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NebFact

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Special-Use and Alternate Valuation of Estate Property

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How much estate tax do heirs have to pay? It's a fair question with a fairly vague answer — it depends. The amount of estate tax due depends on the value of the property. The value of the property can be determined several different ways.

Generally, the value of the decedent's property (real and personal) for estate tax purposes is its fair market value at the date of death. However, some farm and business real property has a fair market value greater than its productive potential. This frequently occurs when the farm or business real property is located close to a metropolitan or resort area. When this is the case, an alternative valuation method can be used.

The personal representative of the estate can choose the special-use valuation method or the alternate valuation method in an attempt to lower the estate tax due by lowering the reported value of property in the estate. This NebFact explains the requirements and limitations of using these valuation methods.

Special-Use Valuation

The personal representative of an estate can choose to value qualified real property on the basis of its actual use for farming or a closely held business, rather than on its fair market value by using special-use valuation.

Special-use valuation does not have to cover all qualified real property included in the estate. However, if not all qualified property is valued this way, certain requirements must be met before selected property can be valued under special-use valuation.

For estate property to be valued using special-use valuation it must be qualified real property, left to a qualified heir to perform a qualified use. The definitions of "qualified" are given below.

Qualified Heir: a member of the decedent's family who acquired or received the property from the decedent. Member of the family includes only:

1. an ancestor (parent, grandparent, etc.) of the decedent,
2. the spouse of the decedent,
3. a lineal descendent (child, stepchild, grandchild, etc.) of the decedent, the decedent's spouse, or a parent of the individual, or
4. the spouse, widow, or widower or any lineal descendent described above.

Qualified Use: the use of property 1) as a farm for farming purposes or 2) in a trade or business other than farming. The term trade or business applies only to an active business such as manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities. It does not apply to passive investment activities or to the mere passive rental of property to a non-family member — except under certain, limited circumstances.

Qualified Real Property: real property used for a qualified use and acquired by a qualified heir from the decedent. Qualified real property includes residential buildings and other structures and real property improvements regularly occupied or used by the owner or lessee to operate the farm or business. Qualified real property also includes roads, buildings, and other structures, and improvements functionally related to the qualified use. Property acquired in a like-kind (tax free) exchange or involuntary conversion is qualified property if it is used for the same qualified use as the replaced property.

The decedent's ownership in the real property may have been indirect. Indirect ownership includes ownership of an interest in a corporation, partnership or trust.

If the indirect ownership is through a corporation:

1. at least 20 percent of the value of the corporation's voting stock must be included in the gross estate, or
2. the corporation must have had no more than 15 shareholders.

If the indirect ownership is through a partnership:

1. at least 20 percent of the value of the partnership's total capital interest must be included in the gross estate, or
2. the partnership must have had no more than 15 partners.

Qualified real property includes directly owned real property which was leased by the decedent to a separate closely held business of which the decedent was a stockholder or partner under the guidelines above, on the date of the decedent's death, and for a period of time that equals at least five of the eight years preceding death.

General requirements for special-use valuation: The property must have been qualified real property used for a qualified use by the decedent or a member of the decedent's family on the date of the decedent's death, and:

1. the adjusted value (fair market value of the property less any debts against the property) of *real or personal property* that was being used as a farm or in a closely held business must be at least 50 percent of the adjusted value of the gross estate,
2. at least 25 percent of the adjusted value of the gross estate must consist of the adjusted value of qualified farm or closely held business *real* property (not personal property),
3. for at least five years out of the eight-year period ending on the date of the decedent's retirement, disability or death, the decedent or a member of the decedent's family must have

a. owned the qualifying real property and
b. used it for a qualified use and
c. materially participated in the operation of the farm or closely held business.

Material Participation: No one factor brings about the existence of material participation, but physical work and participation in management decisions are the principal factors to be considered. To constitute material participation, the decedent or a member of the decedent's family must have been employed full-time. Full time means at least 35 hours per week or enough time to fully manage the farm or business. For many farming operations that require only seasonal activity, material participation exists as long as all necessary functions are performed.

If participants are self-employed with respect to the farm or other trade or business, their income must be earned income on which they pay social security tax before they are considered to be materially participating. Generally, if no self-employment taxes have been paid, material participation is not considered to have occurred. However, payment of the self-employment tax alone does not equal material participation.

If property is owned indirectly through a partnership or corporation, an arrangement must exist calling for material participation in the business by the decedent owner or family member. Holding an office in which certain material functions are performed may be enough for material participation. Merely receiving a salary, or being listed as a partner and sharing in the profits and losses does not constitute material participation.

Passively collecting rents, salaries, draws, dividends, or other income from the farm or other business is not material participation. Neither is merely advancing capital and periodically reviewing a crop plan or other business proposal and financial reports.

Other important factors in determining material participation are:

1. whether the owner or family members furnish a substantial part of the machinery, implements and livestock used in production activities;
2. whether the participating decedent or heir maintains his or her principal residence on the premises.

The required participation of the decedent must have lasted five years of the eight years prior to death. If the decedent was retired on social security or disabled prior to death, the required participation is five years of the last eight years prior to the date of retirement or disability.

Limitations: There are two significant limitations placed on special-use valuation of property. First, the total decrease in the value of qualified real property cannot exceed $750,000.

Second, property obtained through special-use valuation must be used for a qualified use by a qualified heir for 10 years after the decedent's death or some of the estate tax benefits obtained through special-use valuation may be forfeited. Property ceases to be used for a qualified use if:

1. it is sold to an unqualified heir;
2. it is no longer used as a farm or in a closely held business; or
3. the qualified heir ceases to materially participate for periods of time totaling more than three years in any eight-year period.

Special-Use Valuation Methods

Valuing farm real property. Generally, the special-use value of property that is used for farming purposes is determined by dividing the local average annual net cash rental per acre for comparable land by the five-year moving average annual effective interest rates for all new Federal Land Bank (FLB) loans in the district where the farm or business is located. Net cash rental rates are the gross cash rent minus average annual state and local real estate taxes per acre for comparable land. Net *share* rental rates may be used only if cash rental rates for comparable land are unavailable.

> Current Use Valuation = net cash rental divided by five-year moving average of FLB interest rates on new loans

Example: *Darlene owns a 640-acre farm which is located near a city. Its fair market value is $1,000,000 because of development pressures of the nearby city. However, the average annual cash rental rate for the farm is only $65,000. Real estate taxes are $10,000 per year. If the average annual effective interest rate for all new FLB loans were 10 percent, the current use valuation would be $550,000 ([$65,000 - $10,000] , .1). Using current use valuation would reduce the taxable estate by $450,000 ($1,000,000 - $550,000).*

Alternative methods for valuing qualified real property. Qualifying non-farm real property and farm property may be valued by any one of the following methods:

1. The capitalization of expected income from farming the property or for other closely held business purposes over a reasonable time with prudent management;
2. The capitalization of the fair rental value of the land for farming or for closely held business purposes;
3. The assessed land values in a state that provides a differential or use value assessment law for farmland or closely held business;
4. Comparable sales of other farm or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price;
5. Any other method which fairly determines the farm or special-use value of the property.

Taxation of commodities inherited. If the decedent materially participated in the operation of the farm, commodities received as rent and held at the time of death receive a basis that is adjusted to the date-of-death value. If the decedent did not materially participate in the operation of the farm, commodities received as rent and held at the time of death are considered income and do not receive a basis adjusted to the date-of-death value.

Example: *Sam owned 10,000 bushels of corn valued at $2.50 per bushel when he died. Sam was considered to have been materially participating in the farm prior to his death so the heirs receive a basis of $25,000 for the corn. If they sell the corn for $2.60 per bushel, they will have to pay capital gains tax on $1,000. If Sam had not been considered materially participating in the farm, the heirs would have no basis in the corn and would have to include the entire $26,000 received as ordinary income subject to both federal and state income tax. Alternatively, the personal representative of the estate could have sold the corn and used the proceeds to pay off any outstanding debt of Sam's. This would result in no capital gains tax liability by the heirs.*

Alternate Valuation

The purpose of alternate valuation is to reduce the tax liability if the *total* value of the estate's property has decreased since the date of the decedent's death. Alternative valuation applies to *all* of the property in the estate. It cannot be used for only part of the property, as is the case with special-use valuation.

However, the personal representative may choose alternate valuation and also use special-use valuation for qualified real property. The choice must be made on the first estate tax return filed for the estate.

Alternate valuation rules. When alternate valuation is used the estate is valued according to the following rules:

1. Any property distributed, sold, exchanged, or otherwise disposed of within six months after the decedent's death is valued at the date of the transaction;
2. Any property not disposed of within six months after the decedent's death is valued as of six months after the date of the decedent's death;
3. Patents, remainders, reversions and estates for the lives of persons other than the decedent are valued as of the date of the decedent's death.

When a capital gain dividend is declared and paid by a regulated investment company on its stock between the date of the decedent's death and the alternate valuation date, the capital gain dividend is not computed into the value of the decedent's gross estate on the alternate valuation date.

Example: *Sally died leaving an estate valued at $2,000,000. Six months later, when the estate was settled, the stock she owned, valued at $500,000 on the date of her death, was only worth $400,000. The other property had not changed in value by that time. The personal representative chose to value the estate under the alternate valuation rules. The estate was then valued at only $1,900,000 since there was a $100,000 decrease in the value of the stock.*

Factors to Consider Before Choosing a Valuation Method

It is critical that the decedent have materially participated in the farm or closely held business if the estate expects to use special-use valuation. The law also requires that property inherited by special-use valuation be used for a qualified purpose by a qualifying heir for a minimum of 10 years. It may be wise to stipulate in a will that qualified property be left to a qualified heir likely to materially participate in the farm or closely held business for 10 years. Other property may be left to non-qualified heirs or to heirs which would not materially participate in the business.

When you want to dispose of your assets prior to your death, consider disposing of non-qualifying property such as stocks and bonds, and non-business assets. It is important to manage assets so that the percentage requirements in qualified property discussed earlier is sufficient. The qualifying property can then be passed on to qualifying heirs at the special-use value, saving estate taxes. The savings in federal estate taxes due to passing on qualifying property needs to be considered against the stepped-up basis gained when passing on stocks and bonds through an estate.

An elderly person considering purchasing additional land may want to consider the qualifications of using special-use valuation. Since property must be owned and managed for five years by the decedent prior to retirement or death, it is wise to either not postpone purchases too late or to purchase land from a family member since this meets a general requirement of the law.

Maintaining material participation is critical if land is being leased to a non-family member. For leases to family members, the owner does not need to materially participate. The Internal Revenue Service will, upon request, give a ruling of whether or not the level of participation an individual has in a closely held business is sufficient to meet its material participation rules.

If the size of commodity holdings are substantial, it is best if the decedent had materially participated in the farm. The value of the gross estate for estate tax purposes is not affected. But when the heirs sell the

commodity, their income (for income tax purposes) is only the difference between the price they received and the basis in the commodity they inherited. If the decedent was not considered to be materially participating at the time of death, it may be wise if the personal representative of the estate sold the commodities to pay the outstanding debts of the decedent.

Additional Information

IRS Publication 448, *Federal Estate and Gift Taxes*

The information contained in this NebFact is for educational purposes only. Tax is complicated and the information presented here has necessarily been simplified. See a tax consultant for specific questions.

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