

SPECIAL VALUATION BENEFITS FOR FARMS

And Other Business Real Property



HIGHEST AND BEST USE

Property in a decedent's estate is valued for estate tax purposes by the “willing buyer-willing seller test.” In the world of commerce, property generally changes hands for a price determined by agreement between a knowledgeable seller and a knowledgeable buyer. For purposes of this report, this valuation concept relates to property which is not restricted as to its use. The buyer is not limited to the seller’s previous use of the property. The buyer may have a more profitable use for the property than the seller. This more profitable use is called the “highest and best use.”

APPLICATION OF THE "HIGHEST AND BEST USE" TO THE FAMILY FARM AND OTHER BUSINESS REAL PROPERTY

Real property is unique because the same acreage or parcel may be used for different economic purposes. Perhaps nowhere is this truer than with a Family Farm. However, this concept is also true with respect to other real estate used in a family business. We need to discuss “value” for a moment. To a disinterested person, the value of an acre of real estate is the highest price for which that person could later sell the acre. There is no concern in a pure profit analysis, over the future use of the property by the new buyer. How does this disinterested person’s actions affect the Family Farm or other closely held business real property?

"HIGHEST AND BEST USE" MEETS THE ESTATE TAX

A commonly used phrase by real property owners is: “In the path of development.” That phrase signifies different meanings to different people. To some, it means that developers are “gobbling” up Family Farms for vast rows of homes and shopping malls. To others, it means jobs, a more pleasant environment, or an opportunity to start a new business. Prior to 1976, *the path of development* meant more revenue to the IRS.

Imagine a small Family Farm that supports the family and leaves some money remaining after farming and living expenses. The Family Farm would sell for \$4,000,000 as a working farm. Let’s assume that only one spouse is alive and operating the farm with her children’s help. The Family Farm is located several miles from a small town. The town is rapidly expanding as a residential area for workers at several high tech firms which have recently relocated to the area. Real estate developers have recently offered the family \$6,560,000 for the Family Farm. Soon after the offer, the spouse passes away.

"THE TAX MAN COMETH"

The family meets with a financial advisor to find out what happens now. The advisor learns about the \$6,560,000 offer on the Family Farm and tells the family that development use of the property is its “highest and best use.”

The advisor states that \$6,560,000 is the value of the Family Farm in mother's taxable estate.

The family responds that the Family Farm is only worth \$4,000,000; the value of the Family Farm should be valued as a farm, not a shopping mall.

A family member asks, *"What are the estate taxes?"*

The advisor states, *"The first option seems to be borrowing the money to pay the estate tax owed."*

"But isn't there something else?"

The advisor says she knows an estate planning attorney who specializes in these matters. They will set up an appointment with the attorney and report to the family as soon as possible.

INTERNAL REVENUE CODE SECTION 2032A—ESTATE TAX RELIEF FOR THE FAMILY FARM

During the meeting, the attorney tells the financial advisor that Congress enacted rules to protect Family Farms *"in the path of development"* and, while the rules are complex, they probably apply to this family's circumstances.

What does the special rule do? If the highest and best use of a Family Farm is a higher estate tax value than its value if used as a farm, the estate tax value may be reduced to the value of the real property as a farm. The advisor likes that answer.

"However," the attorney responds, *"the decrease in value may not exceed \$1,110,000, for 2016. What is the development value of the Family Farm?"*

"It's \$6,430,000," answers the advisor.

"Well, if the value of the Family Farm, as a farm, plus all other assets are no greater than the amount you can pass on free from taxes, then there are no estate taxes on the farm."

"The family will be very happy to hear that," says the advisor.

"Just a minute, there are some complicated rules," warns the attorney.

THE TECHNICAL REQUIREMENTS

The valuation reduction rules of Internal Revenue Code (“IRC”) section 2032A were designed to help the owners of a Family Farm. The rules are very technical. Because the benefits of IRC section 2032A are targeted at a very specific type of estate, the rules contain many definitions relating to the property at issue and the family’s use of the property both before the death and its use after the death.

For a Family Farm to qualify for special valuation, the following characteristics must be present:

1. The decedent must have been a U.S. Citizen or resident;
2. As to the real property:
 - a. It must be located in the United States;
 - b. It must have been acquired from or passed from the decedent to family members of the decedent;
 - c. It must have been used as a farm or other qualified use by the decedent or “family members”;
3. At least 50% of the “adjusted value” of the decedent’s gross estate must be composed of farming or other business-use real or personal property;
4. At least 25% of the “adjusted value” of the decedent’s gross estate must consist of real property used in farming, or other business-use real property, for at least five of the eight years prior to death by the decedent or a “family member”;
5. An election must be made on the decedent’s estate tax return;
6. The real property must have been used in farming, or other business-use, for at least five of the eight years prior to death by the decedent or a “family member”;
7. The decedent or a “family member” must have “materially participated” in the farming or other business use for at least five of the eight years prior to death;
8. “Family members” must receive all interests in the property;
9. All “family members” receiving an interest in the real property must sign a tax recapture agreement which requires a repayment of estates taxes saved if the property is “disposed of” within 16 years.

As you can see, this is a very complex set of rules, and this report is not intended to be a legal treatise. Suffice to say that if the Family Farm (remember, that term includes any business real

property) passes all the tests, the “highest and best use” (\$6,560,000 in our example) may be reduced up to \$1,110,000 to the use as a Family Farm.

PLANNING FOR SPOUSES

As you know, the IRS allows spouses, if properly planned, to leave their heirs \$10,860,000 estate tax-free in 2016. If planning for such spouses involves a Family Farm, as much as \$13,160,000 can pass estate tax-free. How? Let’s look.

Example:

Assume Husband and Wife each own 400 acres of farmland with a “highest and best use” of \$6,530,000, and for simplicity, no other assets. Properly planned, their children receive:

	H	W	Children
“Highest Best Use”	\$6,560,000	\$6,560,000	\$13,120,000
Less 2032A Reduction	<1,110,000>	< 1,110,000>	<2,220,000>
Taxable Amount	\$ 5,450,000	\$ 5,450,000	\$10,900,000
Estates Taxes	-0-	-0-	-0-

As you can see, with proper planning, the children have received \$13,160,000 estate tax-free. That represents a savings of \$880,000, as illustrated below:

\$13,120,000	
< <u>5,450,000</u> >	<i>(H’s Exemption Amount)</i>
\$ 7,670,000	<i>(W’s Taxable Estate)</i>
< <u>5,450,000</u> >	<i>(W’s Exempt Amount)</i>
\$ 2,220,000	<i>(Estate Subject to Taxation)</i>
\$ <u>888,000</u>	<i>(Estate Taxes due without proper planning)</i>
\$ 0	<i>(Estate Taxes due <u>with</u> proper planning)</i>

ABOUT THE ACADEMY

This report reflects the opinion of the American Academy of Estate Planning Attorneys. It is based on our understanding of national trends and procedures, and is intended only as a simple overview of the basic estate planning issues. We

recommend you do not base your own estate planning on the contents of this Academy Report alone. Review your estate planning goals with a qualified estate planning attorney.



The Academy is a national organization dedicated to promoting excellence in estate planning by providing its exclusive Membership of attorneys with up-to-date research on estate and tax planning, educational materials, and other important resources to empower them to provide superior estate planning services.

The Academy expects Members to have at least 36 hours of legal education each year specifically in estate, tax, probate and/or elder law subjects. To ensure this goal is met, the Academy provides over 40 hours of continuing legal education each year. The Academy has also been recognized as a consumer legal source by *Money Magazine*, *Consumer Reports Money Adviser* and Suze Orman in her book, *9 Steps to Financial Freedom*.

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