VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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SPECIAL USE VALUATION OF REAL ESTATE UPON DEATH

The well known applicable standard of value for property included in the estate of a decedent is fair market value. The definition of fair market value is also well known. The valuation, in the case of real property, is usually based on its "highest and best use."

Congress recognized that it was sometimes inappropriate to value certain types of property on the basis of its potential "highest and best use," because the income potential from these activities may be insufficient to service extended estate tax payments or loans obtained to pay the tax. To encourage the continued use of property for farming and other small business purposes, Congress enacted §2032A. Although a wonderful tax savings tool, there are significant restrictions that must be met to avoid tax recapture or penalty.

First and foremost, the special use valuation concept applies only to federal estate tax, not gift tax. In order for the property to be "qualified real property" for these purposes, certain conditions must be met.

Qualified Use
The real property must have been devoted to either use as a farm for farming purposes, or use in a trade or business other than farming, for periods aggregating 5 years during the 8 year period ending on the date of the decedent's death, and must be located in the United States.

Material Participation
The decedent or a member of his or her family must have materially participated in the farm operation or business for an aggregate of 5 or more of the 8 years before the decedent's death.

Qualified Heir
The property must be passed to a member of the decedent's family to be considered a qualified heir. This includes the ancestors of the decedent or the beneficiary, the spouse of the decedent or beneficiary, a lineal descendant of the decedent or beneficiary or spouse of decedent or beneficiary, or the spouse of the lineal descendent. Legally adopted children are treated as born of issue.

Percentage Tests
50% Test – The adjusted value of the property (after reduction for unpaid mortgages) passed by the decedent that is used for a qualified use must be at least equal to 50% of the adjusted value of the gross estate.

25% Test – The adjusted value of the real property (after reduction for unpaid mortgages) is at least equal to 25% of the adjusted value of the gross estate.

The distinction between these two tests is the 50% test includes all qualified property, whereas the 25% test includes only real property.

Dollar limitation
For an estate of a decedent dying in calendar year 2005, if the executor elects to use the special use valuation method under §2032A for qualified real property, the aggregate decrease in the value of qualified real property resulting from electing to use §2032A that is taken into account for purposes of the estate tax may not exceed $870,000.

Over the last several years, the question of valuation discounts arose as to whether they are appropriate for use in conjunction with the benefits of special use valuation. After several cases where the Tax Court stated that the use of special use valuation and discounts applicable to fair market value are mutually exclusive, the Tenth Circuit overruled. The Appellate Court held that the maximum reduction in value of the qualified real property under §2032A must be subtracted from the true fair market value of a minority interest in the property, which value is determined by applying a discount factor for the decedent's lack of control and marketability.

Beware - the benefits of special use valuation do not come without some potential problems. The qualified heirs are subject to recapture. The tax savings provided by the special use valuation are considered a contingent liability for 10 years after the date of death. If the property is sold to a non-family member or is used for a purpose other than farming (or other stated special use) within the 10 years, the heir will be personally liable for the tax savings.

Additionally, the value used on the estate tax return effects the basis transferred to the heirs. Because of the recapture provisions, it is imperative that you have a good handle on what the family members' intentions are regarding whether and/or how long they intend to continue [farming] the property.

If you would like additional information, or have a question, please do not hesitate to call.

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