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Farmland Valuation For Estate Tax Purposes

Stephen F. Matthews, Ronald L. Plain, and
John C. Banning
Department of Agricultural Economics
College of Agriculture

Inflated land values have increased the impact of the federal estate tax on heirs of family farm operations. In an effort to alleviate the added tax burden, Congress included a special provision for farmland valuation for federal estate tax purposes in the Tax Reform Act of 1976. This Guide explains the *current use* provision and presents the changes made by the Economic Recovery Tax Act of 1981.

When someone dies, an estate tax is levied on any property left to individuals besides the surviving spouse. The amount of the estate tax is based upon the fair market value of the property on either the date of death or six months later. A new provision in the tax law provides an alternative valuation method which can sometimes be used by farmers to greatly reduce estate taxes.

Between 1961 and 1981, the average market value per acre of Missouri farm real estate increased more than seven times (see Table 1). These inflated land values can be serious obstacles to the farmer who wants to pass his business on to his family. This Guide explains a major change in the federal estate tax laws for valuing farmland. This change may reduce the otherwise high federal estate tax caused by increasing land values.

Congress approved a provision in the 1976 Tax Reform Act which allows qualifying farmland to be valued on the basis of its *current use* for farming rather than the usual *market value* (highest and best use). The Economic Recovery Tax Act of 1981 loosened the

qualifying conditions, making the election of *current use* valuation easier and more desirable.

The provision's main purpose is to reduce the likelihood that farm estate heirs will be forced to sell a portion or all of the farm to pay federal estate taxes. A lower estate valuation and a smaller taxable estate will result from using the current use valuation. The new valuation has the potential to reduce the gross estate's value by up to \$700,000 for 1982 and \$750,000 after 1982.

If you own farmland and plan to pass it on to your sons, daughters or other family members, this provision could be of major importance to you. Now is the time to start planning to be sure your farm can qualify.

Qualifying Conditions To take advantage of the current use valuation, **all** of these eligibility requirements must be met.

- The decedent must have been a U.S. resident or a U.S. citizen, and the property must be located in the U.S.
- The property must pass to a *qualified heir*. (Definitions follow.)
- An agreement signed by the heir(s) to abide by the stipulations of Section 2032A must be filed by the executor.
- The decedent or a member of the family must have owned the farm and must have *materially participated* in the operation of the business in five of the eight years preceeding the earliest of the following: (a) the date of the decedent's death, (b) the date the decedent retired, or (c) the date the decedent became disabled.
- At least 50 percent of the *adjusted value* of the gross estate must consist of the value of the farmland and farm personal property.
- At least 25 percent of the *adjusted value* of the gross estate must consist of the value of the qualified farmland.

A qualified heir includes the decedent's spouse, parents, grandparents, and lineal descendants (including adopted children). It also includes all lineal descendants of either the decedent's spouse or the decedent's parents and the spouse of any qualified heir. It does not include uncles, aunts, and cousins.

Qualified use means use for farming purposes such as crops, livestock, orchards, and woodlands.

The adjusted value of the gross estate is the market value (highest and best use) of all the decedent's property as it is reduced by debts, claims against the estate, unpaid taxes, funeral expenses, estate admin-

Table 1. Average dollar value per acre of Missouri farmland.

1961 . . . \$120	1968 . . . \$200	1975 . . . \$396
1962 . . . 127	1969 . . . 217	1976 . . . 456
1963 . . . 132	1970 . . . 224	1977 . . . 548
1964 . . . 145	1971 . . . 236	1978 . . . 641
1965 . . . 155	1972 . . . 261	1979 . . . 726
1966 . . . 168	1973 . . . 294	1980 . . . 878
1967 . . . 186	1974 . . . 384	1981 . . . 941

Source: UMC Guide 406, "Estimating Past Farm Real Estate Values with Limited Information"

Table 2. Effective interest rate for all new Federal Land Bank loans (St. Louis District).

Year of death	Five-year moving average
	percent
1977	8.50
1978	8.71
1979	8.93
1980	9.20
1981	9.77
1982	10.37

istration costs, and losses incurred during administration.

Material participation is a term without definite guidelines. As long as the farmland owner or a member of his family actually participates in the management and production activities of the farm operation, there should be no problem in satisfying the material participation condition.

Questions arise when farmland is leased to someone other than a member of the landowner's family either on a cash rental or crop share basis. Leased land will not qualify for the current use valuation if the landlord or a member of his family is not materially participating in the production and management of the farm.

Current Use Valuation Formula

Once the qualifying conditions are met, the executor of the estate can choose current use valuation. For this to be valid, the executor must obtain an agreement signed by each person (qualified heir) who has an interest in the farmland. The heir(s) must agree to maintain the farmland in a qualified use and to materially participate in the management of the farm for a period of 10 years after inheriting it. (Before 1982, it was 15 years). The qualified heir(s) has a two-year grace period to begin material participation.

To calculate the current use value, **divide** the average annual gross cash rental per acre for compa-

parable land in the locality minus average annual state and local real estate taxes per acre for such comparable land by the average annual effective interest rates for all new Federal Land Bank loans (see Table 2). Each average calculation is based on the five calendar years before the decedent's death.

Current Use Valuation Formula

$$\text{Current use valuation} = \frac{\text{average annual gross cash rental} - \text{average annual state \& local real estate taxes}}{\text{average annual effective interest rate for all new Federal Land Bank loans}}$$

If there is no comparable land from which cash rental rates can be obtained, net crop share rent may be used. Net crop share rent is the landlord's share of the crop minus any cash operating expenses paid by the landlord.

Current Use Valuation

Example. Mr. Farmer, a widower, dies in 1982 and leaves all his property to his children.

- Mr. Farmer owned 1,000 acres of farmland with a fair market value of \$1,200 per acre at his death.
- He owned other property worth \$300,000.
- He had debts totaling \$100,000 at his death.
- Funeral and administration expenses amount to \$50,000.

These assumptions, along with hypothetical cash rent and property taxes for comparable land are shown in Table 3. Obtain current use valuation by first subtracting the five-year average property taxes (\$4.84) from the five-year average cash rent (\$57) and then dividing the difference by the five-year average Federal Land Bank interest rate (10.37 percent from Table 2). This calculation gives a value of \$503 per acre or about 42 percent of the fair market value.

If current use valuation is **not** used, the estate would owe \$428,500 in federal estate taxes (see Table 3). If the estate is eligible for current use valuation, the federal estate tax can be reduced to \$149,610.

This is a reduction of \$278,890 (65 percent) in the

Table 3. Special use valuation example (1982).

Assumptions:

Fair market value at death	\$1,200/acre
Fair market value six months later	\$1,240/acre
Comparable land in locality:	

Year	Cash rent	Property taxes
1977	\$ 50	\$ 3.86
1978	53	4.29
1979	58	4.73
1980	61	5.48
1981	63	5.84
Five-year average	\$ 57	\$ 4.84

Average Effective Federal Land Bank interest rate = 10.37 percent.

Current use value ($\$57 - \$4.84 \div .1037$) \$ 503/acre.

	Without current use valuation	With current use valuation
Value of land (1,000 acres).....	\$1,200,000	\$503,000 ¹
Other property	300,000	300,000
Minus debts	(100,000)	(100,000)
Gross estate.....	\$1,400,000	\$703,000
Less funeral and administrative expenses	(50,000)	(50,000)
Adjusted gross estate	\$1,350,000	\$653,000
Tentative estate tax	\$ 491,300	\$212,410
Minus unified credit	(62,800) ²	(62,800) ²
Estate tax due	\$ 428,500	\$149,610

¹ Maximum reduction from fair market value is \$700,000 in 1982 and \$750,000 thereafter.

² Eligible unified credit for 1982.

amount of federal estate tax due on Mr. Farmer's estate. Of course, to receive this tax savings, Mr. Farmer's children must agree to keep the land in farming and materially participate in the management for 10 years after inheriting it.

Not all \$1,200-per-acre land will result in a similar reduction. The potential for estate size reduction varies by locality because rents, taxes, interest rates, and market values differ, and these things determine the reduction.

Alternative Valuation Procedures

If gross cash rent or crop share figures for comparable land are unavailable or if the estate executor and heirs decide not to use current use valuation, one of the following factors may be used instead of the current use valuation formula in determining the value of qualified farmland.

- Capitalization of the income which the property can be expected to yield from farming over a reasonable period of time under prudent management, using traditional cropping patterns for the area and taking into account soil capacity, terrain, and similar factors.

- Capitalization of fair rental of land for farmland.

- Assessed land values in a state which provides a differential or has a use value assessment law for farmland.

- Sales of comparable farmland in the same geographical area far enough removed from a metropolitan or resort area so that non-agricultural use is not a significant factor in the sale price.

- Any other factor which fairly determines the farm value of the property.

Qualified estates probably will benefit most by applying the current use valuation formula. However, the above alternative valuation factors also promise to remove some of the urban and speculative pressures built into owning farmland and are available if the current use valuation cannot be used.

Table 4. Comparison of market value and current use value.

State	Average market value per acre (Feb. 1, 1981)	Current use value assessment per acre for estate tax purpose ¹	Difference	Current use value as percent of market value
Arkansas	\$1,061	\$299	\$ 762	percent 28
Illinois	2,133	750	1,383	35
Indiana	1,972	781	1,191	40
Iowa	1,941	773	1,168	40
Kentucky	991	384	607	39
Missouri	941	385	556	41
Oklahoma	662	173	489	26
Tennessee	1,042	341	683	33

¹ Calculated as the average gross cash rent minus real property taxes for the years 1976-1980 divided by the average effective interest rate for new Federal Land Bank loans for the same period.

Source: *Farm Real Estate Market Developments*, CD87, ERS, USDA, 7/82.

Comparison of Market Values With Current Use Values

Table 4 compares market values with current use values for selected states. The calculations are based on average values and should not be considered representative of land in a given locality as required by the formula. The table does indicate that current use values are lower than market values.

Possible Recapture of Estate Tax Savings

The current use valuation provision has a clause for recapture of estate tax savings if the qualified heir fails to meet specified requirements. The failure of one heir to meet the requirements usually does not prevent other heirs from using current use valuation on their portion of the land. Recapture happens if **one or more** of the following occurs within 10 years of the decedent's death:

- The farmland is sold to an unqualified heir.
- The farmland is taken out of its qualified use.
- If, in any eight-year period, a total of three years goes by without material participation in the operation of the business by the decedent, the qualified heir, or a family member.

Basically, the qualified heir has to meet the same material participation requirements as the decedent. One slight alteration is that the five-of-eight years requirement may include years before or after the decedent's death. Material participation must be shown by the decedent, the qualified heir or a member of his family for a total of five years during **any** eight-year period, except for the two-year grace period or years

when the decedent was retired or disabled. The three years of non-material participation do not have to be consecutive for recapture to occur.

Failure to materially participate would result in a recapture of the difference between the federal estate tax due, without regard to the current use valuation and the amount due using the current use formula.

In case a surviving spouse, or a qualified heir who has not reached age 21, is disabled, or is a full-time student, the material participation test may be met by **active management**. Active management is defined as the making of management decisions of a business (besides the daily operating decisions).

Tests for Material Participation

The tests for material participation are similar to those used for social security purposes for self-employment income. Presently, the following four tests serve as guidelines to the Social Security Administration and the Internal Revenue Service for determining material participation.

Test Number 1. The landowner or a family member must satisfy three (or more) of the following: (1) advance, pay or stand good for a significant part (half or more) of the direct costs of producing a crop; (2) furnish a significant part (half or more) of the tools, equipment, and livestock; (3) advise and consult with the tenant periodically; and (4) inspect production activities periodically.

Test Number 2. The landowner or a family member must regularly and frequently make decisions which significantly affect the success of the enterprise.

Test Number 3. The landowner or a family member must work at least 100 hours over a period of at least

five weeks in a year in activities connected with producing a crop.

Test Number 4. If a landowner or a family member does those things which in total "show that the landlord is materially and significantly involved in the production of the farm commodities," the material participation condition is satisfied.

In most cases, if one of the four tests can be satisfied, the material participation condition will be met.

Implications of the Current Use Valuation

Beginning farmers may find purchasing farmland more difficult for several reasons.

First, with the current use valuation, the medium-to-large farm estates which were forced to sell off a section of the farm to pay estate tax debts under the pre-1977 estate tax law are now in a better position to avoid a forced sale. This will probably result in fewer land transfers upon farm estate settlements. Therefore, the opportunities for beginning farmers to purchase land may be reduced.

Second, estate planning choices during an owner's lifetime often involve a sale of farmland for retirement, travel, or medical needs. The new law reduces the likelihood that such sales of real property will occur and increases the likelihood that the sale of personal property such as stocks and bonds will be selected to meet retirement needs.

Farmer-landowners now have the potential to substantially reduce federal estate taxes for heirs. But careful planning is required to meet all the qualifying conditions, so an estate can use the current use valuation. Decisions involving acquisition and disposition of property when the owner approaches retirement years are also important. For instance, the family member who owns the property at the time of death influences federal estate taxes.

Another problem deals with land purchased by the decedent within his last five years. The law requires that the decedent or a member of his family own the farmland at least five of his last eight years. When alternative land purchases are under consideration by an elderly farmer, and when one of those tracts is owned by a family member, the current use valuation rules would encourage purchasing farmland from the family member. Furthermore, farmland purchases probably would not be postponed until later years

when the buyer is nearing retirement or is in bad health because the buyer would want to insure ownership for at least five years before death.

Sale of land by a qualified heir to a non-qualified heir may result in a recapture of estate tax savings. Sales to other qualified heirs such as parents, grandparents, brothers, sisters, their spouses, and descendants will not result in a recapture. For example, assume that two brothers (both qualified heirs) inherit land from their father. If one of the brothers decides to sell his interest to the other, no recapture will be triggered. If the land is sold to a non-qualified party, such as a neighbor or business partner, a recapture might result, but only on the land which was sold.

If you are leasing land or having your farm managed by a professional manager, your land may not qualify for the special farmland valuation alternative. The problem with this arrangement is the satisfaction of the material participation condition.

Leases should include provisions requiring material participation by the landowner or a member of his family in the management and production of the operation. Besides such lease provisions, the landowner-landlord or a family member should *actually* participate in the production and management activities in a material manner.

Summary

Current use valuation can result in considerable federal estate tax reductions. If farming has been your life's occupation, and if you intend to pass the farm on to family members, you should have no difficulty in qualifying your farmland.

Meeting eligibility requirements for current use valuation takes more than just having a valid will or having a family member who wants to inherit the farm. The activities of the present landowner, especially if farmland is leased out, are most relevant. Get the new current use valuation requirements straightened out in your mind. Then discuss this new estate planning tool with your attorney.

Information on other new federal estate and gift tax changes, most of which were effective January 1, 1982, can be obtained at your county's University of Missouri Extension Center in Manual 68, *Estate Planning for Missouri Families*. The changes include new tax rates, an increased unified credit, and an unlimited marital deduction.

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