excludes individuals who own farmland as a passive investment.

[80] §1402(a)(1); Reg. §1.1402(a)-4(b)(5). *But see* Notice 2006-108 discussed in XIII.S., below.

[81] Reg. §20.2032A-3(g) *Ex.* 4.

[82] Reg. §20.2032A-3(e)(1).

Comment: Section 1402(a)(1) and the corresponding regulations set forth the activities that constitute material participation by a landlord or tenant. Although §2032A provides that material participation will be determined in a manner similar to that used in §1402(a)(1), it would seem obvious that, if an individual directly operates the farm or trade or business outside of a rental arrangement, there would be material participation by the individual for purposes of special use valuation. The reference to §1402(a)(1) is to clarify the more difficult situation of determining the presence of material participation in the context of a rental arrangement.[83]

[83] *Wuebker v. Commissioner*, 205 F.3d 897 (6th Cir. 2000), *rev'g* 110 T.C. 431 (1998) ("The issue of material participation [in the self-employment context] arises only when there is an arrangement between an owner or tenant and another individual whereby the other individual is to produce agricultural or horticultural commodities on the land."). *Wuebker* rightly recognizes that the exclusion from self-employment tax requires both the income be classifiable as "rents" and the taxpayer not have "materially participated." This distinction was occasionally muddied in cases where the Tax Court found it convenient to hold that material participation existed, thereby mooting the issue of whether the income in question properly constituted "rents." *See, e.g.,*

Schmidt v. Commissioner, T.C. Memo 1997-41 (concluding that determining material participation was necessary where farmer grew beets on his own land and sold them pursuant to contract with food company); *Gill v. Commissioner*, T.C. Memo 1995-328 (material participation where taxpayer personally raised flocks of birds and delivered them under contract to chicken processor). *Cf. Morehouse v. Commissioner*, 769 F.3d 616 (8th Cir. 2014), *rev'g* 140 T.C. 350 (2013), (citing Rev. Rul. 60-32 and distinguishing *Wuebker*, Eighth Circuit held that government Conservation Reserve Program payments received by nonfarmer were rentals from real estate under §1402(a)(1) and, thus, not subject to §1401 self-employment tax), *nonacq.* 2015-41 I.R.B. See XIII.S., below, for a discussion of special use valuation and federal agricultural programs.

The regulations promulgated under §1402 provide that the following elements must be present for an owner of farmland to be a material participant in the context of a rental relationship:

- there must be a written or oral “arrangement” between the owner and an individual;
- the arrangement must contemplate actual material participation by the owner in the producing, or managing the production of, agricultural or horticultural commodities;
- the arrangement must impose an obligation upon the individual to produce an agricultural or horticultural commodity; and
- the owner must actually participate to a material extent in the production and/or production management of agricultural or horticultural commodities.[84]

[84] Reg. §1.1402(a)-4(b)(2), §1.1402(a)-4(b)(3), §1.1402(a)-4(b)(4).

a. **Arrangement** —

In *Mizell v. Commissioner*,[85] the taxpayer argued that, although rental income was derived under a series of leases with respect to a farm partnership in which the taxpayer was a partner and materially participated, no self-employment tax was due because the lease agreements did not contractually require the taxpayer's material participation. The Tax Court disagreed, holding that the word “arrangement” as used in §1402(a)(1) is to be interpreted broadly as encompassing not only the rental or loan agreement, but also “those obligations that existed within the overall scheme of the farming operations” including the partnership agreement and the general understanding between the taxpayer and the other partners. *Mizell* was subsequently cited favorably by the IRS in a technical advice memorandum finding self-employment material participation where payments were received pursuant to the Conservation Reserve Program.[86]

[85] T.C. Memo 1995-571.

[86] TAM 9637004. *See also* CCA 200325002. For more on material participation in the context of federal programs, see XIII.S., below.

In a trio of recommendations, the Chief Counsel's Office favorably cited *Mizell* in concluding that an employment contract and a lease should be examined together in determining whether material participation existed.[87]

[87] FSA 199917008, FSA 199917006, FSA 199917005.

While not directly addressing *Mizell*, the Eighth Circuit, in *McNamara v. Commissioner*,[88] determined that there must be a nexus between the taxpayer's participation and the rental payments before self-employment tax may be imposed. The *McNamara* court concluded that rentals at rates consistent with market prices “very strongly suggest” that the rental arrangement is an independent transaction. The Tax Court followed the *McNamara* court in *Solvie v. Commissioner*,[89] when it found there was a nexus between the taxpayers' participation and the rental payments they received.

[88] 236 F.3d 410 (8th Cir. 2000) (discussing §1402(a)(1)'s "requirement that rents be 'derived under' such an arrangement" for the rents to be considered self-employment income), *rev'g* T.C. Memo 1999-333; *Hennen v. Commissioner*, T.C. Memo 1999-306; *Bot v. Commissioner*, T.C. Memo 1999-256. The IRS nonacquiesced to the Eighth Circuit's *McNamara* decision in 2003-42 I.R.B. 839. In its Action on Decision, the IRS identified factors that would determine whether it would litigate a particular case in the Eighth Circuit: (1) whether fair rental value was paid under the leases, (2) whether wages were paid pursuant to an employment agreement, and whether any wages paid were at fair value, (3) whether there would have been rental income absent the farmer's services, and (4) whether past practices suggest that the services would have been performed absent an employment contract. AOD 2003-03 (Oct. 20, 2003).

[89] T.C. Memo 2004-55. Here, as in *McNamara*, 236 F.3d 410, the taxpayers failed to prove that the rent received was at fair market value.

Practice Tip: As the relevant object of the §2032A inquiry is the real property (instead of the rental income itself), the *McNamara* nexus approach may not be applicable in the context of special use valuation. Nevertheless, the cautious practitioner should advise clients to ensure that any rental agreement explicitly requires material participation by the property owner or a member of his or her family, rather than relying on the broad interpretation of "arrangement" found in *Mizell*.

An example of a material participation farm lease can be found in Worksheet 9, below.

b. **Production** —

The §1402 regulations provide that "production" consists of both: (i) performing physical work, and (ii) providing capital. The owner cannot, however, establish material participation merely by undertaking to provide capital. There must also be some actual physical work performed if material participation is to be established based on production.[90]

[90] Reg. §1.1402(a)-4(b)(3)(iii).

c. **Management of Production** —

The §1402 regulations define "management of production" as "services performed in making managerial decisions relating to the production, such as when to plant, cultivate, dust, spray, or harvest the crop." This term encompasses "advising and consulting, making inspections, and making decisions as to matters such as rotating crops, the type of crops to be grown, the type of livestock to be raised, and the type of machinery and implements to be furnished."[91]

[91] Reg. §1.1402(a)-4(b)(3)(iii).

The regulations place a heavy emphasis on making inspections and periodic advising and consulting. The regulations further provide that undertaking to select crops and livestock to be produced, the type of machinery and implements to be furnished, or to make decisions as to rotating crops, generally is not of itself sufficient.[92]

[92] Reg. §1.1402(a)-4(b)(3)(iii).

Comment: In contrast with the regulations' emphasis on consulting and periodic inspections, when determining the presence of material participation in the context of the Social Security Act, the courts have emphasized ultimate decision-making authority.

The IRS Pub. 225, *Farmer's Tax Guide,* gives further indications of what constitutes material participation. The Guide provides that material participation occurs with respect to an arrangement if any of the following four tests is satisfied:

Test No. 1. The taxpayer does any three of the following: (1) pays, using cash or credit, for at least half the direct costs of producing the crop or livestock, (2) furnishes at least half the tools, equipment, and livestock used in the production activities, (3) advises or consults with tenants on issues like deciding what crops to plant, the type of seed or fertilizer to use, or when and at what price the crops should be sold, and (4) inspects the production activities periodically.

Test No. 2. The taxpayer regularly and frequently makes, or takes an important part in making, management decisions substantially contributing to or affecting the success of the enterprise. For example, the taxpayer makes or is involved in making decisions about when and where to plant or spray, when to harvest, what standards to follow, and what records to keep.

Test No. 3. The taxpayer works 100 hours or more in activities connected with agricultural production spread over a period of at least five weeks.

Test No. 4. The taxpayer does things which, considered in their total effect, show that the taxpayer is materially and significantly involved in producing farm commodities.[93]

[93] IRS Pub. 225, *Farmer's Tax Guide,* Chapter 12. This publication is revised annually, usually in October. The IRS also posts information on developments affecting IRS Pub. 225 at https://www.irs.gov/forms-pubs/about-publication-225. Four similar tests are presented by the Social Security Administration in the Social Security Handbook §1221–§1232 (available at https://www.ssa.gov/OP_Home/handbook/handbook-toc.html), although with important variations. For example, the SSA Test No. 1 substitutes the more subjective term "significant" where the IRS requires "at least half." The SSA Handbook continues by stating that "one-third or more" is generally "significant.".

Only Test No. 3 provides a quantitative standard for material participation. Test Nos. 2 and 4 are simply restatements of the "production" and "management of production" requirement. Test No. 1's standard for satisfying the combination "production/management of production" requirement is partly quantitative in that it specifies the percentage of financial contribution for certain factors of production. Overall, however, Test No. 1 is a subjective test.

3. **Social Security Act Material Participation** —

The Social Security Act contains provisions that parallel §1402(a)(1) in defining material participation. The underlying rationale of the Act is that when an individual's income is reduced because of an inability to work, a portion of the income should be replaced. Included in the types of income eligible for replacement is the income of farm owners and tenants if there was "material participation" by the farm owner or tenant in producing or managing the production of agricultural or horticultural commodities.

The provisions of §1402(a)(1) are almost identical to §211(a)(1) of the Social Security Act [94] and the corresponding regulations defining self-employment income of owners and tenants who produce agricultural and horticultural commodities. This apparent symmetry makes sense in that the funds to finance the benefits distributed under the Social Security Act are generated by the tax imposed by §1401.

[94] 42 U.S.C. §411(a)(1).

Even though §2032A(e)(6) only references §1402(a)(1), given the parallel language in §1402(a)(1) and SSA §211(a)(1) and the complementary purpose of the two sections, it is useful to examine the case law of material participation in the context of SSA §211(a)(1).[95] These cases typically involve the denial of Social Security benefits based on the government's position that the individual's income from a lease arrangement was not eligible for replacement because the individual was not materially participating with respect to the leased property.

[95] At least one court did so. See the discussion of *Mangels* at III.A.6.c., below.

a. **Production** —

Three cases from the Fifth Circuit indicate that the material participation requirement is satisfied if an arrangement requires a substantial financial contribution to producing agricultural or horticultural commodities. This position was first set forth in *Henderson v. Flemming* [96] in the following dictum:

[96] 283 F.2d 882, 888 (5th Cir. 1960).

> [W]e know at least today that agriculture is or may be big business. It takes more than land and a willing hand. It takes working capital, frequently in considerable amounts. An owner of land who is required to (and does) furnish substantial amounts of cash, credit or supplies toward this mutual undertaking which are reasonably needed in the production of the agricultural commodity and from the success of which he must look for actual recoupment likewise makes a “material participation.”

The above dictum was cited favorably in two other Fifth Circuit cases, *Celebrezze v. Miller* [97] and *Celebrezze v. Maxwell*.[98] In *Maxwell*, the court viewed a 25% financial contribution as proportionately small and concluded there was not material participation. Although there were other factors in *Henderson* and *Miller* that were absent in *Maxwell* (such as advice and consultation), both the *Henderson* and the *Miller* courts emphasized the financial contribution to find material participation.[99] Two district court cases are split on the position taken in *Henderson* that material participation can be established by financial contribution alone. In *Bridie v. Ribicoff*,[100] a district court approvingly cited *Henderson*, while the district court in *Bryant v. Celebrezze* [101] rejected that position.[102]

[97] 333 F.2d 29 (5th Cir. 1964).

[98] 315 F.2d 727 (5th Cir. 1963).

[99] *See also Harper v. Flemming*, 288 F.2d 61 (4th Cir. 1961), *aff'g* 185 F. Supp. 14 (E.D.N.C. 1960); *Vance v. Ribicoff*, 202 F. Supp. 790 (E.D. Tenn. 1961).

[100] 194 F. Supp. 809 (N.D. Iowa 1961).

[101] 229 F. Supp. 329 (E.D.S.C. 1964).

[102] *See also Celebrezze v. Wifstad*, 314 F.2d 208 (8th Cir. 1963).

Practice Tip: Because the regulations for §1402(a)(1) specifically indicate that merely providing capital will not constitute material participation and there is nothing in the §2032A regulations that would support a “capital only” qualification, one should not rely on providing substantial amounts of capital alone to establish §2032A material participation. Nevertheless, the Fifth Circuit cases indicate that when other factors are present, the extent of the capital provided may be relevant.

b. **Management of Production** —

The regulations under the Social Security Act emphasize inspections, advising and consulting to establish material participation by managing production. However, cases analyzing material participation by managing production place more emphasis on final decision-making authority.

In *Colegate v. Gardner* [103] and *Conley v. Ribicoff*,[104] the property owner undertook only limited inspections but made a substantial number of final decisions regarding material matters. In *Hoffman v. Gardner*,[105] a resident of Missouri and owner of Iowa farmland engaged in limited inspection and did not frequently advise or consult. The lease by its terms gave him complete managerial control which he exercised by telephone communication and mail. In all three cases, the courts found that there was material participation by production management based on the authority to make significant management decisions.[106]

[103] 265 F. Supp. 987 (S.D. Ohio 1967).

[104] 294 F.2d 190 (9th Cir. 1961).

[105] 369 F.2d 837 (8th Cir. 1966).

[106] *See also McCormick v. Richardson*, 460 F.2d 783 (10th Cir. 1972); *Foster v. Celebrezze*, 313 F.2d 604 (8th Cir. 1963); *Hoffman v. Ribicoff*, 305 F.2d 1 (8th Cir. 1962); *Rausch v. Gardner*, 267 F. Supp. 4 (E.D. Wis. 1967).

Comment 1: It is questionable how much weight should be placed on the Social Security Act cases. First, §2032A(e)(6) refers only to §1402(a)(1) and not to the comparable provisions in §211(a)(1) of the Social Security Act. While it seems reasonable to conclude that material participation would be given the same meaning under the Social Security Act and the Self-Employment Contributions Act of 1954, it may not follow that courts called upon to interpret §2032A material participation would be persuaded by analysis in the context of the Social Security Act. It is notable that the Eighth Circuit in *Mangels v. United States* cited with approval in its analysis of “material participation” an SSA §211(a)(1) case as it analyzed material participation in the context of §2032A.[107]

[107] 828 F.2d 1324 (8th Cir. 1987), citing *Foster v. Celebrezze*, 313 F.2d 604 (8th Cir. 1963).

Comment 2: Because the purpose of the material participation test is to limit access to the benefits of §2032A, which is an exception to the standard estate valuation procedures, the courts may be more hesitant to find the presence of material participation in the context of §2032A than under the Social Security Act.

4. **Material Participation and Passive Loss Restrictions** —

Enacted as part of the Tax Reform Act of 1986 (TRA 1986),[108] §469 seeks to curtail the use of various income tax shelter schemes by grouping a taxpayer's items of income, gain and loss by activity, classifying these activities as either “active” or “passive,” and then providing that losses from passive activities may not be used to offset income and gains from active activities. For purposes of this section, generally, the term “passive activity” means any activity involving the conduct of a trade or business in which the taxpayer does not materially participate.

[108] Pub. L. No. 99-514 (Oct. 22, 1986). For further discussion of passive activity losses and §469, see 549 T.M., *Passive Loss Rules* (U.S. Income Series).

The Senate Report to the TRA 1986[109] states that the §469 “material participation” requirement was derived from the existing standards under §1402(a) and §2032A, but was modified to take into account the purposes of the passive loss provisions. For example, the report indicates that in the case of farming, it is not necessary that the taxpayer perform physical labor, but the taxpayer must at least be liable for the §1402 self-employment tax to establish material participation. The examples given in the report indicate that Congress expected that a stricter standard be applied to material participation in the passive loss context, and Treasury took this approach in the regulations.

[109] S. Rep. No. 99-313, at 732-735 (1986), *reprinted in* 1986-3 C.B. vol. 3 (described as *Internal Revenue Cumulative Bulletin 1986 [5]* at https://www.govinfo.gov/app/details/GOVPUB-T22-1286c5320d83f63528466d064ff9ef02/GOVPUB-T22-1286c5320d83f63528466d064ff9ef02-3/context).

On the most subjective level, a taxpayer meets the §469 material participation requirement with respect to an activity only if he or she is involved in its operations on a regular, continuous and substantial basis.[110] In temporary regulations first issued in 1988 and subsequently amended in 1989 and 1992, the IRS expanded on this subjective determination to provide a more objective method for measuring material participation.[111] Accordingly, a taxpayer is considered to materially participate in an activity if his or her activities satisfy at least one of seven specific tests established by those regulations, only five of which appear to have any relevance in the context of special use valuations. Under each test, participation by the individual's spouse is counted as participation by the individual personally.[112] However, work that is not ordinarily performed by an owner of such an activity is not counted if the primary reason for doing such work was to avoid the disallowance of any loss or credit from such activity. Furthermore, unless the individual is directly involved in the day-to-day activity management, any investment work done by the individual is similarly not treated as participation.[113]

[110] §469(h)(1).

[111] Reg. §1.469-5T(a).

[112] Reg. §1.469-5T(f)(3).

[113] Reg. §1.469-5T(f)(2).

Under the temporary regulations, an individual is treated as materially participating in an activity if:

• The individual participates in the activity for more than 500 hours during the taxable year, and the individual owns an interest in the activity at the time the work is performed.[114]

• The individual's work constitutes substantially all the work performed in connection with the activity by all individuals involved during that tax year. Thus, a one-person operation satisfies the material participation standard, and it is irrelevant how few hours that individual spent participating in the activity.[115]

• The individual participates in the activity more than 100 hours during the taxable year, and his or her level of participation in the activity for the taxable year is not less than the participation in the activity of any other individual for such year.[116]

• The activity is a “significant participation activity,” and the individual's total participation in all such activities during the taxable year exceeds 500 hours. A significant participation activity is a trade or business activity in which an individual participates for more than 100 hours during the year and in which the individual does not materially participate under any other test.[117]

• Based on all of the facts and circumstances, an individual participates in an activity on a regular, continuous and substantial basis during the year.[118] A taxpayer cannot qualify as materially participating under the facts-and-circumstances test, however, unless he or she participates in the activity for more than 100 hours during the taxable year.[119] Also, an individual's services performed in managing an activity shall not be taken into account unless no other person is compensated for management services and no other individual performs management services exceeding the hourly total of such services performed by the taxpayer.[120]

[114] Reg. §1.469-5T(a)(1).

[115] Reg. §1.469-5T(a)(2).

[116] Reg. §1.469-5T(a)(3).

[117] Reg. §1.469-5T(a)(4).

[118] Reg. §1.469-5T(a)(7).

[119] Reg. §1.469-5T(b)(2)(iii).

[120] Reg. §1.469-5T(b)(2)(ii).

Unfortunately, the regulations fail to define "management services," and determining regular, continuous and substantial participation, as mentioned above, is a highly subjective standard.

The remaining two tests listed in the temporary regulations condition material participation in a given year based upon material participation in other years, which is inappropriate in §2032A applications.[121]

[121] *See* Reg. §1.469-5T(a)(5), §1.469-5T(a)(6).

In approving the above tests as the sole measures of determining material participation for the passive loss rules, Reg. §1.469-5T(b)(2) explicitly provides that the definition of material participation under other sections such as §2032A is irrelevant for purposes of §469, except in the case of certain retired individuals and surviving spouses participating in farming activities.[122]

[122] §469(h)(3); Reg. §1.469-5T(h)(2).

Thus, §2032A material participation is not conclusive for purposes of §469. However, given the express intention of Congress and the IRS in *narrowing* the definition of material participation for passive loss purposes, a finding of material participation for passive loss purposes will likely result in §2032A material participation. For example, in TAM 9428002 the National Office advised that a decedent's treatment of ranch losses as passive activity losses under §469 for income tax purposes was a "significant factor" in establishing the decedent's lack of material participation for §2032A purposes.

Comment: Section 469 and Reg. §1.469-4 provide detailed guidance for determining what constitutes a single activity for purposes of the passive loss rules. This level of detail is absent in §2032A and the regulations thereunder. Nevertheless, to the extent the quantitative tests of the §469 temporary regulations are used to demonstrate §2032A material participation, logical consistency would suggest that these tests be applied after grouping the decedent's activities according to the rules set forth in Reg. §1.469-4(c). For most estates, this is a nonissue, as the decedent is likely to have engaged in only a single activity under any reasonable definition. For decedents with diversified farming and/or business interests, however, the ability to bootstrap the §469 activity grouping rules into the §2032A context may determine whether material participation exists with respect to all, some, or none of the qualified use property.

More recently, material participation in the context of §469 and passive income and losses took on added importance with the enactment of §1411, the Unearned Income Medicare Contribution, or net investment income tax. [123] This 3.8% tax relies on the definitions of §469 to determine what taxpayer activities are subject to the tax.[124]

[123] *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, §1402. The 3.8% net investment income tax, effective for tax years beginning after 2012, cross-references the §469 passive activity rules in determining whether income from a trade or business is subject to the §1411 tax. The §1411 regulations provide guidance on the §469 and §1411 rules interaction (as well as on the §1411 and §1401 self-employment tax interaction). *See* Reg. §1.1411-0 to Reg. §1.1411-10. (generally applicable to tax years beginning after 2013). For

further discussion of §1411 and the regulations thereunder, see 507 T.M., *Income Tax Liability: Concepts and Calculation* (U.S. Income Series), and 852 T.M., *Income Taxation of Trusts and Estates.*

[124] §1411(c)(2).

5. **Former §2057 and Former §2033A Material Participation** —

Former §2057 was originally enacted as §2033A,[125] retroactively amended and renumbered as §2057 as part of the Internal Revenue Service Restructuring and Reform Act of 1998,[126] and formally repealed in 2014.[127] Former §2057 provided a $675,000 estate tax deduction for certain "qualified family-owned business interests" for estates of decedents dying after 1997 and before 2004.[128] Tax benefits under former §2057 were conditioned on meeting a material participation requirement, and former §2057(b)(1)(D)(ii) analyzed material participation by reference to §2032A(e)(6). The recapture provisions found at former §2057(f)(1)(A) similarly refer to the material participation recapture triggers of §2032A(c)(6)(B). As the entire structure of former §2057 closely parallels that of §2032A, it is likely that a finding of material participation in either context should result in a finding of material participation in the other and, similarly, that a finding of no material participation should be conclusive for both purposes. While no cases have directly focused on the material participation requirement in the former §2057 context, this conclusion is supported by several IRS letter rulings, each of which deferred to the statutory direction to apply the §2032A "material participation" standard when analyzing former §2057 issues.[129]

[125] Section 2033A was enacted as part of the Taxpayer Relief Act of 1997 and provided a $1,300, 000 gross estate *exclusion* for the value of certain "qualified family owned business interests" of the decedent. Pub. L. No. 105-34 (Aug. 5, 1997).

[126] Pub. L. No. 105-206. For further discussion of the provisions of former §2057, see 829 T.M., *The Family-Owned Business Deduction — Section 2057.*

[127] Tax Increase Prevention Act of 2014, Pub. L. No. 113-295, §221(a)(97) (Dec. 19, 2014).

[128] Former §2057(a).

[129] *See, e.g.,* PLR 200743031, PLR 200743027, PLR 200620020, PLR 200521001, PLR 200327016.

6. **Section 2032A Regulations: Material Participation**

a. **In General** —

The §2032A regulations discuss material participation in two contexts. First, where the individual is directly involved in managing the farm or business, the requirement is met if the individual is actually employed in managing the farm or business (i) on a full-time basis (35 hours or more per week) or (ii) to any lesser extent necessary personally to fully manage the farm or business, allowing for the seasonal nature of certain activities.[130] Second, if the activities are less than required for such "direct involvement," material participation must be pursuant to an arrangement providing for actual participation in the production or management of production, and must meet the standards prescribed by the §1402(a)(1) regulations.[131]

[130] In the case of a farming activity that is seasonal, material participation is present if all necessary functions are performed even though little activity occurs during nonproducing seasons. Reg. §20.2032A-3(e)(1).

[131] Reg. §20.2032A-3(e)(1). The regulations provide that, if no self-employment taxes were paid, material participation is presumed not to have occurred unless the executor establishes otherwise. Reg. §20.2032A-3(e)(1). *See* III.A.2., above.

The regulations also provide other clarifications. First, the activities of several individuals cannot be aggregated to result in a finding of material participation. At least one individual at a given time must be engaged in sufficient activities to constitute material participation.[132] Second, while a member of the family may materially participate, the individual must be a member of the family at the time the activities were carried out.[133] For example, activities of X's spouse prior to marriage cannot be counted as material participation by a member of X's family.

[132] Reg. §20.2032A-3(e)(1).

[133] Reg. §20.2032A-3(e)(1).

For purposes of the five-of-eight-years test, brief periods (e.g., periods of 30 days or less) during which there was no material participation may be disregarded if both preceded and followed by substantial periods (e.g., periods of more than 120 days) in which there was uninterrupted material participation.[134]

[134] Reg. §20.2032A-3(c).

The regulations provide that the factors to be considered in determining the presence of material participation are as follows:[135]

[135] Reg. §20.2032A-3(e)(2).

- physical work;
- participation in management decisions;
- regular advice and consultation on operating the business;
- regularly inspecting production activities;
- advancement of funds for the operation;
- financing a substantial portion of operating expenses (i.e., in the case of a farm, a substantial portion of machinery, implements, and livestock used in production activities); and
- maintenance of a residence on the premises.

While no single factor is determinative, the first two factors listed above are described as the “principal” factors. At a minimum, the decedent or family member must provide regular advice and consultation and participate in a substantial number of final management decisions.[136]

[136] Reg. §20.2032A-3(e)(2). *See also* PLR 9117046 (finding material participation where family members make all management decisions and perform substantially all physical work).

b. **Material Participation by Arrangement** —

If there was a farm manager employed to operate the farm, the regulations require the decedent or family member to personally materially participate under the terms of an arrangement with the farm manager in order to be considered a material participant.[137] Thus, even if there is an agent employed by the owner, it is still possible for the owner to satisfy the material participation requirement.

[137] Reg. §20.2032A-3(e)(2).

Although the regulations state that if involvement is less than full-time, there must be an arrangement providing for actual participation in the production or management of production. "Full-time" must be interpreted in the context of operating the specific farm or business. For example, if operating a farm does not require full-time efforts (35 hours per week or more), the "arrangement" requirement presumably does not apply if the individual personally and fully manages the business.[138] If the individual does not fully manage the farm or business, however, there must be an arrangement and the activities must satisfy the requirements of §1402(a)(1) and the §2032A regulations.

[138] Reg. §20.2032A-3(e)(1).

While the regulations provide that the arrangement may be oral, the regulations further provide that the arrangement must be formalized in a manner capable of proof.[139] A discussion of the required "arrangement" in the self-employment tax context is set forth in III.A.2.a., above.

[139] Reg. §20.2032A-3(e)(1).

Comment: The IRS argued that a special use valuation election was invalid because there was no "formal" arrangement when the arrangement was oral in nature and sufficient evidence of the arrangement was not provided.[140] Therefore, as a practical matter, the arrangement should be pursuant to a written document. Activities not contemplated by the arrangement will not be considered in determining the existence of material participation. Therefore, if the arrangement is in written form, it is important to include a sufficient number of activities to result in material participation.

[140] *See Finfrock v. United States*, 860 F. Supp. 2d 651 (C.D. Ill. 2012). In *Finfrock*, the service argued that a special use valuation election was invalid "because there was no formal arrangement calling for material participation by the decedent owner or a family member." In that case, the executor replied that although there was no written arrangement, there was an oral arrangement. The IRS conceded that an oral arrangement may satisfy the material participation requirement, but stated it required additional documentation before the IRS would abandon its argument.

c. **Material Participation Under Lease** —

A substantial amount of case law analyzed material participation by a landlord under a crop share lease. Because lease arrangements are frequently used both as a farmer nears retirement and in the post-death period, it is important to understand the elements that will qualify the lease as a material participation lease.

Reg. §20.2032A-3(e) specifies several factors to be considered in determining the presence of material participation. As a result, the cases that address the issue of material participation are fact intensive. It appears from the cases and private letter rulings that actual physical inspection and substantial input into the decision-making process are important.

(1) **Material Participation Found** —

In *Mangels v. United States*,[141] the Eighth Circuit, reversing the district court, held that activities of the landlord under a crop share lease arrangement would be enough to constitute material participation. The court also held that the activities of a court-appointed conservator would be attributed to the disabled decedent. In overruling the lower court, the court cited its decision in *Foster v. Celebrezze*.[142] As the *Foster* case arose under §211(a)(1) of the Social Security Act,[143] which provides replacement income to farm owners and tenants who materially participate in producing or managing the production of agricultural or horticultural commodities, it is significant that the court in *Mangels* indicated a willingness to equate material participation under the

Social Security Act and material participation under §2032A, augmenting the §2032A(e)(6) provision that material participation will be determined in a manner similar to that under §1402(a)(1). *Foster* and *Mangels* seem to suggest that it is inappropriate to set a standard that the landlord must participate beyond a normal amount for purposes of determining material participation with respect to both statutes.

141 828 F.2d 1324 (8th Cir. 1987), *rev'g sub nom. Foster v. Fleming*, 632 F. Supp. 1555 (S.D. Iowa 1986).

142 313 F.2d 604 (8th Cir. 1963), *rev'g* 190 F. Supp. 908 (N.D. Iowa 1960).

143 42 U.S.C. §411(a)(1).

The activities that constituted the landlord/conservator materially participating under the lease in *Mangels* were as follows:

- daily attention to farm market reports and executing futures contracts as required;
- physically inspecting the growing crops and the farm ground (approximately two hours per inspection) quarterly;
- monthly telephone or in-person contact with the tenant concerning operating problems (approximately one hour per month);
- annual sessions with the tenant concerning cropping decisions and the prospective year's operating plan (one and one-half to two hours per session);
- annual post-harvest analysis of the cash equivalent rental effect of annual crop share proceeds (approximately four hours annually); and
- occasional long-term management decisions.

The *Mangels* court determined that the activities of the landlord satisfied the two minimum requirements in the regulations of (i) regular consultation and (ii) substantial participation in final management decisions. The landlord jointly participated with the tenant in decisions concerning crop patterns and rotation; the level and formula of fertilizer application; chemical, weed and insect control; fence repair; plowing and minimum tillage techniques; seed and crop planting; and harvesting. In addition to the minimum requirements, two of the four additional factors in Reg. §20.2032A-3(e)(2) were present: regularly inspecting production activities, advancing funds, and assuming financial responsibility for a substantial portion of the farm's operating expenses. While the Commissioner argued that the inspections of only eight hours annually were inadequate, the court disagreed. Instead, it argued, the regularity requirement does not necessarily require expending a great deal of time nor frequent inspections. Rather, the sufficiency of the inspections must be measured against the total need for such inspections, as contemplated by Reg. §20.2032A-3(g) *Ex.* 7. The court also found that the landlord assumed financial responsibility and risk by paying one-half the fertilizer, pesticide, herbicide, and seed costs incurred in the farm operations.

The Tax Court in *Estate of Ward v. Commissioner* [144] found that there was material participation in a crop share rental arrangement where the landlord lived on the premises, inspected the crops on a regular basis, consulted directly with the tenant, and made decisions regarding harvesting and selling of her portion of the crops, independently of the tenant's decisions.

144 89 T.C. 54 (1987).

In PLR 8939031, the IRS found that the payment for all property taxes and irrigation equipment, the individual's harvesting of his or her crop share, and a share of the fertilizer used, and both living on and regularly inspecting the farm, in conjunction with fulfilling the two basic requirements, was sufficient to establish material participation under the regulations.

(2) **Material Participation Not Found** —

In *Estate of Coon v. Commissioner*,[145] the Tax Court found that material participation by the landlord was absent where the farm was leased to an experienced tenant and the only participation by the decedent or a member of the decedent's family consisted of:

[145] 81 T.C. 602 (1983).

- discussing with the tenant the planned crops for the succeeding year;
- directing the tenant where to purchase the landlord's share of seed and fertilizer;
- consulting with the tenant regarding improvements or major repairs to the property; and
- occasionally viewing the farm and checking for damage after storms.

The Tax Court held in *Estate of Coffing v. Commissioner* [146] that the decedent did not materially participate for purposes of §2032A where she neither lived nor worked on the farm and was only minimally involved in management decisions. The decedent employed a farm manager whose activities were not attributed to the decedent. After he was hired, the manager and the decedent implemented a basic plan for operating the farm, which was not subsequently changed. The decedent had discussions with the farm manager concerning the seeds, herbicides, or fertilizer to buy and when or where to market the crops. The farm manager visited with the decedent about once a month. On three occasions, the decedent was consulted concerning farm management proposals. The farm manager took the decedent by automobile to visit the farm. During those visits she made limited inspections. In a comparison with the facts in *Coon*, the Tax Court found that in both instances the decedent assumed financial responsibility for a substantial portion of the expenses involved in operating the farm; however, in both cases neither machinery nor implements were provided by the decedent nor did the decedent reside on the farm. In *Coffing*, the decedent inspected the production to a greater extent than in *Coon*. On the other hand, there was less involvement in the decision making in *Coffing*. Based on those findings, the Tax Court held that there was not material participation.

[146] T.C. Memo 1987-336.

In *Estate of Heffley v. Commissioner*,[147] the Tax Court held that the activities of the decedent and her son did not constitute material participation. The land in question was farmed under a combination of rental arrangements prior to death. Although the decedent lived on the property, neither the decedent nor her son participated in management decisions. The record indicated that the tenants made all important decisions about operating the farm. The tenants chose the brand of seed, fertilizer, and herbicide to be used and determined the proper crop rotation. They also determined the appropriate time for planting, tilling, and harvesting crops. They neither sought nor received the advice of the decedent or her son on such matters. Furthermore, neither the decedent nor her son regularly inspected the crops or assumed financial responsibility for any expense of operating the farm except for the incidental expenses of applying lime to the soil. The son performed occasional minor chores, but he did so as the tenant's employee and not as the decedent's family member.

[147] 89 T.C. 265 (1987), *aff'd*, 884 F.2d 279 (7th Cir. 1989).

Where real property is rented to an unrelated party for the conduct of a business, the material participation test is applied to the underlying business rather than the superimposed rental business. Thus, one cannot bootstrap into material participation in a rental context by arguing that the rental itself constituted a trade or business activity. In *Estate of Trueman v. United States*,[148] the Claims Court held that the decedent did not materially participate in the operation or management of two gas stations or a parking lot, which he had leased to unrelated third parties, where the decedent bore no part of the financial risk of the operation nor based its rent upon production.

[148] 6 Cl. Ct. 380 (1984).

d. **Material Participation Despite Failure to Pay Self-Employment Tax** —

Although the §2032A regulations presume that material participation is lacking where no self-employment tax was paid, special use valuation may still be available if the executor provides an explanation to the IRS and pays any applicable self-employment tax, interest and penalties.[149]

[149] Reg. §20.2032A-3(e)(1). For a more detailed discussion, see III.A.8, below.

7. **Material Participation: Real Property Owned by or Leased to an Entity** —

If a corporation, partnership, or trust owns or leases the real property, regulations require an arrangement calling for material participation by the decedent or member of the family.[150] In addition, the decedent's interest in the corporation, partnership, or trust must be an interest in a closely held business as defined by §6166(b)(1).[151] If the business is a partnership, §6166(b) requires that either 20% or more of the total capital interest in such partnership must be included in the gross estate of the decedent, or the partnership must have 45 or fewer partners. In the case of a corporation, either 20% or more in value of the voting stock of the corporation must be included in the gross estate of the decedent, or the corporation must have 45 or fewer shareholders.[152] There is no definition of interest of a closely held business in §6166(b) for a trust or estate.

[150] §2032A(g); Reg. §20.2032A-3(f)(1).

[151] §2032A(g); Reg. §20.2032A-3(b)(1). For a more detailed analysis of §6166, see X.A., and XIII.L., below, and 832 T.M., *Estate Tax Payments, Liabilities, and Liens (Sections 6161 and 6166)*.

[152] Prior to the enactment of Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, on June 7, 2001, the §6166(b) definitions of closely held partnership and closely held corporation limited the owners to 15. The EGTRRA amendments, increasing the number from 15 to 45, apply to estates of decedents dying after December 31, 2001, and thus, the 45-owner limitation is presumably applicable to decedents dying in 2002 or later for the entire pre-death period. Thus, if a decedent died in 2003 and had always materially participated in a partnership (or corporation) with 30 partners (or shareholders), the decedent's interest in the real property of such partnership (or corporation) would not be barred from special use valuation. EGTRRA's amendments of the §6166(b) partner/shareholder limits were made permanent by the American Taxpayer Relief Act of 2012 (ATRA), Pub. L. No. 112-240, §101(a)(1), §101(a)(3).

a. **Owned by Corporation or Partnership** —

Serving as an officer or director in a corporation, or a general partner responsible for the management of the partnership, will not necessarily establish material participation. Participating in the management and operation of the property is the determinative factor. If the position's established duties are enough to constitute material participation, the requirement is satisfied. Although as corporate employees such individuals are not subject to self-employment tax, the activities must be sufficient to subject the individuals to self-employment taxes were they self-employed. Regardless of whether the individual serves as an officer, director, or employee, the determinative factor is participation in the qualified real property's management and operation.[153]

[153] Reg. §20.2032A-3(f)(2).

The National Office advised in TAM 9220006 that a decedent's ownership of preferred stock in a corporation that owned and operated a ranch met the requirements for a §2032A election. The decedent owned more than 78% of the preferred shares, and his children and grandchildren owned the remaining preferred shares and the common shares. The preferred and common stock had equal voting rights. Noting that a passive interest is not generally eligible for §2032A valuation under Reg. §20.2032A-3(b)(1), the National Office advised that even though the preferred stock did not participate in the appreciation in the corporation, it was nevertheless an equity interest eligible for special use valuation on the facts at hand.[154]

[154] See the discussion at X.C. and X.D., below.

b. **Owned by Trust** —

The §2032A regulations provide that if a trust owns property, an arrangement can generally be found in one of four situations:[155]

[155] Reg. §20.2032A-3(f)(1).

- appointing the individual with material participation as a trustee;
- an employer-employee relationship in which the participant is employed by a qualified closely held business owned by the trust in a position requiring material participation;
- a contract with the trustee whereby the participant manages or takes part in managing the property for the trust; or
- granting management rights to the beneficial owner in the trust agreement.

As with corporate and partnership-owned property, the determinative factor with respect to activities rendered pursuant to the arrangement is participation in managing and operating the qualified real property itself.[156]

[156] Reg. §20.2032A-3(f)(2).

c. **Owned by Estate** —

In the post-death period when real property is held by an estate, material participation is determined in the same manner as if a trust held the property.[157]

[157] Reg. §20.2032A-3(f)(2).

d. **Leased to Entity** —

The regulations state:

> When real property is directly owned and is leased to a corporation or partnership in which the decedent owns an interest which qualifies as an interest in a trade or business within the meaning of section 6166(b)(1), the presence of material participation is determined by looking at the activities of the participant with regard to the property in whatever capacity rendered.[158]

[158] Reg. §20.2032A-3(f)(2).

If the qualified real property is leased by the decedent to an entity, the entity apparently must be a §6166(b)(1) closely held business with respect to the decedent. The regulations provide:

> Directly owned real estate that is leased by a decedent to a separate closely held business is considered to be qualified real property, but only if the separate business qualifies as a closely held business under §6166(b)(1) with respect to the decedent. . .[159]

[159] Reg. §20.2032A-3(b)(1).

Although the regulations expressly address only pre-death leasing by the decedent, in *Minter v. United States*,[160] the Eighth Circuit held that the §6166(b)(1) test set forth above should be used with respect to leasing by qualified heirs in the post-death period as well. The court did not appear to be concerned with the size of the interest in the closely held business. The court held the property interests were not subject to recapture where the decedent had held a 7% interest in the family farming corporation and the two qualified heir petitioners each held less than 6% interest therein.

[160] 19 F.3d 426 (8th Cir. 1994), *rev'g and remanding* No. 2:91-cv-00034, #35 (D.N.D. Sept. 28, 1992).

Comment: If the farm was leased to a nonfamily member, it would be possible to satisfy the qualified use and material participation requirements through a material participation crop share lease.[161] It seems that a material participation crop share lease to an entity should also qualify. There is no statutory justification for an additional requirement that the entity must be a §6166(b)(1) closely held business with respect to the decedent.

[161] *See* III.A.6.c., above.

8. **Material Participation and Self-Employment Tax** —

Most arrangements that contemplate material participation result in imposing the self-employment tax due to the relationship between §1402(a)(1) and §2032A. However, paying the self-employment tax does not conclusively prove the presence of material participation.[162] One cannot bootstrap oneself into satisfying the material participation test merely by paying the self-employment tax.

[162] Reg. §20.2032A-3(e)(1).

Alternatively, if no self-employment tax was paid, the presumption is there is no material participation unless the executor is able to satisfy the IRS that material participation did in fact occur, and informs the IRS why no tax was paid. If tax was due, all tax, interest, and penalties must be paid.[163]

[163] Reg. §20.2032A-3(e)(1).

In TAM 8207006, the National Office advised that an estate attempting to qualify for special use valuation did not have to pay all unpaid self-employment taxes if the §6501(a) three-year statute of limitations had run. Section 6501(a) provides that no tax may be assessed three years after the return was filed. If no return was filed, §6501(c)(3) provides that an assessment may be made at any time. In the case considered by the IRS, the taxpayer filed a Form 1040 for each year the self-employment tax should have been paid. The income and expenses were reported on Form 4835, *Farm Rental Income and Expenses*. The IRS held that because the taxpayer had filed Form 1040 for all years in question, a return had been filed for self-employment tax purposes and §6501(c)(3) would not apply. Therefore, §6501(a) would permit assessing and collecting unpaid self-employment tax only for the three-year period following the date the Form 1040 was filed. If no self-employment tax was paid and Form 1040 was filed, the most that the estate electing use value could be assessed would be the tax for the three-year period.[164]

[164] *See also* TAM 8244014, TAM 8052011, TAM 8046012.

The IRS later ruled in Rev. Rul. 83-32 that the requirement in Reg. §20.2032A-3(e) that all self-employment taxes be paid is limited to those self-employment taxes that can be assessed at the time of the determination. The voluntary payment of self-employment taxes after the expiration of the assessment period does not waive the statute of limitations but instead constitutes an overpayment subject to refund or credit. From that the IRS reasoned that self-employment taxes that would result in overpayment are not taxes determined to be due within the meaning of Reg. §20.2032A-3(e).

Practice Tip: Rev. Rul. 83-32 does not clarify when the executor must make the determination that an unpaid self-employment tax may no longer be assessed. Common sense would dictate that the date of filing the estate tax return is determinative, because that is when the special use election is made and should be the point in time at which the determination of whether any self-employment tax is due can be made.

Rev. Rul. 82-185 addressed the related issue of whether filing a Form 1040 begins the running of the three-year statute of limitations on the self-employment tax where no Schedule SE was filed. Distinguishing Rev. Rul. 79-39, which ruled that the filing of a Form 1040 did not trigger the limitation period where the taxpayer had failed to separately report the Social Security tax on unreported tip income, the IRS ruled that because the self-employment tax was an integral part of the income tax, the filing of a Form 1040 reporting all income would start the limitation period.

9. **Material Participation and Social Security Benefits** —

If the decedent personally meets the material participation requirement, §2032A(b)(4) provides that the five-of-eight-year material participation requirement is determined as of the decedent's date of retirement (receiving Social Security benefits) or disability, if the retirement or disability is for a continuous period before the decedent's death. Thus, it is possible for an individual to retire, not continue to materially participate, and still qualify for special use valuation, if for five or more of the eight years prior to the decedent's retirement or disability there was material participation.[165]

[165] §2032A(b)(4). Prior to passage of the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, (for decedents dying prior to January 1, 1982) if the material participation requirement was met by the decedent personally, the income from a material participation rental arrangement would satisfy the pre-death material participation requirements for §2032A, but would reduce Social Security benefits if the individual earned more than the maximum allowance. Alternatively, if the individual eliminated the material participation aspects of the rental arrangement to avoid a reduction in Social Security benefits, his or her estate would not satisfy the §2032A material participation requirements unless the land was rented to a family member as a tenant. Thus, the material participation requirement forced retired or disabled persons renting land to an unrelated tenant to choose between qualifying for use valuation or receiving Social Security benefits.

Comment: This exception permitting an individual to discontinue material participation before death is limited to a period of continuous retirement before death. Thus, a trap exists for the individual who retires, discontinues material participation, and then later comes out of retirement and resumes work. Under this scenario, the general rule requiring material participation for five or more of the last eight years before death applies and, therefore, the lack of material participation during the retirement period could cause the estate to fail to qualify for §2032A valuation.

Example: Frank Farmer materially participated with respect to Parcel X for 10 years prior to 2015. In 2015, Frank retired at age 62. Four years later in 2019, Frank came out of retirement and farmed for one year. In 2020, Frank again retired and in 2021 he died. To qualify, Frank must participate for five of eight years prior to death. Frank cannot meet the test. Under the facts of this example, Frank had not materially participated for five or more of the last eight years before his retirement that continued until death (the second retirement). Therefore, the first retirement period from 2015 through 2019 is not excepted from the material participation requirement. As a result, Frank's estate will not qualify for special use valuation.

10. **Material Participation by Conservator** —

The Eighth Circuit, in *Mangels v. United States*,[166] found that activities of a legally appointed conservator were attributable to the decedent for purposes of satisfying the material participation requirements of §2032A. Pursuant to court approval, the conservator entered into crop share leases with the tenant and performed decedent's obligations under the leases. The court found that it would be putting form over substance to consider the conservator's actions differently from those of the decedent merely because the regulation defining material participation did not include a phrase specifically addressing the statutorily created conservatorship.

[166] 828 F.2d 1324 (8th Cir. 1987).

11. **Material Participation and Government Programs** —

In informal guidance and letter rulings, the IRS determined that participation in a land diversion program sponsored by the Department of Agriculture will be treated as materially participating in the operation of a farm with respect to the diverted acres and will not adversely affect the decedent or his or her qualified heirs from electing and retaining use valuation treatment under §2032A.[167]

[167] Announcement 83-43, PLR 8330016 (federal Payment-In-Kind Program). *See also* PLR 8946023 (state conservation easement program), PLR 8802026, PLR 8745016, PLR 8743004, PLR 8729037 (federal Conservation Reserve Program), Notice 2006-108 (federal Conservation Reserve Program). *But see Morehouse v. Commissioner*, 769 F.3d 616 (8th Cir. 2014), *rev'g* 140 T.C. 350 (2013), (citing Rev. Rul. 60-32 and distinguishing *Wuebker*, Eighth Circuit held that government Conservation Reserve Program payments received by nonfarmer were rentals from real estate under §1402(a)(1) and, thus, not subject to §1401 self-employment tax), *nonacq.* 2015-41 I.R.B. For a discussion on planning for federal agricultural programs, see XIII.S., below.

12. **Exchanges or Involuntary Conversions** —

Section 2032A contemplates the possibility of either a §1031 like-kind exchange or a §1033 involuntary conversion in either the pre-death or post-death period. These rules were significantly modified by the Economic Recovery Tax Act of 1981 (ERTA)[168] for decedents dying after 1981 in order to provide for more liberal rules with respect to the tacking of time periods to satisfy the five-of-eight-year rule for ownership, material participation and qualified use. Unfortunately, Reg. §20.2032A-3(d) was not updated to reflect these changes and still reflects pre-ERTA law, by providing that these time periods run from the date the involuntarily converted or like-kind exchange property was acquired.

[168] Pub. L. No. 97-34, § 421(h)(1), *§421(j)(4).*

For decedents dying after 1981, the period of ownership of, use of, and/or participation in property disposed of in a §1031 exchange or as part of an acquisition that results in nonrecognition under §1033 may be tacked to that of the property acquired in the exchange or conversion to satisfy the qualified use test and the material participation test. The value of the replacement property eligible for tacking cannot exceed the value of property disposed of.[169]

[169] §2032A(e)(14)(B).

Example: Frank Farmer exchanged parcel X (100 acres) for parcel Y (200 acres). In addition to transferring parcel X, Frank gave $300,000 in cash. The value of parcel X on the exchange date was $100,000 and the value of parcel Y was $400,000. Material participation or qualified use of the exchanged property can be attributed to the qualified replacement property only to the extent of the fair market value of the exchanged property. Therefore, material participation and qualified use could be tacked from exchanged property to the qualified replacement property only with respect to one-fourth of the qualified replacement property.

If a decedent owned multiple tracts of property acquired in different years and converted through §1031 or §1033 to qualified real property, only the portion of qualified real property attributed to converted property that satisfies the five-of-eight-year test with tacking will be eligible for use valuation.[170]

[170] Rev. Rul. 81-285.

Example: Frank Farmer owned two tracts of farmland, X and Y, which were condemned in 2020. Frank received $100, 000 for tract X and $50,000 for tract Y. Prior to condemnation, Frank farmed tract X for 10 years and tract Y for three years. Frank acquired tract Z for $150,000 and died one year later in 2021. The proportionate share of tract Z attributable to tract Y will not satisfy the five-of-eight-year test with tacking. Therefore, only two-thirds of tract Z will satisfy the five-of-eight-year test.

Practice Tip: If there is an exchange or involuntary conversion of property subject to a §6324B lien, the designated agent should notify the IRS so that the lien can be transferred to the qualified replacement property.[171]

[171] PLR 8207050.

For additional discussion of involuntary conversions and like-kind exchanges in the post-death period, see VI.D.1.b. and VI.D.1.c., below.

13. **Conclusion** —

Establishing material participation is important both for qualifying for §2032A and for avoiding the recapture tax. The reference to §1402(a)(1), as guidance for determining material participation, is of only limited help, as the factual inquiry demanded by the §1402(a)(1) regulations was not well defined through case law interpreting that section. There is, however, considerable case law that analyzes material participation in the context of the Social Security Act. Although the language in §1402(a)(1) and SSA §211(a)(1) are almost identical, one should not assume that the liberal analysis of material participation in the context of the Social Security Act necessarily will be applied in the context of §2032A.

The factors that seem most influential in the Social Security Act cases[172] are assuming economic risk, significant financial commitments to the business's capital requirements, and final decision-making authority. Although the regulations in both the Social Security Act and the Self-Employment Contributions Act of 1954[173] place emphasis on advice, consultation, and inspections, the courts seem to place more significance on decision-making authority. The factors on which the courts and §2032A regulations seem to place the most significance are regular consultation and substantial participation in final management decisions. A pattern of on-site inspection and financial contribution also appears to be given substantial weight.

[172] *See* III.A.3., above.

[173] Pub. L. No. 83-761, also known as the Social Security Amendments of 1954.

Given that higher standards are required to establish material participation for purposes of §469, analysis of the law under §469 will be of limited use in defining material participation in the §2032A context. Nevertheless, §469 and the regulations thereunder do provide several objective tests for determining material participation that, if met, are likely to require a finding of material participation for special use valuation purposes.

It was suggested that the arrangement or lease should require involvement in making the following decisions:

- cropping patterns and rotation to be followed each year;
- levels of fertilization and formulae of fertilizer to be applied;
- participation or nonparticipation in government price/income support programs;
- plans for chemical weed and insect control, including type of chemical, rate of application and type of application (broadcast or band);
- soil and water conservation practices to be followed;
- scheduling of repairs to buildings, fences and tile lines;
- use of storage facilities as between landowner and tenant;
- changes in basic tillage practices (e.g., shift to minimum tillage);
- varieties of seed to be purchased;
- marketing of the landowner's share of the crop and coordinating delivery by the tenant; and
- with respect to livestock share leases, type of livestock production to be undertaken, level of production planned, nutrition and animal health plans, and marketing strategies.[174]

[174] Neil E. Harl, *Agricultural Law*, Vol. 2, §43.03[3][d][viii], pp. 43-160 to 43-161 (2008, updated semiannually).

Practice Tip: If material participation is being established by the owner pursuant to an arrangement/lease, the income should be reported on Schedule F rather than Schedule E of Form 1040. In addition, Schedule SE should be completed to report self-employment earnings arising from a material participation arrangement.

B. Active Management

If the taxpayer does not meet the requirements of material participation for §2032A, as more fully described in III.A., above, he or she may alternatively meet the active management requirement to qualify for the §2032A election.

1. **Active Management in the Pre-Death Period** —

It is common for one spouse to be intimately involved in operating a farm or closely held business, while the other spouse's business activities remain limited. If a surviving spouse acquired "qualified real property" from a spouse, "active management" by the surviving spouse is treated as material participation in applying §2032A to the surviving spouse's estate.[175]

[175] §2032A(b)(5). Prior to 1981, the fact that one spouse was more involved in operating the farm or closely held business than the other spouse created a significant disparity in the estate tax treatment of otherwise similar couples depending on the spouses' order of death. Where the primary participant died *last*, electing special use valuation posed little problem, especially considering the rules relating to retirement or disability. In contrast, where the materially participating spouse died *first*, and passed the closely held business to the survivor pursuant to the marital deduction, it was necessary for the survivor (or a member of the survivor's family) to increase his or her involvement in the business to preserve the possibility of electing special use valuation upon such survivor's death. To alleviate the perceived inequity in this result, the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, introduced the "active management" test as a substitute for material participation by the surviving spouse in determining whether the historical usage requirements are met. To be eligible for the pre-death active management test as a substitute for material participation, it appears that the first deceased spouse must have died after 1976 when §2032A became part of the Code.

Comment: The active management test provides another example of Congress narrowly tailoring the benefits of special use valuation based on specific fact patterns. Only the surviving spouse of a material participant, and not any other heir, is eligible to substitute active management to qualify property for special use valuation at the heir's subsequent death. Furthermore, the exception applies only to qualified real property acquired from or passed from the first spouse to die. Consider the classic serial ownership of Spouse 1, then Spouse 2, then Son. Generally, special use qualification for S1's estate is unnecessary due to the marital deduction, but critical for S2's estate. In this fact pattern, only S1 and Son would need to materially participate, but S2 need only actively manage.

2. **Active Management in the Post-Death Period** —

There is a narrow "active management" exception for the future usage (post-death) material participation requirement. Under §2032A(c)(7)(B) and §2032A(c)(7)(C), the material participation requirement to avoid the IRS imposing recapture tax is met by active management by a qualified heir who is a surviving spouse, a minor under the age of 21, a disabled individual, a student,[176] or a fiduciary for a minor or disabled heir.

[176] For this purpose, "student" is defined with reference to §152(f)(2) as an individual who, for five calendar months during the relevant taxable year "is a full-time student at an educational organization described in section 170(b)(1)(A)(ii)" or "is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational organization described in section 170(b)(1)(A)(ii) or of a State or political subdivision of a State." §2032A(c)(7)(D).

3. **Requirements of Active Management** —

The Senate Finance Committee Report for Economic Recovery Tax Act of 1981[177] provides that the active management requirement can be met even though no self-employment tax is payable under §1401.[178] Therefore, if the Committee Report position is adopted by the IRS, a surviving spouse could lease the qualified real property pursuant to an active management rental arrangement, satisfy the pre-death and post-death material participation requirements with respect to real property acquired from or passed from the deceased spouse, and not have the §1401 self-employment tax imposed on the income earned from the rental arrangement.

[177] Pub. L. No.

[178] S. Rep. No. 97-144, at 134 (1981), *reprinted* in 1981-2 C.B. 412. But note that "material participation" is defined to include liability for the self-employment tax. §2032A(e)(6).

Active management is defined by §2032A(e)(12) as the making of the management decisions of a business, other than daily operating decisions. The House Committee Report provides that, in the farming context, combinations of the following activities constitute active management:

> [I]nspecting growing crops, reviewing and approving annual crop plans in advance of planting, making a substantial number of the management decisions of the business operation, and approving expenditures for other than nominal operating expenses in advance of the time amounts are expended. Examples of management decisions are decisions such as what crops to plant, or how many cattle to raise, what fields to leave fallow, where and when to market crops and other business products, how to finance business operations, and what capital expenditures the trade or business should make.[179]

[179] H.R. Rep. No. 97-201, at 170-171 (1981), *reprinted* in 1981-2 C.B. 352.

A surviving spouse's active management may be tacked to a deceased spouse's material participation to satisfy the five-of-eight-year material participation requirement.[180] A surviving spouse can tack even though there was an intervening period with no material participation by the deceased spouse prior to death during a continuous period of retirement or disability.

[180] §2032A(b)(5)(C).

Example 1: Assume that B dies two years after A (B's spouse), in whose estate Whiteacre was eligible for special use valuation. B engaged in the active management of Whiteacre during the two years following A's death. A was retired for five years immediately before A's death but had materially participated in Whiteacre's operation for eight years before her retirement. The six most recent of the eight years before A's retirement will be considered with B's two years of active management for purposes of satisfying the five-of-eight-year period pre-death material participation requirement for B's estate.[181]

[181] H.R. Rep. No. 97-201, at 170 (1981), *reprinted* in 1981-2 C.B. 352.

TAM 200911009 cites the House Committee Report example and expands it to apply to a situation where the surviving spouse was retired from the activity. In the TAM, the National Office advised that material participation existed for a farmer's surviving spouse when the farmer materially participated for five of the eight years preceding a farmer's retirement and the spouse was already retired at the time of the farmer's death.

Example 2: Assume the same facts as in Example 1 except that B did not engage in the active management of Whiteacre after A's death because B was already retired upon A's death. The eight years before A's retirement will be considered for purposes of satisfying the five-of-eight-year period pre-death material participation requirement for B's estate.

Estates, Gifts and Trusts Portfolios
Estates, Gifts and Trusts Portfolios: Valuation
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Detailed Analysis
III. Definitions

C. Qualified Use

In addition to material participation, the qualified use requirement is the other principal gate that limits access to the benefits of special use valuation. A qualified use of real property is (i) use as a farm for farming purposes or (ii) use in a trade or business other than farming.[182]

[182] §2032A(b)(2). The distinction between a "farm" and other trades or businesses is only important for the required valuation method. While farms may be valued using either a capitalization of rents method or a five-factor method, other trades or businesses must use the five-factor method. *See* IV.C., below.

1. **Farm vs. Closely Held Business** —

The legislative history of §2032A indicates Congress's intent to limit the benefits of special use valuation to real property subjected to a trade or business use.[183] In order to limit applying the "capitalization of rents" method of special use valuation to farm property, however, the statute distinguishes between property used as a farm for farming purposes and property used in a trade or business other than farming.[184]

[183] H.R. Rep. No. 94-1380, at 21, 23 (1976).
[184] §2032A(b)(2).

Section 2032A(e)(4) defines a farm as including "stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands."

A farming purpose is defined as:

- cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;

- handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and

- either the planting, cultivating, caring for, or cutting of trees, or the preparation (other than milling) of trees for market.[185]

[185] §2032A(e)(5).

Neither revenue from the sale of farmable land nor revenue derived from the sale of development rights attached to such land constitute income from the trade or business of farming for the purposes of §2032A(e)(5).[186]

[186] *Rutkoske v. Commissioner*, 149 T.C. 133 (2017) (where farmers conveyed conservation easement in bargain sale to qualified exempt organization and sold remaining interest in

underlying land to third party, Tax Court held that these sales are not activities listed in §2032A(e)(5), and therefore proceeds from these sales do not constitute income from the trade or business of farming for purposes of §170(b)(1)(E)(v)).

The House Committee Report for the Tax Reform Act of 1976 indicates that the activities conducted on the real property are determinative of whether the real property was used as a farm for farming purposes.[187] Consistent with this notion, the IRS held that real property used for a hunting operation is not property used for farming purposes.[188]

[187] H.R. Rep. No. 94-1380, at 21, 23 (1976).

[188] TAM 8516012. While not referenced in §2032A or its accompanying regulations, the definition of "farming business" provided in Reg. §1.263A-4(a)(4) may also provide guidance on how the Treasury Department defines farms.

2. **Land, Buildings and Other Property** —

In addition to land, qualified real property devoted to a qualified use may include a residence on the real property occupied on a regular basis by the owner, lessee, or an employee of the owner or lessee for the purpose of operating the farm or business.[189] A farm residence occupied by the decedent owner of the specially valued property is considered to be occupied for the purpose of operating the farm even though a family member (not the decedent) was the person materially participating in the operation of the farm.[190] Also included are roads, buildings and other structures and improvements functionally related to the qualified use. The regulations interpret this to require use or occupation on a regular basis for the farm or business purpose.[191]

[189] §2032A(e)(3).

[190] Reg. §20.2032A-3(b)(2).

[191] Reg. §20.2032A-3(b)(2).

The buildings must be devoted to the qualified use.[192] The Claims Court held that a residential dwelling that is leased to a third party is not qualified real property.[193] The court reasoned that there was "no devotion" of the property by the decedent to any business use, as required by §2032A(b)(2). The court pointed out that the issue is the actual physical use to which the property is put and not merely the relationship of the property as a profit source for the owner.

[192] §2032A(b)(2).

[193] *Estate of Trueman v. United States*, 6 Cl. Ct. 380 (1984); *see also Estate of Geiger v. Commissioner*, 80 T.C. 484 (1983); PLR 8306049.

A mineral interest located on the qualified real property does not qualify for special use valuation and should be reported separately at fair market value. In Rev. Rul. 88-78, the IRS ruled that if a royalty interest in mineral deposits on the property was separately reported at fair market value, there would be no recapture upon its subsequent disposition. Conceivably a working mineral interest could qualify for special use valuation, but it is unlikely that its special use value as a working mineral interest would be any less than its fair market value. Citing Rev. Rul. 88-78, the National Office advised in TAM 9443003 that the land and buildings constituting a stone quarry qualified for §2032A valuation, but that the value of the stone in the quarry (i.e., the mineral interests) must be included in the decedent's estate at its fair market value.

Groundwater underneath specially valued pastureland is also generally not a part of the qualified use. In PLR 200608012, the IRS ruled that selling specially valued land's groundwater would not trigger the recapture tax where the §2032A election did not include groundwater rights and the specially valued land was mostly pastureland that did not need irrigation.[194]

[194] The property specifically used to remove groundwater, however, was subject to the recapture tax. See discussion in VI.D.1.g., below.

The Eleventh Circuit held that pastureland and cropland that on their own could not qualify for special use valuation cannot be considered as qualified adjacent timberland because the properties were not “functionally related.”[195]

[195] *Estate of Sherrod v. Commissioner*, 774 F.2d 1057 (11th Cir. 1985), *rev'g* 82 T.C. 523 (1984). See discussion at III.C.6.b.(2), below.

3. **Special Rule for Woodlands** —

The executor of an estate can elect that the trees growing on a qualified woodland be treated as part of the woodland rather than a growing crop.[196] To be a qualified woodland, the woodland must be an identifiable area used as a timber operation for planting, cultivating, caring for, and cutting trees, or preparing trees for market (not milling).[197] The election must be made at the time the federal estate tax return is filed and is irrevocable.[198]

[196] §2032A(e)(13). *See, e.g.*, FSA 199924019. This is applicable to deaths after 1981. Before 1981 and the passage of the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, the IRS ruled in TAM 8046012 that merchantable timber and young growth should not be considered a part of qualified real property, but rather should be valued at fair market value as growing crops.

[197] §2032A(e)(13)(B).

[198] Reg. §22.0(a) provides detailed guidance on making the election. The election is made with the estate tax return and must specify both the property subject to the election and such information as may be necessary for the IRS to determine whether the election was proper.

4. **Community Property** —

If at the time of death the decedent and the surviving spouse held qualified real property as community property, §2032A(e)(10) provides that “the interest of the surviving spouse in such property shall be taken into account . . . to the extent necessary to provide a result . . . with respect to such property which is consistent with the result which would have obtained . . . if such property had not been community property.”

For purposes of §2032A, community property is treated as if the property were wholly owned by the decedent in his or her individual capacity. The community property's full value will be considered for purposes of satisfying the 50% and 25% tests. In technical advice,[199] the National Office advised that where one-half of all community property assets are included in a noncontributing (within the meaning of §2040(a)) predeceasing spouse's gross estate, the reduction limit under §2032A(a)(2) applies in full against the decedent's one-half community property share.

[199] TAM 8227014; *see also* TAM 8301008, TAM 8229009 and TAM 8023027.

5. **Point-in-Time and Period Tests** —

Unlike material participation, the qualified use test is both a point-in-time test[200] and a period test.[201] There must be a qualified use both at the *point in time* of death and over a *period* comprised of five or more of the eight years prior to death. In contrast, material participation is solely a period test because it is required only for five of eight years prior to retirement, disability, or death.[202]

[200] §2032A(b)(1)(A)(i); *see also* TAM 8435013, TAM 8435008.

[201] §2032A(b)(1)(C)(i).

[202] §2032A(b)(1)(C)(ii).

An example of a cash lease arrangement that failed both qualified use tests is found in *Estate of Heffley v. Commissioner*.[203] There, the lease provided for the payment of a specified amount of cash and a specified number of bushels of a commodity. The taxpayer failed both the period and point-in-time tests because her §2032A farm was rented to a nonfamily member at the time of her death and for four of the five years prior to her death.[204]

[203] 884 F.2d 279 (7th Cir. 1989), *aff'g* 89 T.C. 265 (1987).

[204] No qualified use was found due to the lack of an "equity interest" under the lease. See III.C.6., below, for a discussion of leasing arrangements under the "equity interest" rules.

In *Brockman v. Commissioner*,[205] the dispute focused on whether the pre-death five-of-eight-year test for qualified use was met with respect to 100 acres of a 443-acre farm. At audit, the IRS agreed that the decedent's family had used 343 acres for a qualified use, with material participation, for the eight years before his death. However, the IRS disallowed special use valuation for the 100 acres that had been leased to a neighbor for cattle grazing as a fixed cash rental for five summers and was not used during the winter months. The Tax Court held that, because the rental periods totaled less than 36 months, the estate had met the five-of-eight-year test. Reversing, the Seventh Circuit held that unproductive months (the winter months) may be counted as qualified use periods only when the decedent or his or her family member actually used the property during the productive months. Here, the family's activities during the winter months did not expose the family to any farming risks, thus indicating a landlord's role and a lack of qualified use.[206]

[205] 903 F.2d 518 (7th Cir. 1990), *rev'g sub nom. Estate of Donahoe v. Commissioner*, T.C. Memo 1988-453.

[206] See the discussion of the equity interest requirement at III.C.6., below.

Both parts of the qualified use test were satisfied in TAM 9433003, even though the decedent, at the time of his death, was planning to develop as residential real estate unimproved land used in a horse boarding and riding business, had entered into a contract with a land development company to begin the necessary planning and engineering, and had applied for a preliminary subdivision plan. The National Office advised that (i) the horse operation began in 1985 and continued uninterrupted until the decedent's death in 1991, and (ii) at no time during the decedent's life was any physical action taken that prevented the land from being used in the horse operation business.

In the post-death period, the continuous qualified use requirement is tempered by a grace period of up to two years after death.[207] To the extent the grace period is used, however, the recapture period is extended for a like time.[208]

[207] §2032A(c)(7)(A). See III.C.7., below, concerning the grace period.

[208] §2032A(c)(7)(A)(ii).

6. **Equity Interest "At Risk" vs. Passive Interests**

a. **In General** —

In order to be eligible for §2032A valuation, *either* the decedent *or* a member of the decedent's family must use the property for a qualified use during the pre-death period. The regulations state that the decedent or a member of the decedent's family must hold an "equity interest in the farm operation."[209] Thus, the qualified use test can be satisfied if the decedent had cash rented the farm to a family member,[210] as the renting family member would maintain the required "equity interest." In contrast, the decedent's passive rental to any other party is insufficient to maintain §2032A eligibility.[211]

[209] Reg. §20.2032A-3(b)(1). Note that, prior to ERTA, §2032A did not expressly provide for pre-death qualified use by a member of the decedent's family. When the IRS issued proposed regulations regarding the "equity interest" rule in 1980, the proposed regulations required that the equity interest be held by the decedent. This created a problem in that the common procedure of cash renting the family farm to a child would not satisfy the equity interest aspect of the qualified use test. Accordingly, the IRS announced in April 1981 that the qualified use test could be satisfied in the predeath period by the decedent or a member of the decedent's family. IRS News Release *IR 81-147* (Apr. 27, 1981). This policy was then codified by ERTA and is reflected in the present regulations. Note that no such change was made to the qualified use test applicable to the post-death period.

[210] TAM 8803004, TAM 8735001, TAM 8652005, TAM 8540003, PLR 8508081, TAM 8435013, TAM 8435008, PLR 8408020, TAM 8201016.

[211] Reg. §20.2032A-3(b)(1).

In the post-death period, however, the qualified use test must be satisfied by continuous qualified use by the qualified heir.[212] Unlike in the pre-death period, the post-death test cannot be satisfied by a member of the qualified heir's family maintaining an equity interest.[213] Therefore, it is not possible to qualify by cash renting to members of the qualified heir's family in the recapture period, except during the two-year grace period following death or under the special §2032A(c)(7)(E) provisions allowing qualified heirs who are also the decedent's surviving spouse or a lineal descendant to cash rent special use property to family members of such qualified heirs.[214]

[212] §2032A(c)(1)(B).

[213] TAM 8240015.

[214] The two-year grace period is discussed in III.C.7., below. For a more specific discussion on applying the equity interest rule to post-death recapture, including the §2032A(c)(7)(E) surviving spouse and lineal descendant exception, see VI.D.2.b.(2), below.

Practice Tip: It is inadvisable for a member of the qualified heir's family merely to pay a cash rent or use the property in the post-death period without compensation. The qualified heir must have something at risk. If there is nothing at risk, the IRS may take the position that there is not an "equity interest in the farming operation."[215]

[215] TAM 8108004 (pre-ERTA denial of special use valuation when decedent allowed lineal descendants to use land rent free).

b. **Lease Arrangements** —

Like material participation, the elements of qualified use in a lease arrangement have been subject to substantial analysis in case law and IRS rulings. Understanding the elements of qualified use in the context of a lease is important for qualifying the estate for special use valuation in the pre-death period and avoiding recapture in the post-death period. The analysis in the rulings and cases gives an indication of the elements that must be present to satisfy the qualified use test.

(1) **Crop Share** —

If the landlord leases farmland to a nonfamily member pursuant to a crop share lease in which the landlord shares in the economic risk of the farm operation, the qualified use test should be satisfied.[216] The lease would also have to be a material participation crop share lease to satisfy material participation requirements.

[216] *See, e.g.*, PLR 9033030 (finding qualified use under farming share lease where

lessee farmed but decedent equally shared all expenses, profits and losses).

To satisfy the “equity interest” requirement, the decedent or the decedent's family member in the pre-death period, and the qualified heir in the post-death period, must have something at risk. A standard crop share lease should satisfy the “equity interest” requirements set forth in the regulations. In a crop share lease, the landlord shares in the expenses and the crops produced. Two types of business risks are present under a crop share lease: (i) a market risk attributed to changes in market price for the crops or livestock produced; and (ii) production risk relating to quantity produced, which is dependent upon such factors as weather and management skills. There are numerous variations to the standard crop share lease. Most of those variations result in shifting risk from the landlord to the tenant. As the landlord shifts risk to the tenant, there is less assurance that the equity interest requirement will be satisfied.

(2) **Cash Rent** —

At the other end of the spectrum, except for (i) leases by the decedent to a member of the decedent's family in the pre-death period, (ii) leases during the two-year grace period, or (iii) leases by a surviving spouse or lineal descendant in the post-death period to a member of such surviving spouse or lineal descendant's family, if the farmland is leased through an ordinary cash rent lease, the qualified use test ordinarily will not be satisfied.[217]

[217] *See, e.g.*, *Hohenstein v. Commissioner*, T.C. Memo 1997-56 (initiating cash lease arrangement to unrelated parties during recapture period triggers recapture).

In *Estate of Sherrod v. Commissioner*,[218] the Eleventh Circuit reversed the Tax Court's finding that certain pastureland and cropland owned by the decedent were used for a qualified use. The decedent's land was divided into the following three categories: (i) 270 acres of cropland partially rented under a cash lease, (ii) 1, 108 acres used for timberland, and (iii) 100 acres of pastureland partially rented under a cash lease. As the timberland was in a state of natural forestation and the decedent had inspected it at least twice annually, the IRS conceded that it was qualifying real property.[219] The court held that the cropland and pastureland were not employed in an active trade or business and therefore did not satisfy the qualified use test.[220] As a result, the 26% of the overall adjusted gross estate held as the timberland did not satisfy the 50% test of §2032A(b)(1)(A) and the timberland failed to qualify for alternate valuation.[221]

[218] 774 F.2d 1057 (11th Cir. 1985), *rev'g* 82 T.C. 523 (1984).

[219] *See also* IRS NSAR 20250 (Dec. 2, 2002) (“[I]t is clear that forestry is treated as farming.”).

[220] The executors argued, and the lower court supported, the position that it is irrelevant that the activity with respect to an isolated part of the enterprise does not meet the required standard so long as the sum of the activities constitutes a trade or business. The Eleventh Circuit pointed out that real property, such as the pastureland and cropland, physically connected to qualifying farmland is not automatically classified as qualifying real property for purposes of §2032A and that §2032A(e)(3) provides that nonqualifying real property must be “functionally related” to other qualifying real property.

[221] For a discussion of the §2032A(b)(1)(A) rules applied in *Sherrod*, see II.A.3., above.

In *Estate of Trueman v. United States*,[222] the decedent rented two residences, a parking lot, and two gas stations to unrelated parties. The court held that such a passive rental income business did not amount to a qualified use under §2032A, even though the gas stations and parking lot operations by the unrelated parties were active businesses that themselves would be qualified under the statute. Similarly, the two residences, which were rented solely as dwellings, could not be treated as qualified real property under §2032A(e)(3). The court reasoned there was no "devotion" of the property to any business use.

[222] 6 Cl. Ct. 380 (1984).

(3) **Mixed** —

The IRS issued a series of private letter rulings and the National Office issued technical advice memoranda which, together, illustrate the permitted boundaries of a rental based at least in part on a percentage of income. In TAM 8516012, the National Office advised that where lease payments are based upon a percentage of the operation's income, the lease payments are dependent on production, and therefore, the property is used in a trade or business for §2032A purposes. It is notable that the National Office's position might have been different if the initial installment was a fixed minimum. In PLR 8639022, the IRS found that a rental based on a percentage of income with a cap on the total rent earned satisfied the qualified use test. In another arrangement where the farm was leased for a base rent of $50.00 per tillable acre plus 5% of profits, the National Office advised that the equity interest requirement was not satisfied.[223]

[223] TAM 8652005.

Practice Tip: A lease with a fixed minimum rent may not satisfy the equity interest requirement and, as a result, fail the qualified use test.

In a letter ruling, the IRS ruled that where the landlord receives the first X bushels of grain, but cannot receive more than the crop amount produced, the landlord satisfies the qualified use test. The IRS stated that because the landlord's return was contingent upon what the land produced, the landlord had an "equity interest in the farming operation."[224]

[224] PLR 8217193.

The National Office, in a technical advice memorandum,[225] advised that the landlord did not have sufficient risk to satisfy the equity interest requirements under a hybrid crop share lease arrangement. The lease formula was based on a two-tier computation. The first tier determined a base payment to the landowner. This payment was determined by multiplying 50% of the total acres leased, the hypothetical yield for market corn, and the average price of market corn for May delivery on the commodity grain futures market quoted by the Chicago Board of Trade during the preceding month of December. The landlord would receive this base payment regardless of the farm's yield, except if there was no hybrid seed corn harvested by the tenant on the farm during the crop year. In addition to the base payment, the landlord would receive a second-tier payment. This additional payment used the actual tenant's average seed corn production on all the farms it operates. For the first 16 bushels of the average production, the landlord would receive one-half of the number of bushels multiplied by twice the same price of May futures used in the first-tier calculation. For all bushels over 16, the landlord would receive one-half of the number of bushels multiplied by the same first-tier futures price.

[225] TAM 8230007.

The National Office advised that although the price for the crop was not fixed at the time the lease was entered into, the decedent did not bear a substantial risk as to the farming operation's production.

In *Estate of Heffley v. Commissioner*,[226] the Tax Court and the Seventh Circuit held that a lease that provided for a specified cash payment and a commodity's specified number of bushels did not satisfy the qualified use test. The court's rationale was that income was not dependent upon production. The only risk was the price risk for the commodities. Price risk was not enough to satisfy qualified use.

[226] 884 F.2d 279 (7th Cir. 1989), *aff'g* 89 T.C. 265 (1987).

In *Schuneman v. United States*,[227] the Seventh Circuit reversed the district court and held that rent received under a cash lease to an unrelated party satisfied the qualified use requirement of §2032A because a rental adjustment clause effectively shifted part of the farming risk to the decedent, and amounts paid under the lease were substantially dependent upon production. The lease provided for two different levels of cash rent with the applicable level being determined by yield and price for the lease year.[228] The district court had held that the passive rental of the farmland at the decedent's death did not satisfy the "qualified use" requirement.

[227] 783 F.2d 694 (7th Cir. 1986), *rev'g and rem'g* 570 F. Supp. 1327 (C.D. Ill. 1983). *See also Bruch v. United States*, 86-2 USTC ¶ 13,692, *86-2 USTC 86,244* (N.D. Ind. 1986).

[228] In AOD 1986-047, the Chief Counsel's Office recommended against seeking certiorari in *Schuneman*. However, the AOD stated that the court's emphasis on whether the rent adjustment clause was likely to be triggered was erroneous. The Chief Counsel explained that such an analysis is administratively impractical and that a better approach would be to focus on the lease arrangement itself. The Chief Counsel added that the court erred in stating that the decedent would have satisfied the qualified use test if, at the time of her death, she materially participated in operating the farm or that her rental income was substantially dependent upon farm production. Citing, inter alia, *Estate of Sherrod v. Commissioner*, 774 F.2d 1057 (11th Cir. 1985), the Chief Counsel's Office explained that qualified use and material participation are separate requirements, both of which must be satisfied to qualify for special use valuation.

As is made clear by several cases and rulings, participation in activities alone is not enough to demonstrate an "equity interest." The lessor must maintain an economic stake in the overall operations, consistent with entrepreneurial activity. As framed in *Shuneman*, "We can answer this question by determining whether she had assumed risk under the lease substantially approaching the risk that she would have incurred had she farmed the land herself".[229] Where a cash rent lease required the landlord to undertake certain limited responsibilities, the National Office advised that there was not an "equity interest in the farming operation."[230]

[229] 783 F.2d 694, 700 (7th Cir. 1986).

[230] TAM 8201016.

In another case involving the rental of otherwise qualified property to an unrelated third party, the Tax Court[231] adopted the reasoning of the Claims Court in *Estate of Trueman v. United States*,[232] in ruling that qualified use applies to the underlying use to which property is put rather than the derivative use to which rental property is put. Thus, leasing a cattle ranch to an unrelated corporation for cattle operations at a fixed sum did not qualify the ranch for §2032A treatment, even though the individual lessor continued to live on the ranch and was primarily responsible for its maintenance and upkeep during the lease's term.

[231] *Estate of Abell v. Commissioner*, 83 T.C. 696 (1984).

[232] 6 Cl. Ct. 380 (1984). *Estate of Trueman* is further discussed in III.C.6.b.(ii), above.

In *Martin v. Commissioner*,[233] the Tax Court followed its decision in *Abell* and held that the cash lease of the decedent's farmland to an unrelated party ended the farm's qualified use by a qualified heir and thus triggered the §2032A(c)(1)(B) recapture tax. In *Martin*, the decedent bequeathed to seven heirs, as tenants in common, a 209-acre family farm. At the decedent's death, the farm was leased to his son-in-law on a sharecrop basis. After the decedent's death in 1978, the executor elected special use valuation for the property. The executor terminated the sharecrop lease, and in August 1979, entered a one-year cash lease of the entire tillable portion of the farm with an unrelated third party. The rental was not based upon the level of crop production from the farm; instead it involved a flat fee based on the number of tillable acres.

[233] 84 T.C. 620 (1985), *aff'd*, 783 F.2d 81 (7th Cir. 1986).

While the cash lease was in effect, the lessee conducted the farming operation with the lessee's own equipment. Two of the heirs performed maintenance and operational duties and a third heir (the executor) regularly conferred with the lessee, providing advice regarding crop locations, plowing and fertilizing methods, etc. At the end of the cash lease, the lessor executed a sharecrop lease with the same lessee for approximately 143 acres. The court held that the recapture tax was due, because a qualified use must be a trade or business use, and not merely a passive rental.

The Seventh Circuit, in affirming the Tax Court's decision in *Martin*, relied heavily upon the legislative history of §2032A [234] and gave substantial weight to the fact that Reg. §20.2032A-3 closely followed the committee reports in stating that “the mere passive rental of property to a party other than a member of the decedent's family will not qualify.”

[234] H.R. Rep. No. 94-1380, at 21-23 (1976); H.R. Rep. No. 97-201 (1981); S. Rep. No. 97-144 (1981).

The Tax Court in *Hight v. Commissioner* [235] held that a surviving spouse/executrix's net cash leasing ended qualified use, rejecting the taxpayer's argument that her frequent visits to the ranch met the physical or financial participation threshold expounded in *Martin*.

[235] T.C. Memo 1990-81.

In *Brockman v. Commissioner*,[236] the fixed cash rental of pastureland to an unrelated party was found not to be a qualified use. The family did pay for and physically participate in upkeep during the winter months, but this was not enough to give them an economic stake in the actual farming operations. Citing *Sherrod*, the court held that merely proving a legitimate business purpose is insufficient to bring the situation within the statute. The decedent and her family were not “in the business of farming” on the acreage, even if the property's use was consistent with good land management and benefited the rest of the farm.

[236] 903 F.2d 518 (7th Cir. 1990), *rev'g sub nom. Estate of Donahoe v. Commissioner*, T.C. Memo 1988-453.

In TAM 9428002, the National Office, citing *Brockman*, advised that there was no qualified use where a decedent leased ranchland to independent ranchers during grazing season for a fixed-dollar amount determined by the number of cattle brought onto the land. The tenants took the land in “as is” condition and were solely responsible for stocking, feeding, watering, and otherwise maintaining their cattle. The National Office also advised that collecting a flat fee from hunters to hunt on the ranch was a passive rental activity that was not qualified use.

A farmland lease may make use of both a cash lease and a crop share, depending upon the lessee's or lessor's election. This was the situation in *Estate of Gavin v. United States*,[237] where the decedent, shortly before his death, leased farmland to his son under a lease that gave the son the option of a cash lease or a crop share for the first year, and then gave the same option to the father (and hence, upon his death, to the estate) for the ensuing lease term. The land was left to the children and grandchildren as qualified heirs. Although the son had farmed the land on crop shares when his father died, he switched to a cash lease shortly thereafter. The IRS denied the §2032A election, finding that the cash lease ended the qualified use. The Eighth Circuit, reversing an unreported district court decision, held that the land qualified for special use valuation. The court concluded that the interests held by heirs were substantially dependent upon production because, during the first year, it was likely that the son would choose to use a crop share if production were poor, and likewise during later years the heirs would choose to use a crop share if production were high. The court also found significant the fact that the son was granted a purchase option under the terms of the will, locking the heirs into an arrangement dependent upon the son's purchase decision, which in turn was at least partially dependent on the farm's profitability; and, when the son eventually did exercise his right to purchase the property, his continuous active farming clearly satisfied the qualified use requirement.

[237] 113 F.3d 802 (8th Cir. 1997), *rev'g in part*, No. 194-cv-00161, Entry No. 34 (Aug. 13, 1996).

Comment: Gavin arose before adding the lineal descendant cash leasing rules under the Taxpayer Relief Act of 1997.[238] As the decedent's son should be deemed a member of all of the other qualified heirs' families, under the amended rules it appears that the same decision would have been reached without the need to find “substantial dependence on production.” However, the Eighth Circuit's analysis should still be relevant in situations where the lessor is not a member of the qualified heirs' families.

[238] Pub. L. No. 105-34.

In PLR 201129019, the IRS followed the reasoning in *Gavin* in finding that a leasing arrangement that gave the lessee the option to pay cash or a percentage of crops grown would not end qualified use. There, the decedent entered a cash lease of his farm with a general partnership owned by his family and he actively and materially participated in the farming operation until his death. Upon his death, part of the farm passed to the decedent's child and a trust for the benefit of that child's children. The executor of the decedent's estate elected to value the farm under §2032A. The child and trust transferred their undivided interests in the farm to a limited liability company in exchange for proportionate interests in the limited liability company. The limited liability company then entered into a lease with the partnership, allowing the partnership *in its sole discretion* to pay the limited liability company a certain sum of cash per year or a certain percentage of crops grown. Relying in part on *Gavin*, the IRS ruled that the payment terms met the requirements of §2032A because the owner's rent was substantially dependent on production as the lessee would undoubtedly choose the cash option in bountiful years and the crop share option in lean years.[239]

[239] PLR 201129019 (citing *Estate of Gavin v. United States*, 113 F.3d 802 (8th Cir. 1997)).

Practice Tip: Whenever there is a deviation from the standard crop share lease that shifts risk from the landowner to the tenant, there is a substantial risk that the equity interest aspect of the qualified use test may not be satisfied. It is recommended that, in order to assure satisfying the qualified use test, the lease should not deviate from the standard crop share lease arrangement through which the landlord and tenant both share in the market and production risks.

Comment: For additional cases and rulings dealing particularly with issues tending to arise in satisfying the equity interest requirement under leasing arrangements in the post-death recapture period, see VI.D.2.b., below.

c. **Property Sold Prior to Death** —

An estate is not entitled to special use valuation for farm property that was sold on the installment method before the decedent's death, even though some of the installment payments were not yet due at the decedent's death.[240] Similarly, in a technical advice memorandum, the National Office advised that a land contract acquired by a decedent as a result of a farm sale to a son and daughter-in-law was not real property for purposes of the 25% or 50% tests.[241]

[240] *Estate of Brandes v. Commissioner*, 87 T.C. 592 (1986).

[241] TAM 8246020.

d. **Use in a Trade or Business** —

In TAM 8820002, the National Office advised that, because the estate did not establish that cattle-raising activities carried out on the land were carried on for a profit, special use valuation could not be elected for the land. In the same memorandum, it was also advised that, because the estate could not establish that the trees on a tract of land were grown with the intention to profit from their sale, the estate could not elect special use valuation for the land on which the trees grew.

7. **Grace Period** —

Section 2032A(c)(7)(A) permits a qualified heir a grace period of up to two years in the post-death period before requiring commencing qualified use. The two-year period begins on the date of the decedent's death. The period for recapture of tax benefits is extended by the amount of time taken to commence the qualified use during the grace period.[242]

[242] §2032A(c)(7)(A)(ii). In addition, §7508 provides individuals or their spouses with relief from performing certain necessary acts during a time of military service in a combat zone, service in support of the Armed Forces in a combat zone, or qualified deployment in a contingency operation, and §7508A provides authority for the IRS to grant relief as a result of a "federally declared disaster" or a "terroristic or military action." Rev. Proc. 2018-58, *superseding* Rev. Proc. 2007-56, supplements the "time sensitive acts" covered by §7508(a)(1) and Reg. §301.7508A-1(b) to include starting qualified use upon the two-year grace period expiring. The IRS will publish a notice or other guidance to provide relief for a disaster or terroristic action.

One example of the planning benefits of the grace period is that it allows time for a conversion of a cash rent lease to a crop share lease. As discussed at III.C.6., above, in the pre-death period, a decedent may meet the equity interest requirement for determining whether a qualified use exists by cash leasing property to a family member. However, in the post-death period, only surviving spouses and lineal descendants are afforded similar treatment. Thus, if property subject to a cash lease passes to someone other than a surviving spouse or a lineal descendant, the cash rent lease must be terminated in order to avoid the recapture tax. The grace period allows a period of up to two years for the qualified heir to terminate the lease or to convert the arrangement to a crop share lease.[243]

[243] §2032A(c)(7)(A).

8. **Exchanges and Involuntary Conversions** —

As discussed at III.A.12., above, it is possible to tack qualified real property ownership to real property acquired in a §1031 exchange or §1033 involuntary conversion to satisfy the qualified use test.[244]

[244] §2032A(e)(14).

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D. Acquired from or Passed from Decedent to Qualified Heir

The requirement that §2032A property must be "acquired from or passed from" the decedent to a qualified heir is found in the "qualified real property"[245] definition and in both the 25% and 50% threshold tests.[246] These provisions require two separate elements: (i) the property must be transferred *from* a decedent and, (ii) the property must be transferred *to* a qualified heir.

[245] §2032A(b)(1).

[246] §2032A(b)(1)(A)(ii), §2032A(b)(1)(B).

1. **Acquired from or Passed from** —

The National Office discussed the §2032A(b)(1) element that the property be acquired from or pass from the decedent.[247] The National Office advised that if property was purchased from the estate, it would not be considered to have passed from the decedent. This position prevented the common practice of granting the heirs living on the farm the option of purchasing the farmland and operating assets from the estate.[248] However, Congress dealt with this problem by amending §2032A retroactively for estates of decedents dying after 1976 to provide that property is considered to have been acquired from or passed from the decedent if: (i) the property is considered to have passed under §1014(b), relating to the income tax basis of property acquired from the decedent; (ii) the property was acquired by "any person" from the estate; or (iii) the property was acquired by "any person" from a trust (to the extent the property was includible in the decedent's estate).[249]

[247] TAM 8110023.

[248] The farm property may be sold to the heirs during an estate's administration in order to raise cash or a note to pay administrative costs, including taxes, or to provide funds for other estate distributions.

[249] §2032A(e)(9), *added by* the Revenue Act of 1978, Pub. L. 95-600, § 702(d)(2), *amended by* the Economic Recovery Act of 1981 (ERTA), *Pub. L. 97-34, Sec. 421(j)(2)(A)*. In TAM 8407006, the National Office found that the "acquired from or passed from" test was not satisfied where, after the decedent's death, the decedent's daughter, the executors, and the named charitable residuary beneficiaries agreed to terminate the trust in which the daughter held a life income interest. As a result, the daughter received a fee interest in the subject real farm property, and the charities received cash. The trust would not have satisfied the Reg. §20.2032A-8(a)(2) requirement that qualified heirs receive all successive interests. The National Office advised that the interest in farm real property acquired by the decedent's daughter as a result of the trust termination agreement was neither acquired from the decedent's estate nor from the residuary trust.

Practice Tip: Although it is now clear that if qualified real property is purchased from the estate (or a trust includible in the estate) and the acquired-from-or-passed-from requirement is satisfied, there may be a question as to whether the test is satisfied if the property was acquired from a devisee pursuant to an option contained in the will. There should be no distinction between a purchase from an estate or trust and a distribution followed by a purchase from a devisee.

2. **To a Qualified Heir** —

A qualified heir is defined as the member of the decedent's family (discussed in the next section) who acquired the property from the decedent.[250] If a qualified heir transfers the property to another member of the qualified heir's family, the transferee becomes the qualified heir with respect to the property.[251]

[250] §2032A(e)(1).

[251] §2032A(e)(1).

Practice Tip 1: Due to the dual elements of the transfer requirements, if either real or personal property is sold to someone other than a qualified heir, the property will fail to be qualified real property and will not be included in the numerator of the 25% and 50% threshold tests. For this reason, an executor or administrator should be cautious when selling real or personal property out of the estate rather than distributing it to qualified heirs.

Practice Tip 2: The threshold qualification requirements of §2032A(b) specify that at least 50% of the adjusted value of the gross estate be from real and personal property used for a qualified use and that amount or more must pass to qualified heirs. If this requirement is in jeopardy, and the liquidity requirements of the estate require the sale of assets, a qualified heir should purchase farm personal property from the estate, and then sell the personal property. The amendment to §2032A(e)(9) permits a purchase from the estate to qualify as a passing if the purchase is by a qualified heir.[252] The subsequent sale of only the qualified personal property will not result in the recapture of tax benefits. If the qualified real property was sold to someone other than a family member, a benefits recapture would occur.

[252] §2032(e)(9), *amended by* ERTA, *Pub. L. 97-34, Sec. 421(j)(2)(A)*.

3. **Redemptions** —

If the estate redeemed the decedent's stock in a corporation owning qualified property and some of the nonredeeming shareholders were qualified heirs, the real property attributable to the increase of the qualified heirs' interest through the disproportionate redemption may not be eligible for special use valuation because it was not acquired from or passed from the decedent to a qualified heir.[253] The same result would be accorded a buy-sell agreement.

[253] Rev. Rul. 85-73; *see also* GCM 39366 (May 28, 1985), TAM 8223017; PLR 8217017. *See* X.E ., below.

4. **Basis Issues** —

Pursuant to §1040, if a qualified heir purchases the property from the estate, the qualified heir's adjusted basis is the special use value (and not the purchase price) increased by the amount of gain recognized by the estate.[254] The estate (or any trust included as part of the decedent's gross estate) recognizes gain only on the fair market value on sale that exceeds the date-of-death fair market value.[255]

[254] §1040(c).

[255] §1040(a), §1040(b). *See* IX., below.

Because the qualified heir who purchases qualified real property from the estate will normally get an adjusted basis equal only to use value and not the purchase price, the means by which the property passes from the estate will determine the gain on any subsequent transfer. If the property passes to the on-farm heirs by purchase from the estate, no gain is ordinarily recognized, but the purchasing qualified heir has a low income tax basis for the property (special use value plus any the gain recognized by the estate) for purposes of depreciation or cost recovery deductions and for calculating gain or loss on later sale.

In contrast, if the estate is settled and the property passes to all family members as qualified heirs, the estate does not recognize gain and the income tax basis of the qualified heirs is equal to special use value. If the property is later sold to the on-farm heirs at fair market value, the selling qualified heirs would have a substantial gain on the transaction and the purchasing on-farm heirs receive a new income tax basis equal to the purchase price. Thus, the planning choice for any sale of the property passing from the estate is quite important.[256]

[256] *See* XIII.O., below.

5. **Buyouts of Nonqualified Heirs** —

If there is a bequest of qualified real property to an individual who is not a qualified heir, a plan to buy out the nonqualified heir's interest in return for a disclaimer will not work because the “acquired from or passed from” test will not be satisfied. In *Estate of Thompson (James) v. Commissioner*,[257] the decedent bequeathed farm properties in trust with income interests to two daughters and a nonqualified heir. The nonqualified heir executed a disclaimer of her income interest for which she was paid $18,000 by the two daughters. The Tax Court held that the disclaimer was not a qualified disclaimer under §2518(b)(3) because the nonqualified heir accepted the benefits of the property disclaimed by receiving the $18,000 payment.[258]

[257] 89 T.C. 619 (1987), *rev'd on other grounds*, 864 F.2d 1128 (4th Cir. 1989).

[258] Reg. §25.2518-2(d)(1) provides that the acceptance of any consideration in return for making the disclaimer is an acceptance of the benefits of the entire interest disclaimed. On appeal, the Fourth Circuit allowed the estate to elect special use valuation for the daughters' interest. See the discussion at III.F., below.

6. **Holding Period** —

Section 1223(10) provides that if property is acquired by any person in a transfer to which §1040 applies, upon the property's sale to a qualified heir within one year after the decedent's death, the person is considered to have held the property for more than one year.[259]

[259] In a tortuous example of congressional whimsy, the decrease in the maximum long-term capital gains rate enacted as part of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, was accompanied by an increase in the required holding period needed to qualify for long-term capital gain treatment from 12 to 18 months, effective for property transferred after July 28, 1997. Former §1223(12) (current §1223(10)) was not similarly amended at that time to ensure that any gain on sale by a recipient of §1040 property between 12 and 18 months after the decedent's death would receive favorable capital gains treatment. This oversight was corrected in the Internal Revenue Service Restructuring and Reform Act of 1998 (1998 Act), Pub. L. No. 105-206. However, the 1998 Act also restored the general 12-month holding period requirement for long-term capital gain treatment, effective for transfers after December 31, 1997. Thus, the 1998 Act was obliged to further amend former §1223(12) (current §1223(10)) to provide that the section's provisions would again only apply to transfers of property held for 12 months or less, effective for transfers after December 31, 1997. The net result is that if §1040 property failed to qualify as long-term capital gain property on a subsequent transfer to a qualified heir — whether before,

during, or after 1997 — the transferor would receive relief. After the redesignations made by the American Jobs Creation Act of 2004, Pub. L. No. 109-357, §413(c), and the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, §402(a), former §1223(12) became §1223(10). For a discussion of the current long-term capital gains rates in §1(h), as amended (effective for tax years beginning after 2012) by the American Taxpayer Relief Act of 2012 (ATRA), Pub. L. No. 112-240, §101(a)(1), §101(a)(3), §102, see 507 T.M., *Income Tax Liability: Concepts and Calculation* (U.S. Income Series).

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E. Member of the Family

The definition of "member of the family" is important for determining who can satisfy the qualified use and material participation tests in both the pre-death and post-death periods. In addition, the definition determines both who is a qualified heir (and thereby is eligible to receive the real property for which special use valuation is to be elected) and who can purchase real property from a qualified heir without recapturing the special use value benefits.

There are two different definitional terms, depending upon whether the point in time is pre-death or post-death. In the pre-death period, individuals who can satisfy the tests are the decedent or members of the decedent's family. In the post-death period, individuals who can satisfy the tests are the qualified heirs or members of the qualified heirs' family. A "qualified heir" is defined as a member of the decedent's family.[260]

[260] §2032A(e)(1). For deaths occurring before 1982, "member of the family" with respect to an individual included: ancestors of such individual; the spouse of such individual; lineal descendants of such individual; lineal descendants of a grandparent of such individual; the spouse of a lineal descendant of such individual; and the spouse of a lineal descendant of a grandparent of such individual. §2032A(e)(2) before amendment by Economic Recovery Tax Act of 1981 (ERTA), Pub. L. No. 97-34, Pub. L. No. 97-34. In *Estate of Cowser v. Commissioner*, 736 F.2d 1168 (7th Cir. 1984), *aff'g* 80 T.C. 783 (1983), the court determined that the grandniece of decedent's predeceased spouse was not a "qualified heir" at his death in 1978 because the plain language of the pre-1981 version of the statute did not include a lineal descendant of a grandparent of the decedent's spouse. If the grandniece had been the grandniece of the decedent, she would have been a qualified heir. The court also ruled that the classifications set forth in §2032A did not violate the Due Process clause because they were rationally related to the legitimate governmental interests of continuing a historically based preference for a decedent's blood relatives. *See also Whalen v. United States*, 826 F.2d 668 (7th Cir. 1987); PLR 9027004 (individual's uncle as member of family). See Worksheet 8, below, for a diagram illustrating the pre-1982 statutory definition.

A "member of the family" with respect to any individual includes:

- ancestors of such individual;
- the spouse of such individual;

- lineal descendants of such individual;
- lineal descendants of the parent of such individual;
- lineal descendants of the spouse of such individual;
- the spouse of a lineal descendant of such individual;
- the spouse of a lineal descendant of a parent of such individual; and
- the spouse of a lineal descendant of a spouse of such individual.[261]

[261] §2032A(e)(2). *See Estate of Cone v. Commissioner*, T.C. Memo 1990-359 (decedent's husband's nephew failed to come within statutory definition); PLR 9642055 (sale to heir's brothers will not trigger recapture because they are lineal descendants of selling heir's parents). ERTA narrowed the set of “member of the family” by eliminating lineal descendants of grandparents, which removed uncles, aunts and cousins. At the same time, the 1981 amendment broadened the members of the family by adding the lineal descendants of the spouse of the decedent.

See Worksheet 8, below, for a diagram illustrating the statutory definition.

While the rules include nonadopted children from the surviving spouse's prior marriage, because a divorce severs the marriage relationship, the natural children of the decedent's spouse who were not adopted by the decedent cease being members of the decedent's family upon the decedent's divorce.[262]

[262] PLR 8444034.

Example 1: Dave Decedent died. For eight years prior to Dave's death, the husband of Dave's aunt farmed the property pursuant to a crop share lease. By the definition of a “member of the family,” an aunt is not a member of the family. Therefore, the spouse of an aunt would not be a member of the family, and the pre-death period would not be a period of material participation.

Although it is not clear from the statute, the IRS ruled that the unremarried surviving spouse of a deceased lineal descendant is a member of the family and, therefore, can be a qualified heir. However, if the surviving spouse remarries, he or she would no longer be considered a member of the decedent's family.[263]

[263] Rev. Rul. 81-236. *But see* TAM 8412014 (advising that son-in-law, who remarried after death of decedent's daughter (who predeceased decedent), is no longer considered member of decedent's family for purposes of electing special use valuation for farmland and thus is not qualified heir under §2032A; *distinguishing* Rev. Rul. 81-236 (marriage relationship is not considered terminated solely because of spouse's death) on the grounds that remarriage terminates prior marriage).

Example 2: Assume Frank Farmer died in 2021; his daughter died in 2018. Frank's will, which was written in 2010, provided that the farm was to go to Frank's daughter and her husband, Harry. At the time of Frank's death, Harry had not remarried. Harry would be a qualified heir even though his spouse, the lineal descendant, predeceased Frank.

Example 3: Assume that Frank Farmer satisfied the material participation and qualified use tests in the pre-death period. Frank died in 2021 and the farmland passed to Frank's spouse, Wilma. Wilma leased the farmland to Frank's brother. Frank's brother is not a member of Wilma's family, and therefore cannot satisfy the material participation test in the post-death period. Nevertheless, Wilma, as a surviving spouse, may be able to substitute active management for material participation in the post-death period to qualify for special use valuation.[264]

[264] See III.B.2., above.

A legally adopted child is treated the same as a child by blood for purposes of the §2032A definition of "member of the family."[265] However, an acknowledged child, as defined by Illinois law, who was not adopted will not be considered a member of the family.[266] Likewise, a child of an unadopted foster child of the decedent is not considered a member of the family.[267]

[265] §2032A(e)(2). The same rule of construction was also added to the provisions allowing for qualified use by a surviving spouse or lineal descendant cash leasing to a family member. §2032A(c)(7)(E).

[266] Rev. Rul. 81-179; TAM 8032026.

[267] TAM 8033018.

In certain situations, adopting stepchildren may qualify real property for special use valuation. For example, in PLR 8610073, a decedent's brother had a stepdaughter whose spouse farmed the decedent's land upon the decedent's retirement. By the brother adopting the stepdaughter prior to the decedent's death, the stepdaughter's spouse became a member of the decedent's family, thus qualifying the property for special use valuation.

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F. Qualified Heir

For real property to be qualified real property, the property must be acquired from or passed from the decedent to a "qualified heir." Under §2032A(e)(1), a qualified heir is defined as a member of the decedent's family, as described in III.E., above.

Practice Tip: If the will provides for an interest in a nonqualified heir, a special use election may be preserved if a disclaimer of the property would result in the property passing to a qualified heir. In this case, the disclaimant must take care to ensure the requirements of §2518 are satisfied.

In *Estate of Thompson (James) v. Commissioner*,[268] an attempted disclaimer by a nonqualifying heir was deemed ineffective.[269] Because the properties did not pass from the decedent solely to qualified heirs for purposes of §2032A(b), the Tax Court initially held that the property did not qualify for special use valuation. However, the Fourth Circuit ultimately allowed the election for 98% of the property. While it agreed with the Tax Court's determination that the disclaimer was ineffective, the Fourth Circuit ruled that the devise of a 2% income interest to a nonqualifying heir was so minor as to allow an election for the remaining property

[268] 89 T.C. 619 (1987), *rev'd*, 864 F.2d 1128 (4th Cir. 1989).

[269] The disclaimer was made in exchange for value. See discussion at III.D.5., above.

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G. Present/Successive Interests

Section 2032A generally speaks of “qualified real property” rather than “interests in qualified real property.”[270] Given the variety of levels of ownership available to both the decedent and qualified heirs, it is perhaps not surprising that defining the boundaries of “qualified real property” proved difficult. This section addresses issues of direct ownership of less than a fee simple interest in real property. Indirect ownership, through corporations, partnerships, and trusts is discussed in X., below.

[270] *But see* §2032A(c)(2) (allocating recapture tax by “interest”).

1. **Present Interest** —

A long-standing controversy exists with respect to whether a “present interest” requirement is imbedded in §2032A.

a. **History** —

The Conference Committee Report accompanying the Tax Reform Act of 1976[271] stated that “[t]rust property shall be deemed to have passed from the decedent to a qualified heir to the extent that the qualified heir has a present interest in the trust property.”[272] Based on this language, in 1980 the IRS issued a regulation stating that “real property is considered to be qualified real property only if a qualified heir receives or acquires a present interest in the property (determined under section 2503) from the decedent.”[273] Contemporaneously, the IRS issued a regulation that provided:

[271] Pub. L. No. 94-455.

[272] S. Rep. No. 94-1236, at 610 (1976), *reprinted in* 1976-3 C.B. vol. 3, 807, 960.

[273] Former Reg. §20.2032A-3(b)(1), T.D. 7710, 45 Fed. Reg. 50,736 (July 31, 1980).

> Where successive interests in specially valued property are created, remainder interests are treated as being received by qualified heirs only if (i) a qualified heir receives a present interest in that real property, (ii) all preceding interest in the property are vested absolutely in qualified heirs, and (iii) such remainder interests are not contingent upon surviving an alternate taker who is not a member of the decedent's family or are not vested subjected to divestment in favor of a nonfamily member. For the definition of present interest, *see* section 2503 and the regulations thereunder.[274]

[274] Former Reg. §20.2032A-8(a)(2), T.D. 7710, 45 Fed. Reg. 50,736 (July 31, 1980).

The House Report to the Economic Recovery Tax Act of 1981 (ERTA)[275] provided that “[u]nder current law, property qualifies for current use valuation only to the extent that an heir receives a ‘present interest’ in the trust property.” Notably, the House's sole citation to this proposition was Reg. §20.2032A-3(b), as cited above. To alleviate a perceived deficiency in this rule in the case of trusts that would otherwise fail the §2503 “present interest” test, the House recommended an amendment to §2032A stating that “an interest in a discretionary trust all the beneficiaries of which are qualified heirs shall be treated as a present interest.” This amendment was ultimately enacted as an additional sentence at the end of §2032A(g).[276]

[275] Pub. L. No. 97-34.

[276] *See Pub. L. No. 97-34, §421(j)(1).*

In final regulations issued August 25, 1981, the reference to a present interest requirement was excised from both

Reg. §20.2032A-3 and §20.2032A-8.[277] Curiously, the preamble to this amendment spoke of only the present interest in the context of discretionary trusts where all of the beneficiaries were qualified heirs. While the preamble suggested that the regulations would later be "revised to provide guidance where the parties involved include persons other than qualified heirs and members of the decedent's family,"[278] this additional guidance has not occurred.

[277] T.D. 7786, 46 Fed. Reg. 43,036 (Aug. 26, 1981).

[278] T.D. 7786.

Comment: While, as discussed below, it appears the IRS continues to maintain that a "present interest" rule exists with respect to both the decedent and the qualified heirs, the chain of events discussed above calls into question whether such a rule is based in authority. Commentators differ on whether the IRS's position with respect to the "present interest" rule is justifiable.[279]

[279] *Compare, e.g.,* Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, ¶135.6.3 (concluding that the 1981 amendment to §2032A(g) implicitly affirmed the rule) *with* Richard Stephens, Guy Maxfield, Stephen Lind, & Dennis Calfee, Federal Estate and Gift Taxation, ¶4.04[3][c] ("It appears that the present interest rule, now not directly referred to in the Code or regulations, no longer exists.").

b. **Decedent's Interest** —

Citing the 1976 Conference Committee Report and former Reg. §25.2503-3(a), in TAM 8045018 the National Office advised that a decedent's bequest of his vested remainder interest in farm real property (the decedent's mother was the life tenant) was not eligible for special use valuation.

This position was affirmed in TAM 8223004 under similar facts. There, the National Office acknowledged the amendments to §2032A(g) but maintained that the then-new provision merely created an exception to the general requirement that a "qualified heir receive a present interest."

Comment: The legislative history is silent with respect to whether a decedent must have a present interest throughout the pre-death period. Nevertheless, in TAM 8724006 the National Office clearly imposed a present interest requirement for the decedent. There, the decedent managed farm property in which he held a vested remainder interest for 33 years while a second cousin, once removed, held a life interest. At the death of the life tenant the decedent held fee simple ownership over the property for over one year before dying. Under these facts, the National Office advised that because a second cousin, once removed, does not qualify as a member of the decedent's family, special use valuation could not be elected, even though there was qualified use on the date of death and a full fee simple interest passed to qualified heirs. In the IRS's view, the decedent's remainder interest and management of the farm before the cousin's death were not enough to meet the pre-death period qualified use test.

c. **Qualified Heir's Interest** —

As discussed in III.G.2., below, the IRS maintains that property held by a decedent in fee simple cannot qualify for special use valuation unless qualified heirs receive all successive interests in the property. The property transfer by a decedent to heirs in trust also proved problematic.

The National Office initially took the position in the regulations that a qualified heir holding an income interest in a trust that owned the qualified property did not have a present interest in the property if the trustee was not required to distribute all the income. Therefore, the property held by the trust could not qualify for use valuation.[280] This prevented bequests to the typical family trust which provided for discretionary payment of income.

[280] *See* TAM 8020011.

As discussed at III.G.1.a., above, ERTA changed this interpretation by adding §2032A(g), which provides that as long as all the income beneficiaries of a discretionary trust are qualified heirs they will be considered as having present interests in the trust property. This provision applied to all estates of decedents dying after 1976 and thus nullified the IRS's attempts to restrict the definition of qualified property.

Section 2032A(g), however, does not provide relief to a trust remainder beneficiary. In TAM 8803004, the National Office advised that where the decedent's wife, the life tenant of the trust that acquired the property, cash leased the property to her son, a remainderman, there was a cessation of qualified use because the son was not "a qualified heir with a present beneficial interest in the qualifying property."[281]

[281] Note that the result of this TAM was changed by provisions of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, §6151, providing that a cash lease of the property by a surviving spouse to his or her family member is a qualified use. *See* VI.D.2.b.(2), below.

Practice Tip: In a standard testamentary trust, a spouse often is given a life income interest with remainder to children. Because all interests are held by qualified heirs, a §2032A election is possible. However, care should be taken not to give a child a vested remainder interest, because that interest will not qualify for special use valuation in the child's estate if the child dies before the life tenant, as there will be no present interest being valued at such time.[282] Similarly, if the executor has the discretion to transfer property to a trust in which the beneficiaries are not expressly limited to members of the decedent's family and which would not satisfy the present interest requirement, the real property may not be eligible for special use valuation. The IRS may argue that it cannot be determined with certainty that the real property will pass to a qualified heir.

[282] TAM 8223004.

In TAM 8532007, the National Office advised that farm property held in an inter vivos trust qualified for §2032A treatment despite the trustee having discretion to delay trust distributions until the final satisfaction of state and federal taxes owed by the decedent-settlor's estate. The memorandum stated that even if it were assumed that a discretionary power to withhold trust distribution results in failure to satisfy the present interest requirement, §2032A treatment should still be available by reason of §2032A(g).

It was suggested by a commentator that the present interest requirement may not be satisfied if the real property is owned by a closely held corporation which has not distributed dividends.[283] This position is analogous to cases that analyzed the "present interest" requirement in the gift tax context where gifts were made of interests in entities over which the donee did not have control and/or there was a history of not distributing income. Gifts of closely held corporation stock that does not make dividend distributions, or does not have the capacity to generate income, may not be a gift of a present interest.[284]

[283] Neil E. Harl, *Agricultural Law,* Vol. 2, §43.03[3][d][iv][E][III], 43-149 to 150 (2008, updated semiannually).

[284] *Berzon v. Commissioner*, 534 F.2d 528 (2d Cir. 1976), *aff'g* 63 T.C. 601 (1975); *Stark v. United States*, 477 F.2d 131 (8th Cir. 1973), *aff'g* 345 F. Supp. 1263 (W.D. Mo. 1972), *cert. denied*, 414 U.S. 975 (1973); *Rosen v. Commissioner*, 397 F.2d 245 (4th Cir. 1968), *rev'g* 48 T.C. 834 (1967); Rev. Rul. 69-344.

Practice Tip: If a corporation holds farmland, it might be desirable to periodically distribute dividends. Land trusts could create similar problems. In the gift tax context, transfers of a land trust interest where the grantors maintain control over the land were held to be transfers of a future interest.[285] This problem arguably was not remedied by the §2032A(g) amendments contained in ERTA with respect to "discretionary trusts."

[285] *Maryland Nat'l Bank v. United States*, 609 F.2d 1078 (4th Cir. 1979), *aff'g* 450 F. Supp. 52 (D. Md. 1978); *Estate of McClure*, 608 F.2d 478 (Ct. Cl. 1979); *McManus v. Commissioner*, T.C. Memo 1980-296, *aff'd*, 698 F.2d 1221 (6th Cir. 1982).

2. **Successive Interests** —

The treatment of successive interests in property was highly contested, with the Tax Court and several circuit courts holding certain aspects of IRS regulations invalid, and the IRS vigorously maintaining its position.

a. **IRS Regulations** —

Pursuant to Reg. §20.2032A-8(a)(2), qualified heirs must receive all successive interests in the qualified real property to elect special use valuation. In the IRS's view, if a bequest creates successive interests, such as a life estate followed by a remainder interest, an election for special use valuation may be made only if *all* interests in the qualified real property are held by qualified heirs and the election includes *all* the interests. Note that any remainder interest cannot be contingent upon surviving a nonfamily member nor can it be subject to divestment to a nonfamily member.[286]

[286] *See also* TAM 8435007.

The IRS ruled in Rev. Rul. 81-220 that if a charity receives a remainder interest, the §2032A election is not available because all successive interests are not held by qualified heirs.[287] In PLR 9407015, the IRS ruled that a charitable remainder interest in a trust holding ranchland did not cause any part of the ranchland to be ineligible for §2032A valuation, where the decedent's spouse (who had a life income interest in the trust) disclaimed other trust property sufficient to satisfy the charity's remainder interest. The IRS explained that the spouse's disclaimer converted the charity's pecuniary interest in the trust remainder into an immediate bequest, payable from assets other than the ranchland.

[287] *See also* TAM 8407006 (purchase of remainder interest from charitable remainder beneficiary does not qualify under §2032A(e)(9) as purchase from decedent's estate or from trust includible in decedent's estate, and property is ineligible for special use valuation because members of decedent's family did not receive all successive interests), TAM 8337015 (where decedent transferred life interest in trust to nonqualified heir and remainder to qualified heir, successive interests test was not satisfied).

If a qualified heir is given a life income interest in real property and a special power of appointment for the remainder, the IRS ruled that because the remainder is subject to divestment to a nonfamily member, the remainder is treated as not being received by a qualified heir as required by Reg. §20.2032A-8(a)(2). Because all successive interests were not held by qualified heirs, the IRS ruled that the real property did not qualify for §2032A.[288]

[288] Rev. Rul. 82-140.

Practice Tip: It is possible that remedial action can be taken by making a qualified disclaimer of the special power of appointment pursuant to §2518 and §2046. The IRS ruled privately that if, as a result of a qualified disclaimer of the special power of appointment, the remainder interest vests in the decedent's qualified heir, the Reg. §20.2032A-8(a)(2) successive interest requirements are satisfied.[289] However, in *Estate of Thompson (James) v. Commissioner*,[290] the IRS took the position that such a disclaimer was not effective to meet the successive interest requirement. As discussed below, the *Thompson* court avoided the disclaimer issue by striking down the Reg. §20.2032A-8(a)(2) successive interest requirement.

[289] *See* TAM 8349008, TAM 8146020.

[290] 864 F.2d 1128 (4th Cir. 1989), *rev'g* 89 T.C. 619 (1987).

In a Technical Advice Memorandum,[291] the National Office advised that where the decedent devised otherwise qualified real property to a trust for the benefit of his spouse with the remainder as she appoints by a general power of appointment, such property is eligible for special use valuation under §2032A. The National Office stated that because the decedent's spouse received both a life estate and a general power of appointment over the qualified real property in the trust, the interest created by the decedent was equivalent to a fee simple and was not a successive interest under Reg. §20.2032A-8(a)(2). The National Office, citing the House Report on the Tax Reform Act of 1976, observed that the rationale behind the successive interest rule was to prevent specially valued property from being released from the recapture tax at the death of the qualified life interest heir when that property would not be taxed in that heir's estate. Property that is subject to a general power of appointment is part of the decedent's estate under §2041. Therefore, the recapture tax consequences should be the same for any life tenant with a general power of appointment as for an individual who died with a fee interest in the property.

[291] TAM 8209004.

In subsequent rulings, the IRS followed the principle that a life estate coupled with a testamentary general power of appointment is equivalent to ownership, such that a family member holding such a trust interest will be treated as a qualified heir.[292]

[292] *See* PLR 9027004 (transfer of property by qualified heir to trust for qualified heir's parent not triggering recapture), PLR 9022007 (property bequeathed to trust for decedent's spouse eligible for special use valuation).

In TAM 8249012, the decedent's will granted an income interest in a farm to two children. At the first child's death, the farm was to be sold and proceeds distributed to the surviving child and grandchildren, thus terminating the qualified use. The heirs waived their right to the proceeds and the property was deeded so that the grandchildren would take a remainder interest. Because all the successive interests would be received by family members and no successive interests were contingent upon surviving a nonfamily member or subject to divestments to a nonfamily member, the remainder interests were treated as received by family members.

b. **Court Rulings** —

Throughout the 1980s, the IRS strictly interpreted the Reg. §20.2032A-8 requirement that all successive interests must be held by “qualified heirs” to qualify for special use valuation. In a series of Technical Advice Memoranda, the National Office advised that even if the contingency that caused a remainder interest to pass to a nonqualified heir was remote, the “all successive interests” requirement would not be satisfied.[293] In addition, the IRS maintained that any remainder interest could not be contingent upon surviving a nonfamily member or be subject to divestment to a nonfamily member.

[293] TAM 8441006, TAM 8349008, TAM 8346006, TAM 8332012. In these rulings, the trusts in question provided for distributions to qualified heirs for a specified period followed by a

terminating distribution to qualified heirs and, if none, to either nonqualified heirs or a charity.

The Tax Court, however, in two reviewed decisions, invalidated Reg. §20.2032A-8(a)(2) to the extent it would prohibit the property's testamentary disposition to "qualified heirs" where the testamentary scheme provided for the possibility of a lack of qualified heirs by a remote contingent gift to charity. In *Estate of Davis v. Commissioner*,[294] the decedent's will bequeathed farm property to a trust created for the benefit of the decedent's three children. The trust was to terminate on the last child's death, with the corpus distributed to the children's surviving descendants. If there were no surviving descendants, the corpus was to go to three charities. The parties in the case agreed that the actuarial probability of the trust property passing to the unqualified contingent remainder beneficiaries (the charities) was 1.52%. The IRS denied §2032A treatment because of the contingent nonqualifying beneficiaries' existence.

[294] 86 T.C. 1156 (1986).

In holding for the estate, the Tax Court reasoned that Reg. §20.2032A-8(a)(2) was inconsistent with the statute because it required, as a prerequisite to a special use election, that all successive interests created by a decedent's will be received by qualified heirs. The court noted that there was no such requirement in the statute and that the testator made an "obvious and continuing effort" to comply with §2032A. The court concluded that testators should be allowed a reasonable means to prevent intestacy and possible escheat to the state in the event of a lack of heirs. Rather than penalize the estate as a result of a remote possibility, the *Davis* court concluded that a "wait and see" approach was more in keeping with the congressional intent.

Similarly, in *Estate of Clinard v. Commissioner*,[295] the Tax Court held that a life income interest in farmland bequeathed to each of three grandchildren with a special power of appointment in the remainder interests qualified for special use valuation because of the possibility of the property passing to a university and others if the grandchildren failed to exercise their powers and died without descendants. It was not possible to compute the actuarial probabilities of an interest passing to a disqualified heir in this case, the court determined, although it noted that the possibility was "remote." The majority again invalidated Reg. §20.2032A-8(a)(2) to the extent it requires that all successive interests be in qualified heirs. The IRS's position was that a qualified disclaimer of the special power of appointment would have to be made, with the remainder interest vesting in the decedent's qualified heir, to satisfy the regulations' successive interests requirement.[296] The court rejected the IRS approach and noted that the IRS's interpretation permitted a farm that is bequeathed outright to the decedent's children to be disposed of without adverse tax consequences 16 years after the decedent's death, but at the same time disallowed special use valuation to a farm that (due to the exercise of a special power of appointment) remained in a decedent's family for two or three generations. The court further noted that under the election agreement's terms, a qualified heir remains personally liable for the recapture tax if a disqualifying event occurred.

[295] 86 T.C. 1180 (1986).

[296] *See* Rev. Rul. 82-140.

The concurring opinion in *Clinard* found no legislative support for the IRS's position that an interest which could be created by the exercise of a special power of appointment is a successive interest while one created under a general power is not.

In *Estate of Pliske v. Commissioner*,[297] the Tax Court, citing *Davis* and *Clinard*, upheld an estate's §2032A election despite the fact that there was a remote chance (between .008098% and .002817%) that the property would pass to charity if there was a failure of the decedent's lineal descendants who were bequeathed successive life interests.

[297] T.C. Memo 1986-311.

In TAM 8643005, the National Office relented somewhat and advised that the remote possibility (0.0000001%) of the remainder interest's distribution to nonqualified heirs does not bar a §2032A special use value election.

This trend continued in TAM 8713001, where the National Office advised that property bequeathed in trust to the decedent's nieces until age 30 (at which time the property would be distributed to them) passed to “qualified heirs” for purposes of determining the estate's eligibility to use §2032A even though there was no provision for the property's disposition in the event the beneficiaries died before age 30. The National Office determined that, although the decedent did not provide for a taker-in-default, no successive interest problems existed because, under state law, each niece held a vested interest in the remainder.

In TAM 8230006, where the decedent's will provided that the trustee could sell the trust assets at termination if the heirs were unable to agree on a division of trust assets, the National Office advised that the possibility of the trustee selling special use valuation property to a nonfamily member would not cause the estate to fail the requirement that all successive interests pass to the decedent's qualified heir.

In *Smoot v. United States*,[298] the Seventh Circuit, affirming the district court, allowed the estate to elect special use valuation where there was a remote possibility that a contingent remainder interest would pass to individuals who were not qualified heirs and one of the qualified heirs held a special power of appointment in favor of individuals who were not qualified heirs within the meaning of §2032A.

[298] 892 F.2d 597 (7th Cir. 1989), *aff'g* 88-1 USTC ¶13,748, *88-1 USTC 84,086* (C.D. Ill. 1987).

Citing *Clinard* [299] with approval, the Fourth Circuit in *Estate of Thompson (James) v. Commissioner*,[300] held that a §2032A election was effective even though a qualified heir with an income interest in the property had the power to appoint the remainder interest to charity. Rejecting the Reg. §20.2032A-8(a)(2) successive interest requirement, the court adopted a wait-and-see approach, stating that the §2032A(c) recapture rules were sufficient to deal with the problem of the property passing to nonqualified heirs. Important to the *Thompson* majority was the “plainly evident” intent of Congress to preserve the family farm and therefore a “common sense interpretation, one with an eye towards protecting the family farm and business” should be applied to allow remote, contingent interests.

[299] 86 T.C. 1180 (1986).

[300] 864 F.2d 1128 (4th Cir. 1989), *rev'g* 89 T.C. 619 (1987).

In TAM 9038002, the National Office, citing *Davis*,[301] advised that where there was a 0.001126% probability that qualifying property would pass to contingent remainder beneficiaries, the “exceedingly remote” contingent remainder beneficiaries were not required to sign the recapture agreement.

[301] 86 T.C. 1156.

Comment: As discussed at VII.F., below, in 1997, Congress amended §2032A(d)(3) to eliminate the “substantial compliance” hurdle to perfecting a deficient election. Because of this change, in cases where the IRS believes the contingent remainder beneficiaries are not exceedingly remote, the IRS must provide a reasonable period of time for the executor to obtain any required signatures that were omitted from the original election.

Practice Tip: Reg. §20.2032A-8(a)(2) was last amended in 1981.[302] Since that time, the regulation was attacked by courts both for its position on remote successive interests and its requirement that the special use election include at least 25% of the estate.[303] Until the IRS provides clearer guidance in this area, planning for special use valuation will remain difficult.[304]

[302] T.D. 7786, 46 Fed. Reg. 43,036 (Aug. 26, 1981).

[303] See *Miller v. United States*, 680 F. Supp. 1269 (C.D. Ill. 1988) and *Finfrock v. United States*, 860 F. Supp. 2d 651 (C.D. Ill. 2012), discussed at II.C., above, and VII.D., below.

[304] For more on planning for successive interests in the §2032A context, see Jerald I. Horn, *Flexible Trusts and Estates for Uncertain Times,* C.10 (ALI-ABA, 2007, 3d ed.).