



# Farmland Valuation for Federal Estate Tax Purposes

## New Provisions in the Tax Law

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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 sheet explains the "current use" provision and discusses its pros and cons.

During the years between 1962 and 1976, the average market value per acre of Missouri farm real estate more than tripled. (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 sheet explains a major change in the federal estate tax laws for valuing land used for farming. 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, effective January 1, 1977, 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). For example, Missouri farmland with an average market value per acre of \$399 could be reduced to \$294 per acre by using the special farmland valuation formula. (See Table 3.) This formula is used only for determining the taxable estate for federal estate taxes.

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 \$500,000.

If you own farmland and have plans of passing 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.

Table 1. Average Dollar Value per Acre of Missouri Farmland, 1962-1976

1962	....\$127	1967	....\$190	1972	....\$259
1963	....\$132	1968	....\$206	1973	....\$289
1964	....\$145	1969	....\$224	1974	....\$374
1965	....\$155	1970	....\$233	1975	....\$386
1966	....\$170	1971	....\$236	1976	....\$435

### Qualifying Conditions

To take advantage of the current use valuation, you must meet *all* the following eligibility requirements:

- The farm must have been used for farming on the date of the decedent's (person who died) death.
- The farmland must pass to a "qualified heir." (Definitions follow.)
- The decedent or a member of his family must have owned the farmland and used it for a "qualified use" for at least five of the decedent's last eight years.
- The decedent or a member of his family must have "materially participated" in the operation of the farm for at least five of the decedent's last eight years.
- At least 50 percent of the "adjusted value" of the gross estate must consist of the "adjusted value" of the farmland and farm personal property.
- At least 25 percent of the "adjusted value" of the gross estate must consist of "adjusted value" of the qualified farmland.

**A qualified heir** is the decedent's spouse, other members of the decedent's family, ancestors, lineal descendants, lineal descendants of grandparents and spouses of descendants. An individual's adopted child is treated as a child by blood.

**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 reduced by debts, claims against the estate, unpaid taxes, funeral expenses, estate administration costs and losses incurred during administration.

**Material participation** at this time is a requirement lacking 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.

The principal question arises 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. There will be more on material participation later.

## Current Use Valuation: An Example

Once the qualifying conditions are met, the executor of the estate can choose the 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.

You calculate the current use value by *dividing* the average annual gross cash rental per acre for comparable 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. Each average calculation is based on the five calendar years before the decedent's death.

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

To illustrate, consider this example: Mr. Farmer owns 1,000 acres of farmland free of debt. The land has a market value of \$1,200 per acre. Also assume:

- Mr. Farmer died in 1977 and was survived by Mrs. Farmer.
- Funeral and administrative expenses are ignored.
- The estate is eligible for the maximum marital deduction (in 1977, 1/2 of the adjusted gross estate or \$250,000 whichever is greater).
- No other property is owned.

Based on these assumptions, the estate would owe \$162,800 in federal estate taxes on the death of Mr. Farmer. (See Example 1.) If the estate is eligible for current use valuation, the federal estate tax based on the assumptions stated above could be reduced by more than half!

This can be shown by using figures from Table 2. The current use valuation per acre equals \$685.

$$\frac{\$65 - \$5}{8.75\%} = \$685 \text{ per acre}$$

This is a reduction of \$515 or 43% in the value of the land for estate tax purposes. The federal estate tax due would be

\$74,800. This is a 54% (\$88,000) reduction in the amount of federal estate tax due on a 1,000 acre estate with a market value of \$1,200,000.

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 figures for comparable land are unavailable or if the estate executor decides 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 configuration and similar factors.
- Capitalization of fair rental value of the 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 farmland and are available if the current use valuation cannot be used.

## Comparison of Market Values with Current Use Values

Comparison of market values with current use values is illustrated in Table 3 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 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. Recapture happens if *one or more* of the following occurs within 15 years of the decedent's death:

- The farmland is sold to an unqualified heir.
- The farmland is taken out of its qualified use.

Table 2. Calculation of 5-Year Average Values Using Hypothetical Numbers

Year	Gross Cash Rental per acre for Comparable Land	State & Local Property Taxes per acre for Comparable Land	Interest Rate for all new F.L.B. Loans
1976	\$71	\$6.00	9.25%
1975	68	5.25	9.00%
1974	65	5.00	8.75%
1973	63	4.75	8.50%
1972	60	4.00	8.25%
5 Yr. Avg.	\$65	\$5.00	8.75%



Example 1.

Without Current Use Valuation		With Current Use Valuation	
1,000 A. @ \$1,200/A	= \$1,200,000	1,000 A. @ \$685/A*** (= \$685,000)	= \$700,000****
Minus Marital Deduction	= (600,000)	Minus Marital Deduction	= (350,000)
Taxable Estate	= \$ 600,000	Taxable Estate	= \$350,000
Tentative Estate Tax*	= \$ 192,800	Tentative Estate Tax*	= \$104,800
Minus Estate Credit**	= (30,000)	Minus Estate Credit**	= (30,000)
Estate Tax Due	\$ 162,800	Estate Tax Due	\$ 74,800

\* Based on 1977 Unified Estate Tax Rates.

\*\* Maximum estate tax credit for 1977 allowed under 1976 Tax Reform Act.

\*\*\* Current use value.

\*\*\*\* Note maximum allowable reduction in valuation = \$500,000. Therefore, \$1,200,000 - \$500,000 = \$700,000

- 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 member of his family.

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. 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.

For example, assume the decedent or a member of his family did not materially participate in the farming operation two years prior to the decedent's death. A recapture of estate tax savings would result if the heirs or members of their families fail to materially participate in the farming operation for more than one year after the decedent's death.

**Phase Out of Recapture Possibility.** Phase out of the tax recapture results if the disqualifying event occurs between the 10th and 15th year after the decedent's death. The recapture is reduced by 1/60th for each full month past the 10th year following the decedent's death. Before the 10th year, a total recapture occurs. After the 15th year, no recapture of the federal estate tax will result.

For example, if qualified land was disposed of at the end of the 14th year (48 months past the 10th year after decedent's death went by before the disqualifying event occurred), a 20% recapture of the tax savings results.

### Test for Material Participation

The test for material participation is to be "similar" to the test used for social security purposes relating to self-employment income. Presently, the following four tests serve as guidelines to the Social Security Administration and the Internal Revenue Service in determining whether material participation has been shown:

**Test No. 1.** If the landowner or a member of his family can satisfy three (or more) of the following, material participation is shown: (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 used; (3) advise and consult with the tenant periodically; and (4) inspect production activities periodically.

**Test No. 2.** Material participation is shown if the landowner or a member of his family regularly and frequently makes decisions which significantly affect the success of the enterprise.

**Test No. 3.** Material participation is shown if the landowner or a member of his family works at least 100 hours spread over a period of at least five weeks in a year in activities connected with producing a crop.

Table 3. Comparison of Market Value and Current Use Value.

State	Average Market Value per acre (Mar. 1, 1975)	Current Use Value Assessment per acre for Estate Tax Purpose*	Difference	Current Use Value as % of Market Value
Alabama	\$370	\$195	\$175	53%
Georgia	486	234	252	48%
Illinois	857	561	296	65%
Indiana	726	506	220	70%
Iowa	725	560	165	77%
Kansas	301	183	118	61%
Kentucky	435	285	150	66%
Missouri	399**	294	105	74%
Oklahoma	307	148	159	48%
Tennessee	477	307	170	64%

\*Calculated as the average gross cash rent minus real property taxes for the years 1972-1976 divided by the average effective interest rate for new Federal Land Bank Loans for the same period.

\*\*This figure differs from the 1975 figure in Table 1. This is due to a slight difference in time periods and the different information sources used.

**Test No. 4.** If a landowner or a member of his family 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.

## Conflicts for Certain Retired Landowners

The satisfaction of the material participation requirement by the landowner in the 62-72 age bracket may be at odds with his desire to receive maximum social security benefits. If the retired individual receives self-employment income above a certain level (\$3,000 in 1977), a reduction in social security benefits results. Rental incomes, if material participation does *not* occur, do not reduce social security benefits. The retired farmer consequently faces the trade-off between not showing self-employment income for social security purposes and proving material participation for the current use valuation.

In 1974, the social security law on material participation was altered so that after 1973, the activities of agents such as professional farm managers, acting on behalf of the landlord-landowner, would not be counted as material participation by the landlord-landowner. This means if you are approaching retirement or are already retired and you are having someone else perform management and production activities for you, you probably cannot satisfy the material participation condition for the current use valuation.

Do not confuse this with work done by a hired hand. Work performed by a hired hand is considered to be work done by the employer. The employer maintains management responsibilities by directing the hired hand's activities. In most cases, the farmland owner maintains involvement in the production activities also.

Treasury regulations have not yet clarified how the social security law regarding material participation will be adapted for purposes of current use valuation.

## 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. The result probably will be fewer land transfers upon farm estate settlements. Therefore, the opportunities for beginning farmers to purchase land may be reduced.

Secondly, current landowners who qualify and choose to use the current use valuation will have a tax subsidized advantage in bidding for more farmland. This situation may be similar to one in the early 1960's when peanut allotments were capitalized into the price of farmland, resulting in higher land prices. The tax subsidized farmer-landowner with a medium-to-large estate will be able to capitalize this tax advantage by purchasing additional farmland.

Finally, 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, who owns the property at the time of death influences federal estate taxes. Gifts of farmland made within three years of death, above the \$3,000 annual exclusion per donee, are included in the decedent's gross estate.

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 one tract 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 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. (See "Conflicts for Certain Retired Landowners.")

Leases should include provisions requiring material participation by the landowner or a member of his family in the management and production of the operation without counting the activities of the farm manager. In addition to such lease provisions, the landowner-landlord or a member of his family should actually participate in the production and management activities in a "material" manner.

## Conclusions

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

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 special 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, 1977, can be obtained at your county's University of Missouri Extension Center in Manual 68, *Estate Planning for Missouri Families*. The changes include new rates and the substitution of a credit for previous exemptions.

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