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## **Estate Planning in an Era of Declining Asset Values**

by

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# ESTATE PLANNING IN AN ERA OF DECLINING ASSET VALUES

Neil E. Harl\*

The wrenching financial adjustment encountered by much of agriculture since 1981<sup>1</sup> has produced a sharp contrast to the 1970's when increases in farm and ranch values were consistent and substantial.<sup>2</sup> Thus far in the 1980's farm land values have declined substantially and in some areas are no more than half the levels reached in the early part of the decade. As might be expected, estate and business planning concerns have shifted from an emphasis on planning to reduce federal estate and state death tax liability to planning to assure that high and rising debt loads can be shouldered and serviced by the estate and by the heirs or other successors.

Reductions in farm and ranch asset values since 1980 and decreases in the size of most farm and ranch estates have focused attention on the adequacy of estate and business planning strategies in general use during the 1970's and on planning strategies appropriate for an era of declining asset values. In addition, the higher asset values of the 1970's and early 1980's have left a troubling legacy of tax traps to be avoided in the financially demanding environment of the 1980's.<sup>3</sup>

## I. GENERAL CONSIDERATIONS

Estate and business planning for farm and ranch families amid the realities of the 1980's requires an additional veneer of planning consideration. The results of plans developed in more economically favorable times may now be so unacceptable that a special effort should be made to review all instruments to assure the

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1. See N. Harl, *Problems of Debt in Agriculture*, 6 J. AGRIC. TAX'N & L. 689 (1985).

2. See generally 5 HARL, AGRICULTURAL LAW § 42.03 (1985).

3. See *supra* note 1.

relevant objectives are continuing to be met. In few periods in history have the economic fortunes of a sector changed as sharply as those of agriculture since 1981.

As a result of these changes, the following may be viewed as items to be added to the standard checklist to review for established estate and business plans.

- Wills, trusts, and other types of dispositive instruments (such as insurance policies) should be checked to ascertain whether specified property divisions among beneficiaries continue to be acceptable. Decreasing values of some types of assets and steps taken to dispose of some assets during life to enhance liquidity may have made dispositive patterns unacceptable.

- Options granted by will or otherwise to designated individuals to purchase estate assets (such as land) at specified values may no longer be acceptable.

- Special attention should be given to reviewing the feasibility and acceptability of provisions which specify estate indebtedness be paid during estate settlement and that assets are to pass free of claims of creditors. In some instances, such provisions can no longer be carried out by the estate representative because of poor liquidity of the estate. In other instances, the outcome may have an unacceptable impact on property distribution patterns.

- Careful attention should be given to the impact of a testator's death on the ability of the estate to meet debt obligations. The problems of liquidity have shifted from concern toward having sufficient funds available or liquidity augmenting options in place to pay death taxes and estate settlement costs to concerns about sufficient liquidity to assure that farm and ranch debt can be serviced after death.<sup>4</sup>

- For those estates still of sufficient size to warrant concern about federal estate tax liability, attention should be given to use of the alternative valuation date.<sup>5</sup> Assets may be valued either as of the date of death or up to six months after death.<sup>6</sup> If the latter approach is selected, questions may arise as to valuation proce-

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4. See generally 5 HARL, *supra* note 2, § 42.02.

5. I.R.C. § 2032. See generally 5 HARL, *supra* note 2, § 43.03[1].

6. I.R.C. §§ 2031, 2032.

dures to be applied to: (1) grain and livestock existing at death but changing in value thereafter; (2) crops planted and animals born after death; and (3) crops planted before death which mature and are sold after death.<sup>7</sup>

•The eligibility tests should be checked (and rechecked periodically) to ascertain if the percentage tests can be met for fifteen-year installment payments of federal estate tax,<sup>8</sup> special use valuation of farmland,<sup>9</sup> and Section 303 corporate stock redemption after death.<sup>10</sup> In all instances, declining values for business assets relative to investment assets may render the estate ineligible for the tax provision.<sup>11</sup>

For installment payment of federal estate tax, eligibility requires that the decedent have an "interest in a closely-held business." This test can be met if twenty percent or more of the value of the business (interest of partners in a partnership or voting stock in a corporation) is included in the decedent's gross estate or the business entity has fifteen or fewer partners or shareholders.<sup>12</sup> For decedents who are lessors, interests under crop share or livestock share leases (but not cash rent leases) count as interests in a closely-held business.<sup>13</sup> For decedents who had participated in an estate freeze by receiving corporate non-voting preferred stock or debt securities, neither type of interest counts as an interest in a closely-held business for this purpose.<sup>14</sup> In addition, the interest in the closely-held business must exceed thirty-five percent of the adjusted gross estate.<sup>15</sup>

In the case of special use valuation of farmland, the adjusted value of the farm (or other closely-held business) real and personal

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7. See HARL, *supra* note 2, § 43.03[1].

8. I.R.C. § 6166. See 5 HARL, *supra* note 2, § 42.05.

9. I.R.C. § 2032A. See 5 HARL, *supra* note 2, § 43.03[2].

10. I.R.C. § 303. See 5 HARL, *supra* note 2, § 42.09.

11. Attempts to reduce uncertainty of income by shifting from a crop share to a cash rent lease could cost the estate eligibility for special use valuation of farmland and is highly likely to cost the estate eligibility for installment payment of federal estate tax. See 5 HARL, *supra* note 2, §§ 43.03[2][d], 42.05[2][d].

12. I.R.C. §§ 6166(b)(1)(B), 6166(b)(1)(C).

13. See Rev. Rul. 75-366, 1975-2 C.B. 472. See *e.g.*, Ltr. Rul. 8133015 (Apr. 29, 1981) (necessary involvement in management under lease can come from lessor or lessor's agent or employee.)

14. See I.R.C. § 6166(b)(1)(C).

15. I.R.C. § 6166(a)(1).

property must equal at least fifty percent of the adjusted value of the gross estate, using fair market value figures, and that amount or more must pass to qualified heirs.<sup>16</sup> In addition, at least twenty-five percent of the adjusted value of the decedent's gross estate must be comprised of qualified farm (or other closely-held business) real property that was acquired from or passed from the decedent to a qualified heir or heirs.<sup>17</sup> Efforts to stabilize income in the period before death by selling some assets on installment could cost the estate eligibility for special use valuation. Installment sale obligations are not an eligible interest for purposes of the percentage tests.<sup>18</sup>

Section 303 corporate stock redemption<sup>19</sup> allows capital gain treatment on any gain involved in the redemption<sup>20</sup> up to the sum of death taxes, and funeral and estate administration expenses.<sup>21</sup> To be eligible, the value of the corporate stock included in the decedent's estate must exceed thirty-five percent of the gross estate less allowable deductions.<sup>22</sup>

#### A. *Hazards of Freezing Estates*

During the 1970's, when inflation persisted and eventually reached double-digit levels, efforts were made in many quarters to accommodate inflation.<sup>23</sup> Thus, Social Security taxes and benefits were indexed,<sup>24</sup> labor union contracts were indexed as to compen-

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16. I.R.C. § 2032A(b)(1)(A). "Adjusted value of the gross estate" means gross estate less allowable unpaid indebtedness attributable to the property. I.R.C. § 2032A(b)(1)(A). "Adjusted value of real or personal property" is defined as fair market value less allowable indebtedness attributable to the property. I.R.C. § 2032A(b)(3)(B). The full amount of an unpaid mortgage, for which the decedent was personally liable and which was enforceable against other property of the estate, is allowable as a deduction when the entire amount of mortgaged property is included in the gross estate. Rev. Rul. 83-81, 1983-1 C.B. 230.

17. I.R.C. § 2032A(b)(1)(B).

18. Ltr. Rul. 8221005 (Feb. 16, 1982); Ltr. Rul. 8246020 (Aug. 11, 1982). See Ltr. Rul. 8115015 (Dec. 19, 1980) (value of note receivable, even though secured by farm property, is not considered farm real or personal property for purposes of 50% test).

19. I.R.C. § 303.

20. I.R.C. § 303(a), (b).

21. I.R.C. §§ 303(a)(1), 303(a)(2).

22. I.R.C. § 303(b)(2)(A). See also Prop. Treas. Reg. § 1.303-1(a)(5), 27A FED. TAX COORD. 2d P150, 967 (1984).

23. In addition to indexing, presidential authority was granted to adjust federal civil service compensation levels. 5 U.S.C. § 5303 (1982).

24. 42 U.S.C. § 415(i).

sation levels, and the federal income tax system was indexed commencing in 1985.<sup>25</sup> In the same era, the concept of "estate freezing" burgeoned in the estate planning literature.<sup>26</sup>

In a time of great economic uncertainty, the "capping" or "freezing" of estates can lead to serious financial problems.

If inflation occurs subsequent to a freeze, fixed principal assets from a freeze (or fixed incomes which often accompany a freeze) are reduced in real value.

Example: M agreed to a freeze of asset values with preferred stock issued to M in exchange for ownership of farmland. The preferred stock paid dividends of \$15,000 per year. In ten years, at eight percent inflation per year, the real value of \$15,000 drops to \$6,514.

If deflation occurs, a larger estate may result.

Example: N owns two sections of farmland (1,280 acres). In 1980, when the land was valued at \$1,500 per acre, N formed a corporation with a primary objective of freezing estate values with preferred stock. At that time, in addition to the land valued at \$1,920,000, N had \$80,000 in other assets for a total estate of \$2,000,000.

The corporation was formed with \$1,000,000 of corporate common stock and \$1,000,000 in fixed principal preferred stock. Fourteen years later, at N's death, after giving twenty-five percent of the common stock to children, the farmland had declined to \$1,000 per acre for a value of \$1,280,000. Adding \$80,000 in other assets, corporate net worth would be \$1,360,000. With the preferred stock still valued at \$1,000,000, the corporate common stock would be valued at \$360,000. N's estate would be valued at \$1,270,000.

Had the corporation been established with only corporate stock, and had N given away 12½% of the stock, N's estate would have totalled \$1,190,000. Thus, capping the estate led to a larger estate at death.

With deflation, fixed payments sufficiently large to support the fixed principal obligation could become an onerous obligation. The current economic downturn in agriculture has magnified the importance of this disadvantage. The relatively low rate of return to agricultural assets, particularly land, makes fixed payments tied to market interest rates burdensome in any era. In a deflationary

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25. Economic Recovery Tax Act of 1981, Pub. L. 97-34, § 104, 95 Stat. 188-190 (1981).

26. See, e.g., Kanter, *Freezing Future Estate Growth: Estate Planning Challenges and Opportunities*, 113 Tr. & Est. 132 (Mar. 1974). See generally 7 HARL, *supra* note 2, § 52.01[2][g].

period, the burden can be fatal to the payer.

Implementation of an estate freeze may lead to gift tax consequences unless the assured payments and rights received by the transferor of the property are adequately and fairly valued.<sup>27</sup> Thus, conveyance of property to a newly formed partnership or corporation with fixed principal interests where the property conveyed is of greater value than the interests received in exchange results in a gift as to the excess, at least if the beneficiaries are members of the same family.<sup>28</sup> Thus, the value of fixed principal interests depends on: (1) the adequacy of the payment rate on the fixed principal security; (2) whether the fixed principal security has voting and control rights; and (3) any liquidation preference accorded the holder of the fixed principal interest.<sup>29</sup> In a 1982 case,<sup>30</sup> ranch property conveyed to a newly formed corporation had a substantially greater value than the value of stock and securities received by the transferor who was a parent. In that case, a sizeable gift was deemed to have arisen from the parent to the two children receiving the variable value equity securities.<sup>31</sup>

Farmland that is represented by a fixed principal obligation may be ineligible for special use valuation for federal estate tax purposes.<sup>32</sup>

If an estate freeze is accomplished by the issuance of debt securities by a corporation, installment payment of federal estate tax may be jeopardized.<sup>33</sup> Debt securities are not an interest in a closely-held business which is required for an estate to be eligible.<sup>34</sup>

Eligibility of corporate stock for Section 303 stock redemption after death may be endangered.<sup>35</sup> Only corporate stock counts to-

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27. Rev. Rul. 83-120, 1983-2 C.B. 170. See generally 6 Harl, *supra* note 2, § 46.02[2][a].

28. See Rev. Rul. 83-120, 1983-2 C.B. 170.

29. *Id.*

30. Kincaid v. United States, 682 F.2d 1220 (5th Cir. 1982).

31. *Id.*

32. See 5 Harl, *supra* note 2, § 43.03[2][e][iii], for a discussion of the reasons why special use valuation may not be available for farmland represented by fixed principal interests.

33. I.R.C. § 6166. See generally 5 Harl, *supra* note 2, § 42.05.

34. I.R.C. § 6166(b)(1).

35. See I.R.C. § 303(b)(2)(A).

ward the requirement that stock must exceed thirty-five percent of the gross estate less allowable deductions.<sup>36</sup>

In general, in a time of economic uncertainty, the outcomes of either periods of inflation or deflation are sufficiently negative to suggest that a freezing of asset values should be undertaken only if the estate is of sufficient size that the possible negative consequences would not be unacceptable.

## II. AVOIDING ACCELERATION OF FEDERAL ESTATE TAX UNDER INSTALLMENT PAYMENT

For estates that elected fifteen-year installment payment of federal estate tax, a major concern since 1981 has been the avoidance of acceleration of deferred federal estate tax if heirs have taken steps to transfer or mortgage property to stabilize the farm firm.<sup>37</sup> If the deferred payment of federal estate tax is accelerated, the debt burdens of the heirs are exacerbated as the remaining federal estate tax becomes due.<sup>38</sup>

### A. General Rule

Except for Section 303 corporate stock redemptions,<sup>39</sup> certain testamentary transfers, and some corporate reorganizations, if 50 percent or more of the decedent's interest in the closely-held business is distributed, sold, exchanged, otherwise disposed of, or is withdrawn from the business, the remaining installments become due.<sup>40</sup> For transfers, not deaths, after 1981, the transfer of the decedent's interest upon death of the original heir or upon death of any transferee receiving the interest as a result of the transferor's death does not cause acceleration of payment if each subsequent

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36. *Id.*

37. For a general discussion of acceleration of federal estate tax under 15-year installment payment, see 5 Harl, *supra* note 2, § 42.05[5], [6].

38. I.R.C. § 6166(g)(1)(A).

39. For Section 303 stock redemptions to come within the exception, there must be paid an amount of federal estate tax, including interest, not less than the amount of the distribution, and the payment must be made on or before the date prescribed for payment of the first installment which comes due after the date of the distribution (or, if earlier, on or before the day that is one year after the distribution). I.R.C. § 6166(g)(1)(B).

40. I.R.C. § 6166(g). For deaths before 1982, the figure was one-third or more, and for withdrawals, it applied to the entire business.



transferee is a family member of the transferor.<sup>41</sup>

### *B. Events Causing Acceleration*

Although the statute provides some guidance on what types of transfers will cause acceleration of payment, Internal Revenue Service rulings have provided guidance on the hazards accompanying some types of transfers. Unfortunately, the rulings do not provide complete guidance, particularly in the area of mortgaging assets to generate additional liquidity.

Mortgaging property is not a disposition if the funds obtained pay the costs of refinancing and the liens and security interests are discharged.<sup>42</sup> Moreover, the sale of property to pay off mortgages is not a disposition or withdrawal if the proceeds are applied on the mortgage.<sup>43</sup>

The mere execution of a stock redemption agreement after death does not, of itself, accelerate the payment of tax.<sup>44</sup>

A change in organizational form such as a shift from sole proprietorship to partnership form<sup>45</sup> or a shift from a partnership or sole proprietorship to a corporation,<sup>46</sup> is not a disposition, if the transfer does not involve a shift in nature of the investment, such as, from equity to debt and issuance of debt securities.<sup>47</sup> Transfer of interests from a trust to a corporation have similarly escaped acceleration of federal estate tax payment.<sup>48</sup> Likewise, acceleration

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41. I.R.C. § 6166(g)(1)(D). The term "family member" is defined in I.R.C. § 267(c)(4). I.R.C. § 6166(g)(1)(D).

42. Ltr. Rul. 8313046 (Dec. 27, 1982).

43. Ltr. Rul. 8441029 (July 10, 1984) (proceeds received in excess of mortgage would be considered a disposition).

44. Ltr. Rul. 8504126 (Oct. 31, 1984).

45. Ltr. Rul. 8025095 (Mar. 30, 1980). See Ltr. Rul. 8226156 (Apr. 6, 1982) (transfer of interest in sole proprietorship to limited partnership did not accelerate payment of federal estate tax).

46. Ltr. Rul. 8212096 (Dec. 28, 1981) (formation of corporation with stock ownership held by heirs in same proportion as inheritance not a disposition; ruling leaves unanswered questions of effect of corporate purchase of stock from an heir).

47. Ltr. Rul. 8220119 (Feb. 22, 1982) (incorporation of sole proprietorship and later distribution of corporate stock to trust beneficiaries was mere change in form of doing business; proposed issuance of corporate debentures would be disposition).

48. Ltr. Rul. 8503067 (Oct. 24, 1984) (transfer of decedent's interest in land trust to corporation which was actively engaged in farming ruled to be mere change in form of doing business, not disposition of decedent's interest).

generally does not occur on corporate liquidation.<sup>49</sup> Various transfers within trusts have also been the subjects of favorable rulings on the question of whether the transfer constituted a transfer or disposition.<sup>50</sup>

The transfer of assets in a tax-free, like-kind exchange generally does not accelerate federal estate tax payments.<sup>51</sup>

An installment sale constitutes a disposition even if to family members.<sup>52</sup>

Execution of an oil and gas lease does not cause acceleration of tax payment; however, parcels of land on which farming is discontinued as a result of oil and gas exploration and production activities are considered to be disposed of for purposes of acceleration of tax payment.<sup>53</sup>

Apparently, cash renting farmland during the period of installment payment of tax is treated as a disposition.<sup>54</sup> Sale of timber and leasing of timber land under a long-term "net lease" is consid-

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49. Ltr. Rul. 8321085 (Feb. 18, 1983) (no acceleration when corporation liquidated under I.R.C. § 331 to sole proprietorship owned by trust; money could be removed from business up to post-death net income without being deemed a withdrawal). See Ltr. Rul. 8452043 (Sept. 24, 1984) (no acceleration on transfer of all stock in corporation to partnership and liquidation of corporation assets to partnership); Ltr. Rul. 8103066 (Oct. 22, 1980) (proposed liquidation of corporation under I.R.C. § 331 with subsequent formation of partnership not a disposition).

50. Ltr. Rul. 8334022 (May 20, 1983) (no acceleration on funding marital and family trusts from estate and subsequent distribution from marital trust to surviving spouse; surviving spouse empowered by will to withdraw principal); Ltr. Rul. 8326023 (Mar. 24, 1983) (no acceleration on transfer of corporate stock to grantor trust when grantor trust terminated with corpus distributed to beneficiaries or when trust terminated by reason of death of a beneficiary with the interest passing to family member). See Ltr. Rul. 8314007 (Dec. 17, 1982) (no acceleration when decedent's stock passed at death of surviving spouse who had life estate plus general power of appointment and failed to exercise the power).

51. Ltr. Rul. 8304033 (Oct. 22, 1982); See Ltr. Rul. 8509025 (Nov. 29, 1984) (exchange of two beneficiaries' undivided half interests in two farms for entire interest in half of farms not a disposition resulting in acceleration of balance of estate tax payable in installments); Ltr. Rul. 8452134 (Sept. 27, 1984) (exchange of farmland between estate beneficiaries not a disposition); Ltr. Rul. 8248103 (Aug. 31, 1982); Ltr. Rul. 8034165, *modifying* Ltr. Rul. 8025095 (Mar. 30, 1980) (transfer of assets in tax-free, like-kind exchange did not accelerate tax payments).

52. Ltr. Rul. 8224075 (Mar. 17, 1982) (disposition not sufficiently large to trigger acceleration of payment).

53. Ltr. Rul. 8326167 (Apr. 1, 1983).

54. Ltr. Rul. 8339023 (June 24, 1983).

ered a disposition.<sup>55</sup> This outcome is especially notable because some property-owning heirs have been pressured by lenders to shift to cash rent leasing in the interests of greater certainty of income under the lease.

Special care should be exercised on post-death transfers to a spouse. Such transfers appear to constitute dispositions even though inter-spousal transfers are now shielded from federal income tax liability.<sup>56</sup>

Four types of transactions are treated as dispositions of holding company stock for purposes of acceleration of estate tax payment: (1) disposition of holding company stock included in the decedent's gross estate; (2) withdrawal of holding company property attributable to the decedent's stock interest in the holding company; (3) disposition of stock in the business held by the holding company; and (4) withdrawal of property of the business attributable to the holding company's stock interest in the business.<sup>57</sup>

Dividend payments after death are deemed to be a withdrawal to the extent of earnings and profits accumulated before the decedent's death.<sup>58</sup>

On the basis of authority to date, it is obvious that some strategies to deal with heavy debt burdens and to stabilize deteriorating financial conditions may lead to acceleration of deferred federal estate tax under the fifteen-year payment option. Careful planning is necessary if the additional tax burden from accelerations of deferred federal estate tax is to be avoided.

### III. RECAPTURE OF SPECIAL USE VALUATION BENEFITS

Another painful consequence of property transfers in response to pressure from creditors may be recapture of the benefits from special use valuation of farmland for deaths after 1976.<sup>59</sup> For deaths before January 1, 1982, if farmland under a special use valuation election is disposed of within fifteen-years after the death of

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55. Ltr. Rul. 8437043 (June 8, 1984) (disposition even if proceeds are reinvested in remaining business interest).

56. See I.R.C. § 1041.

57. I.R.C. § 6166(g)(1)(E), (F)

58. Rev. Rul. 75-401, 1975-2 C.B. 473.

59. I.R.C. § 2032A. See 5 HARRL, *supra* note 2, § 43.03[2].

the decedent to non-family members or ceases to be used for farming or other closely held business purposes, part or all of the federal estate tax benefits are recaptured.<sup>60</sup> For deaths after 1981, the recapture period has been reduced to ten years after the decedent's death (or ten years after the commencement of "qualified use" under the two-year grace period).<sup>61</sup>

#### A. *Disposition of Property*

With several exceptions, any disposition of interests in property *other than* to a member of the *qualified heir's* family (not the decedent's family) subjects the property to special use valuation recapture.<sup>62</sup> Thus, stock redeemed under Section 303 does not trigger recapture, but reissue of the stock by the corporation to non-family members would be a recapture event.<sup>63</sup> And, sale of stock by a qualified heir to a corporation owned by the remaining qualified heirs does not result in recapture.<sup>64</sup>

Execution of an oil and gas lease does not constitute a disposition for recapture purposes where there is no interruption of the farming operation, but well-drilling activity, to the extent of interruption of the farming operation, is a disposition.<sup>65</sup> Incorporation of farm property by a qualified heir does not result in recapture if the qualified heir holds all of the stock in the corporation.<sup>66</sup> Presumably, there would be no recapture so long as the stock was held by members of the incorporating qualified heir's family.

There is no direct authority on the effects of transfers in bankruptcy, foreclosure, or forfeiture. Apparently, recapture does not occur on filing for bankruptcy under Chapters 7 or 11 and transfer of the property to the bankruptcy estate.<sup>67</sup> In the event of forfei-

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60. I.R.C. § 2032A(c).

61. I.R.C. § 2032A(c)(1).

62. See Ltr. Rul. 8133012 (Apr. 16, 1981) (sale of land by decedent's spouse to decedent's brothers was not transfer to family of spouse as qualified heir).

63. Ltr. Rul. 8217075 (Jan. 28, 1982).

64. Ltr. Rul. 8217017 (Jan. 26, 1982).

65. Ltr. Rul. 8318070 (Feb. 2, 1983).

66. Ltr. Rul. 8416016 (Jan. 13, 1984).

67. See I.R.C. § 1398(f)(1):

a transfer (other than by sale or exchange) of an asset from the debtor to the estate shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the estate shall be treated as

ture, recapture would apparently occur upon loss of the property to the seller by forfeiture under state law, unless the seller was a member of the family of the purchaser as qualified heir. With respect to foreclosure of real property under a special use valuation election, it is not clear whether recapture would occur on a foreclosure sale, or whether recapture would be delayed until expiration of the right to redeem. The latter would seem to be the proper treatment of recapture.

There is no authority on whether a mortgage or other credit obligation would constitute disposition of an interest in property for recapture purposes. It would seem that if funds obtained are reinvested in the business there should be no recapture.

For exchanges after 1981, recapture does not occur if qualified real property is exchanged in a tax-free exchange for "qualified exchange property."<sup>68</sup> If both qualified exchange property and other property are received, the recapture tax is reduced by an amount bearing the same ratio to the recapture tax as the fair market value of the exchange property bears to the fair market value of the property exchanged.<sup>69</sup> Qualified exchange property is real property used for the same qualified use as the property transferred.<sup>70</sup>

Recapture does not occur if qualified real property is involuntarily converted and "qualified replacement property" is acquired.<sup>71</sup> Qualified replacement property is real property used for the same qualified use as the property involuntarily converted.<sup>72</sup> Recapture does not occur, however, on transfer at the death of the qualified heir.<sup>73</sup> Death of the qualified heir terminates the possibility of recapture of special use valuation benefits on the property

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the debtor would be treated with respect to such asset. [Emphasis added].

Thus, federal estate tax (for purposes of both special use valuation recapture and acceleration of installment payments of federal estate tax) is under "this title". It is not clear what effect "abandonment" of farmland under special use valuation by the trustee in bankruptcy would have on recapture.

68. I.R.C. § 2032A(i). See Rev. Rul. 85-66, 1985-21 I.R.B. 11 (disposition of five-acre tract to one of qualified heirs for construction of residence for heir and heir's spouse did not result in recapture where transferee was involved in management of farm). See, e.g., Ltr. Rul. 8304106 (Oct. 27, 1982).

69. I.R.C. § 2032A(i)(1)(B).

70. I.R.C. § 2032A(i)(3).

71. I.R.C. § 2032A(h).

72. I.R.C. § 2032A(h)(3).

73. I.R.C. § 2032A(c)(1).

involved.<sup>74</sup> For interests left to qualified heirs in life estate/remainder form, recapture apparently does not cease prior to the end of the recapture period unless the holders of all interests die.

A partition of real property under a special use valuation election constitutes a disposition, but no recapture tax is due if the eligible transferee agrees to be personally liable for any additional tax.<sup>75</sup> In the case of a "qualified woodland," disposition or severance of standing timber is treated as a recapture event if the election has been made to treat the trees as part of the land.<sup>76</sup>

### B. Cessation of Qualified Use

Attempts by overburdened debtors who are qualified heirs often involve changes in the type of lease on the land and may lead to a shift to off-farm employment and away from personal involvement in the farm operation. These changes can lead to recapture of special use valuation benefits.

For purposes of "cessation of qualified use," which can cause recapture of special use valuation benefits, absence of material participation for more than three years during any eight-year period ending after the decedent's death triggers recapture.<sup>77</sup> Material participation is to be by the qualified heir or a member of the qualified heir's family for the period during which the property was held by the qualified heir, and by the decedent or a member of the decedent's family during the time the property was held by the decedent.<sup>78</sup> For a qualified heir who is the surviving spouse of the decedent, a person who has not reached age twenty-one or a disabled individual or student, the material participation test may be met by "active management" by the qualified heir (or by a fiduciary if the qualified heir is a person under age twenty-one or a dis-

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74. *Id.*

75. Ltr. Rul. 8249014 (Aug. 23, 1982); Ltr. Rul. 8120127 (Feb. 23, 1981); Ltr. Rul. 8213155 (Dec. 31, 1981).

76. I.R.C. § 2032A(c)(2)(E).

77. I.R.C. § 2032A(c)(6)(B).

78. I.R.C. § 2032A(c)(6)(B)(i),(ii). See Ltr. Rul. 8217017 (Jan. 26, 1982) (material participation by family members for corporate-owned land under crop share lease). Compare Ltr. Rul. 8218008 (Jan. 28, 1982) (brother-in-law as material participator was not member of qualified heir's family); Ltr. Rul. 8307110 (Nov. 18, 1982) (sons of decedent's half brother could not meet material participation requirement for decedent's children as qualified heirs).

abled individual).<sup>79</sup> "Active management" means the making of management decisions of a business (other than the daily operating decisions).<sup>80</sup> Since material participation cannot be achieved by agent, it does not seem that material participation by an estate representative or representatives who are not family members would satisfy the post-death material participation requirement.

Failure of each qualified heir to meet the "qualified use" test (an equity interest in the farm operation) causes recapture.<sup>81</sup> A 1981 amendment created a two-year "grace period" after the decedent's death for meeting the qualified use test retroactive to January 1, 1977.<sup>82</sup> To have an equity interest in the farm operation, the qualified heir must bear the risks of production. A crop share or livestock share lease generally meets the test,<sup>83</sup> but a cash rent lease fails to meet the requirement.<sup>84</sup> The Internal Revenue Service has ruled in a private letter ruling that a "bushel lease" met the qualified use test.<sup>85</sup>

Participation in government acreage diversion programs (including the 1983 and 1984 payment-in-kind programs) by a qualified heir does not lead to recapture of federal estate tax benefits because of the absence of material participation or failure to meet

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79. I.R.C. § 2032A(c)(7)(B), (C).

80. I.R.C. § 2032A(e)(12). This provision is effective for deaths after 1981. Pub. L. 97-448, § 104(b)(4)(A), 96 Stat. 2382 (1982) (amending Pub. L. 97-34, § 421(k)(5)(B)).

81. I.R.C. § 2032A(c)(6)(A).

82. I.R.C. § 2032A(c)(7)(A).

83. Ltr. Rul. 8429058 (Apr. 18, 1984) (crop share lease to corporation owned by family members met qualified use and material participation test); Ltr. Rul. 8330016 (Apr. 26, 1983) (50-50 crop share lease met qualified use test; lease was to member of family as tenant so material participation requirement met by tenant); Ltr. Rul. 8217017 (Jan. 26, 1982) (crop share lease between corporation owning land and corporation as farm tenant 89% owned by family members).

84. Ltr. Rul. 8427052 (Apr. 3, 1984) (cash rent lease to family partnership failed qualified use test as to qualified heir not involved in partnership); Ltr. Rul. 8346046 (Aug. 15, 1983) (cash rent lease to family corporation failed qualified use test); Ltr. Rul. 8346046 (Aug. 15, 1983) (cash rent lease to family corporation failed qualified use test); Ltr. Rul. 8240015 (June 29, 1982) (surviving spouse did not have equity interest in land which was rented to children under "net lease"); Ltr. Rul. 8307110 (Nov. 18, 1982) (children as qualified heirs not "at risk" with cash rent lease to sons of decedent's half brother).

85. See Ltr. Rul. 8217193 (Jan. 29, 1982) (bushel lease of 40 bushels of corn and 13 bushels of soybeans as rent per acre met the qualified use test where the landlord would receive no more than the amount of production if less than the specified number of bushels per acre).

the qualified use test, if the qualified heir receives agricultural commodities for idling the land.<sup>86</sup>

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86. Pub. L. 98-4 § 3, 97 Stat. 7 (1983). *See* Ann. 83-43, 1983-10 I.R.B. 29, Ltr. Rul. 8330016 (Apr. 26, 1983) ("participation by a qualified heir in the PIK program or other Department of Agriculture program will not cause the qualified heir to be treated as having ceased to use the property for a qualified use under Section 2032A").