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# Use Valuation of Farmland for Federal Estate Tax Purposes

University of Tennessee Agricultural Experiment Station

Ronald W. Todd

Timothy S. Moore

B. R. McManus

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# Use Valuation of Farmland for Federal Estate Tax Purposes

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# Use Valuation of Farmland for Federal Estate Tax Purposes

Ronald W. Todd, Timothy S. Moore, and B. R. McManus\*

## INTRODUCTION

**T**he Tax Reform Act of 1976<sup>1</sup> provided an optional method of valuing real estate for estate tax purposes when used for farming or other closely held business purposes and when certain other qualifying conditions are met. Under this option, administrators of the estates of persons who die after 1976 may elect to value qualifying real property according to its current use rather than at market value.

Purpose for the provision was to lower taxes on qualifying farm estates in order to facilitate family farm transfers, thereby permitting the next generation to continue the business that might otherwise be liquidated in order to pay estate taxes. While ease of intergenerational transfer and the continuation of the family farm may be legitimate goals, available evidence indicates that relatively few farms are force-transfers to secure funds to pay estate taxes.<sup>2</sup> However, as value of farm assets increase, the need for use valuation will likely become more important.

## PURPOSE

The purpose of this publication is to: 1) delineate the qualifying requirements for use valuation of farm property in estates; 2) estimate the potential for estate tax savings through use valuation in specified estate situations; and 3) project the potential for use valuation as farm estates appreciate.

## STATUTORY PROVISIONS

The implementation of use valuation of farmland by Congress was an attempt to reduce the frequency of forced sales of farmland to pay estate taxes. Use valuation applies only to estates of decedents

\*Associate Professor, former Graduate Research Assistant and Professor, respectively, Department of Agricultural Economics and Rural Sociology, Knoxville.

<sup>1</sup> See IRC (Internal Revenue Code) § 2032A for the use valuation provisions.

<sup>2</sup> Harold D. Guither, "Death, Taxes, and Farmland Transfers," **Farm Economics Facts and Opinions**, Department of Agricultural Economics, University of Illinois, August, 1978, p. 2.

who were residents or citizens of the United States at death. The estate administrator, on proper election of use valuation, can effectively reduce the gross value of an estate for tax purposes up to a maximum of \$500,000.<sup>3</sup> To limit use valuation to family type farm estates while providing needed flexibility, Congress included certain additional qualifying requirements, imposed a recapture tax, and provided two methods for appraising real property.

### Qualifying Requirements

To qualify for use valuation, real property must be located in the United States, be transferred to a qualified heir, be devoted to farming or other closely held business, and meet certain ownership and material participation requirements. Additionally, at least 25 percent of the adjusted gross estate must consist of qualified real property and at least 50 percent of such estate must consist of qualifying real or personal property which was acquired from the decedent by one or more qualified heirs.<sup>4</sup>

**Qualified heir.** The term “qualified heir” for purposes of use valuation means a family member of the decedent who acquired a present interest in the subject property or to whom such interest in the property passed from the decedent. The term also includes any family member of the qualified heir.<sup>5</sup> A “member of the family” is a phrase which for purposes of the statute means, “with respect to any individual, only such individual’s ancestor or lineal descendant, a lineal descendant of a grandparent of such individual, the spouse of such individual, or the spouse of any such descendant. For purposes of the preceding sentence, a legally adopted child of an individual shall be treated as a child of such individual by blood.”<sup>6</sup>

**Farm or farming purposes.** In the agricultural context “qualified use” means real property used as a farm for farming purposes. More specifically, the term “farm” includes livestock, dairy, poultry, fruit, furbearing animal, and truck crop production. Plantations, ranches, nurseries, ranges, orchards, woodlands, and greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities also are included in the term “farm” for use valuation purposes. “Farming purposes” includes the activities nor-

<sup>3</sup>IRC, § 2032A(a).

<sup>4</sup>IRC, § 2032A(b).

<sup>5</sup>IRC, § 2032A(e) (1).

<sup>6</sup>IRC, § 2032A(e) (2).

mally associated with agricultural production such as soil cultivation and management, as well as the growing and preparation, other than milling, of trees for market. The handling, drying, packing, grading, or storing of any agricultural or horticultural commodity on a farm in its unmanufactured state is treated as having been done for farming purposes only if the owner, tenant, or operator of the farm regularly produces more than half of the commodity so treated.<sup>7</sup>

**Ownership and material participation.** A prerequisite to the use valuation election is that the decedent or a member of his family own and materially participate in the operation of the farm or other closely held business for periods aggregating five or more years during the eight years immediately preceding the decedent's death.<sup>8</sup> Such participation must be continued by at least one qualified heir for a period of 15 years or until all qualified heirs have died, in order to obtain full advantage of the use valuation provisions.<sup>9</sup>

Section 2032A states that "material participation shall be determined in a manner similar to the manner outlined in section 1402(a) (relating to the net earnings from self-employment)."<sup>10</sup> Recent treasury regulations indicate that whether substantial material participation is involved is a factual determination and that sufficient involvement may vary with the type of ownership of both the real property and of any business in which it is used. Actual employment of a decedent or a member of his family on a substantially full-time basis, or to any lesser extent necessary to personally manage a directly owned farm or other business, will constitute material participation. The regulations further indicate that where actual production activities are not performed by the decedent or a member of his family there must be an arrangement requiring material participation in the business by the decedent owner or a member of his family.<sup>11</sup> Under such arrange-

<sup>7</sup>IRC, § 2032A(e) (5).

<sup>8</sup>IRC, § 2032A(e) (2). The ownership requirement could be met indirectly. For example, prior to death the decedent might have owned an interest in a corporation, a partnership, or a trust which held title to qualified real estate. See Treasury Regulation § 20.2032A(3) (f) and accompanying examples for details of special rules for corporations, partnerships, and trusts.

<sup>9</sup>IRC, § 2032A(c) (1).

<sup>10</sup>IRC, § 2032A(d) (6).

<sup>11</sup>Treasury Regulations § 20.2032A-3(e) (f). Additionally, the regulations impose the presumption as to self-employed persons that material participation is not involved unless self-employment taxes have been paid. The executor may rebut this presumption by 1) demonstrating to the satisfaction of the Internal Revenue Service that in fact material participation did occur, 2) informing the Service of the reason such tax was not paid, and 3) paying all such taxes determined to be due. "Where property is indirectly owned, however, even full-time involvement must be pursuant to an arrangement between the entity and the decedent or family member specifying the services to be performed." For further details of special rules for corporations, partnerships, and trusts see Treasury Regulation § 20.2032A-3 (f) and accompany examples.

ment “[a]s a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and/or family members must participate in making a substantial number of these decisions. Additionally, production activities on the land should be inspected regularly by the family participant, and funds should be advanced and financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, the furnishing by the owner or other family members of a substantial portion of the machinery, implements, and livestock used in the production activities is an important factor to consider in finding material participation.”<sup>12</sup>

### Recapture Provisions

As an attempt to prevent an easy loophole in the use valuation provision, Congress included a recapture tax. This provision was designed to prevent estate tax benefits where the subject farmland would not continue to meet the qualifying conditions over a substantial period of time. The recapture provision requires a total repayment of the tax saved through use valuation if a recapture event occurs within 10 years after the death of the decedent, a partial prorated repayment if the recapture event occurs after the tenth and before the end of the fifteenth year after death of the decedent, and no recapture after lapse of 15 years.<sup>13</sup> A recapture event occurs when a qualified heir transfers the subject property to a nonqualified person or ceases to use the property in a qualified manner.

Special rules apply for involuntary conversions of use valued property. The recapture tax does not apply if the entire proceeds of the property subject to involuntary conversion are reinvested in qualifying real property within a specified time period. If there is only a partial investment in qualifying property to replace the use valued property subject to the involuntary conversion, part of the original

<sup>12</sup>Id. § 20.2032A-3(e) (2).

<sup>13</sup>IRC, § 2032A(c) (2) (3). The prorated amount is determined by multiplying the total recapture amount by a fraction: 1) the numerator of which is the number of full months after the death of the decedent in excess of 120, and 2) the denominator which is 60. No recapture is required on the death of the last qualified heir even if the death occurs during the 15-year period, and the executor of the estate of such deceased heir may also elect use valuation if otherwise qualified.

estate tax reduction must be repaid or recaptured. The proportion of the proceeds from such involuntary conversion that is not reinvested in qualifying property will determine the proportion of the original tax saving that must be recaptured.<sup>14</sup> The period within which involuntary converted property must be replaced begins with the date of the disposition of such property, or the date of threat or imminence of requisition or condemnation of such property, whichever is earlier, and generally ends three years after the close of the first taxable year in which any part of the gain upon the conversion is realized.<sup>15</sup>

Recapture does not represent an added tax above that which would have been due in the absence of use valuation. Any recapture tax paid represents only the tax originally saved and no interest will be due for the period the tax was shifted forward. The estate electing use valuation obtains, in effect, an interest-free loan from the government even if a recapture event occurs.

### Valuation Methods

The use value of land may be determined by one of two methods.<sup>16</sup> The first, or formula method, is commonly used in determining the value of land for farming purposes. The second or alternate method of land valuation may be used if the executor chooses and must be used, if gross cash rent data for comparable land is not available.

**Formula method.** Prerequisite to determining use value by the formula method is the availability of average annual cash rent and property tax data on actual tracts of comparable land used for farming purposes in the same general locality. In addition, the average annual effective interest rate for all new Federal Land Bank loans to farmers in the farm credit district where the subject property is located must be obtained. The official interest rates can be obtained from the Internal Revenue Service.<sup>17</sup>

<sup>14</sup>IRC, § 2032A(h) (1). Stated mathematically the recapture would be where:

$$RT = \text{ETS} - \frac{a}{x}(\text{ETS})$$

ETS = the original estate tax saving from use valuation of the subject property

a = the amount of the proceeds from the involuntary conversion of use valued property not timely reinvested in qualifying property

x = the full proceeds from the involuntary conversion of use valued property

<sup>15</sup>IRC, § 2032A(h), § 1033(a) (2) (b) (i); (9) (4).

<sup>16</sup>IRC, § 2032A(e) (7) (8).

<sup>17</sup>Treasury Regulation § 20.2032A-4(e). The effective interest rate reflects the billing rate adjusted upward to account for the reduction in loan proceeds which results from a required investment in Land Bank stock. For example, if a particular Land Bank district required stock equal to 5 percent of the face amount of the loan as a condition of making the loan, the borrower would receive only 95 percent of the face amount. Thus, if the billing rate of interest was 10.25 percent, the average annual effective interest rate would be determined by dividing 10.25 (billing rate) by 0.95 (percent of loan proceeds received by borrower) = 10.79 percent.



In mathematical notation the use value formula is:

$$V = \frac{R - T}{I}$$

where:

V = use value

R = an average annual gross cash rental for similar land in the locality

T = average annual effective interest rate for all new Federal Land Bank loans

To compute use value using the formula method, average data for five years preceding the death of the decedent must be used. Executors electing use value and choosing the formula method of valuation must document to the Internal Revenue Service the actual comparable property and related characteristics upon which their calculations are based.<sup>18</sup>

**Alternate method.** The statute outlines factors which can be substituted for formula valuation in determining use value of qualified farmland. The alternate method must be chosen for farmland in areas where cash rent data are not available and for all eligible nonfarmland. Some of the factors listed as applicable in determining value under this method constitute separate appraisal techniques each of which if used alone might be expected to yield a different value for a particular piece of property. The statute simply says that when formula valuation does not apply,

. . . the following factors shall apply in determining the value of any qualified property:

A. The capitalization of income which the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and related factors,

B. The capitalization of the fair rental value of the land for farmland or closely held business,

C. Assessed land values in a state which provides a differential or use value assessment law for farmland or closely held business purposes,

D. Comparable sales of other farms 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, and

E. Any other factor which fairly values the farm or closely held business value of the property.<sup>19</sup>

<sup>18</sup>Treasury Regulation § 20.2032A-4(b) (2).

<sup>19</sup>IRC, § 2032A(e) (8).

Treasury Regulations are not yet available on this method of valuation. Until such regulations are available, it appears that the alternative method will involve the judgmental assimilation of the listed factors for each respective property. Though helpful, these factors are not self-explanatory and until regulations are made available as a guide to their use, formula valuation has more appeal.

## IMPLICATIONS FOR ESTATE PLANNING

Farm estate owners having relatively large amounts of real property and heirs apparent who desire to continue the farm business should do considerable estate planning. Such planning should take into account the statutory qualifications for use valuation as well as its influence on estate taxes and, in addition, assure adequate retirement income and fairness between beneficiaries. To assure that a particular estate will qualify and that use valuation may be elected, statutory provisions should be considered. In determining whether or not to elect use value, several factors should be considered that do not relate to whether a particular estate property meets the statutory requirements.

### Size of Estate and Type of Property Ownership

The size of estate and type of property ownership influences the desirability of electing to value property by its use in a given estate. Estates large enough to have property taxed at the highest incremental rate of 70% of the unified estate and gift tax scale can receive a reduction in estate taxes of up to \$350,000 based upon the \$500,000 maximum estate reduction available through the use value election. If the farm was acquired as community property or if the spouse is considered to own an undivided 50 percent interest because of his/her contribution to the farm,<sup>20</sup> the \$500,000 estate reduction limit could effectively be increased to \$1 million. Estate tax reductions available from use valuation will effectively be zero in 1981 and

<sup>20</sup> Contribution may consist of: 1) providing capital for purchase, 2) receipt of an interest by gift under IRC § 2040(b) with proper election and payment of gift taxes, and 3) by IRC § 2040(c) recognition of services of a spouse who materially participates in the management and operation of a jointly owned, debt-financed farm business.

thereafter <sup>21</sup> for estates of unmarried individuals valued at no more than \$175,625 and for married persons utilizing the maximum marital reduction having estates of not more than \$425,625. If a married person does not qualify for, or elects not to use the marital deduction, his/her estate will be taxed the same as that of an unmarried person.

### Effect on Section 6166 Deferral

Section 6166 of the Internal Revenue Code permits deferring the estate tax attributable to the first million dollars in value of a farm or other closely held business for up to 15 years with a 4 percent interest rate on such deferred tax. The value of a farm or other closely held business interest must account for at least 65 percent of the adjusted gross estate before it is eligible for § 6166 deferral. If use valuation is chosen, that value must be relied on in determining whether the estate qualifies for § 6166 deferral and the low interest provisions. Some estates which would otherwise qualify for § 6166 deferral will not qualify if use valuation is elected and, therefore, estate taxes cannot be deferred which may result in liquidity problems.

### Maximizing Use Valuation Potential

Maximum benefits from use valuation can be gained only if enough qualified property is available to utilize the maximum estate reduction of \$500,000 in large estates. In estates not large enough to utilize the maximum reduction, greatest benefits from use valuation would be available if all real property owned by the decedent was qualified property. In order to retain qualified property, priority for

<sup>21</sup> For estates of persons dying after 1976 and before 1981 in some cases, savings can be obtained from use valuation in smaller estates due to lower values of unified credit available to offset estate taxes. The following timetable shows the increases in the uniform credit from 1977 to 1981:

Year of death	Amount of tax credit	"Maximum exemption equivalent"
1977	\$30,000	\$120,666
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,563
1981	47,000	175,625

The "maximum exemption equivalent" is the maximum adjusted taxable estate that a person can leave (where the marital deduction does not apply) without any estate tax being due. Where the maximum marital deduction applies, half of the adjusted gross estate or \$250,000, whichever is greater, can pass in addition to the "maximum exemption equivalent" without any estate tax being due provided that the unified credit has not been used to offset gift taxes.

making lifetime gifts, and funding of the marital deduction should first be made from property which does not qualify for use valuation.

The effects of transferring property by gift which qualifies for use valuation should be considered before such transfers are actually made. First, the incentive to make gifts and shift the potential appreciation in farmland value from one generation to another may be lost. Use value is not applicable in valuing property transferred by gift; and if market value of a particular tract of farmland greatly exceeds the projected use value of the tract, the estate taxes saved by transferring that tract by gift might be less than the saving from valuation in the estate if the property was retained and transferred at death. Second, a gift of qualifying property may have the effect of changing the makeup of remaining estate assets to the extent that the estate will not qualify for use valuation. Marital deductions, where possible, should be funded from nonqualifying property. No estate tax benefit can be gained from use valuation of property going to a spouse so long as the value of such property does not exceed half of the adjusted gross estate. Thus, qualifying property should be reserved for use valuation except where there is ample qualifying real property to utilize the \$500,000 maximum estate reduction in addition to property qualifying for the marital deduction.

#### Effect on Retirement Income

The retirement income of a farmer can be reduced under Social Security rules and regulations if he materially participates in the operation of farm property so it will later qualify for use valuation. For farmers between the ages of 62 and 70, income received while materially participating in the farm business may reduce Social Security payments while rental income in the absence of material participation does not affect Social Security benefits. In addition, self-employment income from material participation in the farm business will be subject to continued Social Security taxes even after the farmer is, for practical purposes, retired.

#### Fairness Among Beneficiaries

Use valuation does not give rise to problems of fairness if the decedent has only one heir or devisee. However, potentially unfair situations can arise if there are several heirs or devisees, and one of them receives the use valued property. The major source of unfair treatment is from the recapture provisions which require the qualified heir receiving the use valued property to pay the recapture tax upon disposition to a nonqualified person or on cessation of the qualified use within the 15-year period following the death of the decedent. If the qualified heir receives use valued property having a market value

equal to that received by the other heirs, his share is effectively reduced in value by the contingent recapture tax liability. In the absence of compensating adjustments, the remaining heirs share ratably the reduction in estate taxes resulting from the use value election. Additionally, if the qualified heir finds it necessary to prematurely dispose of the use valued property, potential buyers will be limited to members of the family if the recapture tax is to be avoided. In that situation, members of the family will acquire potential leverage in holding down the price of such property. To avoid such potentially unfair results, offsetting or compensating provisions can be incorporated into the estate plan.

### IMPACT OF USE VALUATION

Several years will be needed to accumulate the information necessary to accurately measure the impacts of use valuation. Data for the analysis and projections of this study came primarily from secondary sources.<sup>22</sup>

Four census classifications of farms by volume of commodity sales were chosen for analysis in this study and assumed to represent actual estates. The classes of farms selected and their respective sales volumes are as follows: Class IA, \$100,000 and above; Class IB, \$40,000 to \$99,999; Class II, \$20,000 to \$39,999; and Class III, \$10,000 to \$19,999. Census data indicated that in 1974, 74 percent of gross farm assets on the average U. S. farm consisted of farmland and that debt represented 16 percent of gross farm assets. These ratios were assumed to apply to all four sales classifications considered.

An average use value based on the use value formula was calculated for each of the 14 states.<sup>23</sup> Average cash rental rates, property taxes, and farmland prices needed for determining use value comparisons were taken from **Farm Real Estate Market Developments**.<sup>24</sup> The average use value for the 14 states was estimated to be 65 percent of market value. A similar value was obtained when Tennessee data were used in the formula. Thus, 65 percent of market value was chosen as the representative use value for all calculations. Projections of potential tax savings from use valuation over time were based on an assumed appreciation rate of 8 percent per year through 1990.

<sup>22</sup>U. S. Department of Commerce, 1974 Census of Agriculture, Vol. 1 pt. 51 (Washington: Bureau of the Census, 1977); USDA, 1978 **Balance Sheet of the Farming Sector** (Washington: Economics, Statistics, and Cooperatives Service), October, 1978; USDA, **Farm Real Estate Market Developments** (Washington: National Economics Analysis Division, Economics, Statistics and Cooperatives Service), March, 1977.

<sup>23</sup>Included were Georgia, Mississippi, Tennessee, North Carolina, Kentucky, Ohio, Indiana, Illinois, Iowa, Missouri, Minnesota, North Dakota, Oklahoma, and Wisconsin.

<sup>24</sup>U. S. Department of Agriculture, **Farm Real Estate Market Developments**, Economics, Statistics, and Cooperatives Service, 1978.

## Potential for Federal Estate Tax Savings

Federal estate tax liabilities for estates having the characteristics of the average farm in each of the four size classifications were calculated based on the assumption that nonfarm assets are just adequate to cover nonfarm debt and estate settlement costs.<sup>25</sup> Four liability situations were analyzed for each estate category as follows: 1) market valuation and no marital deduction, 2) market valuation with a marital deduction, 3) use valuation and no marital deduction, and 4) use valuation with a marital deduction. Federal estate tax law provides a marital deduction of \$250,000 or half of the adjust gross estate, whichever is larger, for outright transfers of property to a surviving marital partner. Selected estate characteristics and estimated estate tax liabilities for the average farm in each of the four selected sales classes are presented in Tables 1 and 2. Similar statistics illustrating the effects of appreciation over time are presented in Tables 3 and 4.

### Impact in 1980

Estates having the assets and liabilities represented by sales classification III and II would have no federal estate tax liability regardless of whether or not use valuation is elected if the marital deduction can be used (Tables 1 and 2) for estates in these size categories when the maximum marital deduction is utilized. There is no federal estate tax incentive to elect use valuation. Where the marital deduction does not apply, however, the federal estate tax liability for Class III farms would be \$17,104 and for Class II farms it would be \$40,468. Thus, there is an incentive to elect use valuation and reduce the federal estate tax liability for Class III to zero and Class II to \$11,249.

In large estates, represented by sales classifications IB and IA, a potential exists to reduce estate taxes through use valuation without respect to use of the marital deduction. Without use valuation, an estate represented by Class IB, having a farm business equity of \$466,730, would have potential estate tax liability of \$17,654 where the maximum marital deduction applies and \$101,988 where no marital deduction can be taken (Table 1). By electing use valuation of farmland, estates represented by Class IB could reduce the federal estate tax to zero where the maximum marital deduction is applicable and to \$51,122 where no marital deduction applies (Table 2). Even greater incentives exist to elect use valuation in estates represented by farms in Class IA. In that category, an estate tax liability of \$127,662 would apply where the maximum marital deduction can be taken and \$335,130 where no marital deduction is available. Use valuation could reduce the tax liability of an estate represented by Class IA to \$64,474 where the marital deduction applies and to \$192,032 where it does not apply.

**Table 1. Estimated 1980 Federal Estate Tax Liability With and Without a Marital Deduction for an Average Size Farm Within Respective Sales Categories—Use Valuation Not Elected**

Item	Sales Classification			
	III 10,000 to 19,999	II 20,000 to 39,999	IB 40,000 to 99,999	IA 100,000 or more
-----dollars-----				
Estate characteristics (market Valued):				
Real estate	174,463	254,492	427,451	1,042,417
Gross farm assets	235,761	343,908	577,636	1,408,672
Debt	20,747	58,120	110,906	331,038
Adjusted farm estate	215,014	285,788	466,730	1,077,634
Tax liability:				
With marital deduction:				
Marital deduction	250,000	250,000	250,000	538,817
Taxable estate	0	35,788	216,730	538,817
Tentative taxes <sup>a</sup>	0	7,273	60,154	170,162
Tax credit <sup>b</sup>	42,500	42,500	42,500	42,500
Tax liability	0	0	17,654	127,662
Without marital deduction:				
Taxable estate	215,014	285,788	466,730	1,077,634
Tentative taxes <sup>a</sup>	59,604	82,968	144,488	377,630
Tax credit <sup>b</sup>	42,500	42,500	42,500	42,500
Tax liability	17,104	40,468	101,988	335,130

<sup>a</sup>Computed from Internal Revenue Code of 1954, as amended, § 2001.

<sup>b</sup>The tax credit is \$38,000, \$42,000, and \$47,000 for 1979, 1980, and 1981, respectively, and \$47,000 each year thereafter.

Sources of data: Land values were taken from **Balance Sheet of the Farming Sector 1977**, Economic Research Service, U. S. Department of Agriculture, p. 47.

<sup>25</sup>This is an oversimplification of the calculations necessary when estate taxes are due but should suffice to illustrate the magnitude of potential tax saving through use valuation.

**Table 2. Estimated 1980 Federal Estate Tax Liability With and Without a Marital Deduction for an Average Size Farm Within Respective Sales Categories—Use Valuation Elected**

Item	Sales Classification			
	III 10,000 to 19,999	II 20,000 to 39,999	IB 40,000 to 99,999	IA 100,000 or more
-----dollars-----				
Estate characteristics:				
Land value (use valued) <sup>a</sup>	113,401	165,420	277,843	677,571
Gross farm assets	174,699	254,836	423,028	1,043,826
Debt	20,747	58,120	110,906	331,038
Adjusted farm estate	153,952	196,716	317,122	712,788
Tax Liability:				
With marital deduction:				
Marital deduction	250,000	250,000	250,000	356,394
Taxable estate	0	0	67,122	356,394
Tentative taxes <sup>b</sup>	0	0	14,852	106,974
Tax credit <sup>c</sup>	42,500	42,500	42,500	42,500
Tax liability	0	0	0	64,474
Without marital deduction:				
Taxable estate	153,952	196,716	317,122	712,788
Tentative taxes <sup>b</sup>	40,065	53,749	93,622	234,532
Tax credit <sup>c</sup>	42,500	42,500	42,500	42,500
Tax liability	0	11,249	51,122	192,032

<sup>a</sup>Use valuation by formulae using general information was determined to be 65 percent of market value. This ratio of market value to use value would not apply to specific farms.

<sup>b</sup>Computed from Internal Revenue Code of 1954, as amended, § 2001.

<sup>c</sup>The tax credit is \$38,000, \$42,000, and \$47,000 for 1979, 1980, and 1981, respectively, and \$47,000 each year thereafter.

Sources of data: Land values were taken from **Balance Sheet of the Farming Sector 1977**, Economic Research Service, U. S. Department of Agriculture, p. 47.



## Effect of Appreciation

The estimated average market value of farm assets, land, and debt for all farms (without reference to sales classifications) in Tennessee and the U. S. for selected years are presented in Tables 3 and 4, respectively, along with potential estate tax liabilities. Information presented in these tables was computed based on 1977 data with an assumed appreciation rate of 8 percent per year.

The average dollar value of assets per farm estate in Tennessee was not large enough to result in any tax liability for decedents dying in 1980.<sup>26</sup> With 8 percent appreciation in farm assets there would not be any tax liability by 1985, but by 1990 farm estates of average size not able to utilize the marital deduction would be subject to a tax liability of \$17,407 (Table 3). Only in this latter situation would there be an incentive to elect use valuation for appraisal of farmland for the average sized farm estate in Tennessee.

<sup>26</sup>The unified tax credit of \$42,500 for 1980 and \$47,000 for 1981 and thereafter would more than offset any tax liability.

**Table 3. Estimated Estate Size and Federal Estate Tax Liability With and Without a Marital Deduction for an Average Farm, Tennessee, Selected Years**

Item	1980	1985	1990
	-----dollars-----		
Estate characteristics:			
Real estate	95,683	140,590	206,573
Gross farm assets	129,301	189,987	279,153
Debt	22,757	33,438	49,131
Adjusted farm estate	106,544	156,549	230,022
Without marital deduction:			
Tentative taxes <sup>a</sup>	25,763	40,896	64,407
Tax credit <sup>b</sup>	42,500	47,000	47,000
Tax liability	0	0	17,407
With marital deduction:			
Marital deduction	250,000	250,000	250,000
Adjusted gross estate	0	0	0
Tentative taxes <sup>a</sup>	0	0	0
Tax credit <sup>b</sup>	42,500	47,000	47,000
Tax liability	0	0	0

<sup>a</sup>Computed from Internal Revenue Code of 1954, as amended, § 2001.

<sup>b</sup>The tax credit is \$38,000, \$42,000, and \$47,000 for 1979, 1980, and 1981, respectively, and \$47,000 each year thereafter.

Sources of data: Land values were taken from **Balance Sheet of the Farming Sector 1977**, Economic Research Service, U. S. Department of Agriculture, p. 47. (These data were adjusted positively at 8 percent per annum.)

The average dollar value of assets per farm estate in the U. S. is somewhat greater than for Tennessee (Table 4). The average farm estate in the U. S. would have an incentive to elect use valuation in 1980 where the marital deduction does not apply, but this incentive would be missing until after 1985 where the marital deduction applies.

**Table 4. Estimated Estate Size and Federal Estate Tax Liability With and Without a Marital Deduction for an Average Farm, United States, Selected Years**

Item	1980	1985	1990
	-----dollars-----		
Estate characteristics:			
Real estate	225,243	330,955	486,280
Gross farm assets	304,877	497,963	657,138
Debt	48,780	71,674	105,142
Adjusted farm estate	256,097	376,289	551,996
Without marital deduction:			
Tentative taxes <sup>a</sup>	72,873	113,738	175,038
Tax credit <sup>b</sup>	42,500	47,000	47,000
Tax liability	30,373	66,738	128,038
With marital deduction:			
Marital deduction	250,000	250,000	275,998
Adjusted gross estate	6,097	126,289	275,998
Tentative Taxes <sup>a</sup>	1,098	31,687	79,639
Tax credit <sup>b</sup>	42,500	47,000	47,000
Tax liability	0	0	32,639

<sup>a</sup>Computed from Internal Revenue Code of 1954, as amended, § 2001.

<sup>b</sup>The tax credit is \$38,000, \$42,500, and \$47,000 for 1979, 1980, and 1981, respectively, and \$47,000 each year thereafter.

Sources of data: Land values were taken from **Balance Sheet of the Farming Sector 1977**, Economic Research Service, U. S. Department of Agriculture, p. 47. (These data were adjusted positively at 8 percent per annum.)

## Variation from Region to Region

The frequency of election and resultant impact of use valuation can be expected to differ among the various states. A comparison of estimated use values and market values for 14 selected states can be made from data presented in Table 5. When use value is calculated as a percentage of market value, considerable variation can be noted from state to state (Table 5). In the Corn Belt states, Ohio has an average use valuation of 43.57 percent of market value, while farmland in both Indiana and Missouri have use values of over 74 percent of market values. Tennessee also has a relatively large use valuation in comparison with market value at 68.48 percent.

The greatest impact of use valuation can be expected in areas of high land value such as the northeast in general and urban fringe areas throughout the U. S. These areas will generally have wide variations between market value and use value due to high real estate taxes and relatively low farm rental income. Market values and use values should theoretically be nearly the same in rural areas, but by formulae determination market value will generally exceed use value even in areas where the highest and best use of the land is agricultural.

**Table 5. Rental Rates, Property Taxes, Estimated Use Value, Market Value, and Use Value as a Percent of Market Value for Selected States, 1977**

State	Average Rent	Property Taxes	Estimated <sup>a</sup> Use Value	Market Value	Use Value as a Percent of Market Value
					—dollars per acre—
Georgia	28.20	3.09	304.00	564	53.90
Illinois	90.00	10.11	967.19	1,581	61.18
Indiana	85.00	5.09	967.43	1,303	74.25
Iowa	82.00	6.76	910.90	1,268	71.84
Kentucky	36.45	2.72	408.35	671	60.86
Mississippi	26.30	1.21	303.75	464	65.46
Missouri	40.00	2.82	450.12	602	74.77
Minnesota	53.90	4.53	597.70	730	81.88
North Carolina	28.90	3.45	303.27	694	43.70
North Dakota	17.40	1.80	188.86	273	69.18
Ohio	52.50	7.05	550.24	1,263	43.57
Oklahoma	16.50	1.24	184.75	402	45.96
Tennessee	37.20	2.81	416.34	608	68.48
Wisconsin	48.00	12.11	434.50	690	62.97

<sup>a</sup>Estimated use value = (average farmland rental rate – property taxes) ÷ average annual effective interest rate for all new Federal Land Bank loans.

Sources of data: Land values were taken from **Balance Sheet of the Farming Sector 1977**, Economic Research Service, U. S. Department of Agriculture, p. 47; real estate taxes were taken from **Farm Real Estate Taxes 1978**, p. 14; and rental data and Federal Land Bank interest rates were taken from **Farm Real Estate Market Developments**, Washington: National Economics Analysis Division, Economics, Statistics, and Cooperatives Service, U. S. Department of Agriculture, pp. 51 and 52, March, 1977.

## SUMMARY

**T**he use valuation election can effectively reduce the value of gross estates by as much as \$500,000 when all of the statutory requirements are met. These requirements or qualifying conditions were imposed to limit use valuation to the family type business which is often subject to liquidation when estate taxes must be paid. Each property owner who plans to minimize his estate taxes via use valuation should familiarize himself with the qualifying conditions so they can be met and use value can be elected after his death.

Use valuation is likely to have its greatest effect in reducing the federal estate tax liability for the larger farm estates in Tennessee. In 1981 and thereafter, estates of unmarried persons valued up to \$175,625 and estates of married persons utilizing the maximum marital deduction valued up to \$425,625 will not generally have an estate tax liability and will not have an advantage in electing use valuation. On the other extreme, large estates taxed at the highest incremental rates can receive estate tax reductions of up to \$350,000 (500,000 x .70 maximum estate tax rate).

The full impact of the use valuation provisions may not be fully known for decades. Projections made in this study for selected years up through 1990 based on census data for four farm size classifications by volume of sales indicate that where the maximum marital deduction can be taken, no estate tax would be due on the average for farms having sales volumes under \$40,000 per year. Administrators of farm estates in these smaller categories would have no incentive to choose use valuation unless a relatively small marital deduction or no marital deduction applies.<sup>27</sup> Larger farm estates consisting of farm businesses with sales of \$40,000 and above would tend to have estate tax liabilities even when the maximum marital deduction applies. However, the incentive to elect use valuation in these larger estates is enhanced considerably when the marital deduction is not available.

If changes are not made in the estate tax laws, inflation will affect the number of potential use value elections over time. While the average sized U. S. farm estate may not gain from the use value election at a given time, inflation in the price of farmland over time would tend to enhance the use value election as a means of reducing the estate tax burden.

The supply of farmland is said to be relatively inelastic, meaning that a decrease in the amount of land offered for sale in a given time period can be expected to result in a greater proportionate increase in price. The expected impact of use valuation would reduce the amount of farmland offered for sale until lands that were withheld under the provision are released at the same rate as new elections occur.

<sup>27</sup> A small marital deduction would result where the living spouse received a small percentage of the estate outright or where the interest received does not qualify for the marital deduction.

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