The Application of Section 2032A to the Valuation of Timberland for Federal Estate Tax Purposes

T. Carter Heyward Jr.

THE APPLICATION OF SECTION 2032A TO THE VALUATION OF TIMBERLAND FOR FEDERAL ESTATE TAX PURPOSES

T. HEYWARD CARTER, JR.*

I. INTRODUCTION

The estate and gift tax area of federal taxation was in large part restructured by the Tax Reform Act of 1976.[1] One of the most innovative changes made was the introduction of section 2032A[2] to allow certain real property used for farming purposes or used in a trade or business other than farming to be included in the value of the gross estate at its "use" rather than "fair market" value.[3] Under certain circumstances, the use of real estate for timber production is one such qualified purpose.[4]

The purpose of this article is to study potential application of section 2032A to privately held timberland and to consider the various advantages and problems connected therewith. Relatively small tracts of privately held timberland represent in the aggregate a majority of the country's timber resources,[5] and it is certain that a substantial amount of this timberland will be involved in probate in the near future.[6] Moreover, because of the preferential treatment received by timber growing operations under the Tax Reform Act of 1976, timberland ownership is likely to become an increasingly popular tax shelter.[7]

* Member of the South Carolina Bar. B.A., Davidson College, 1968; J.D., University of Virginia, 1971; LL.M., University of Florida, 1977.

1. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976) (codified at scattered sections of I.R.C.).

2. I.R.C. § 2032A.

3. *Id.* All statutory references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

4. I.R.C. §§ 2032A(e)(4), (5)(C).

5. *Federal Estate and Gift Taxes: Public Hearings and Panel Discussions Before the House Ways and Means Comm.*, 94th Cong., 2d Sess. 550 (1976) (statement of Bradford S. Wellman, Chairman, Estate and Property Taxation Subcommittee of Forest Industries Committee on Timber Valuation and Taxation) [hereinafter cited as *House Hearings on Federal Estate and Gift Taxes*].

6. A 1972 survey of the American Forest Institute involving over 29,000 tree farmers indicated that 51% of the owners of privately held timberland are over 55 years of age, with 24% of such owners being 65 or older. *Profile of a Tree Farmer,* TREE FARM NEWS (Supp. Feb. 1973).

7. *Compare* I.R.C. §§ 447(a) *and* 464(e)(1) *with* I.R.C. § 278. See also I.R.C. § 465(c)(1)(B), which excludes timber growing from the "at risk" activities of § 465.

Both executors of estates that include timberland interest and attorneys involved in predeath estate planning for clients owning these interests will be obligated at least to consider the application of section 2032A. Until further guidelines are available on the application of the statute to timberland, pre- or postmortem estate planning involving section 2032A and timberland will be a confusing and sometimes dangerous task.

II. THE STATUTE

A. *History and Provisions*

In attempting to apply the provisions of section 2032A to timberland owned by his client or included in the gross estate of a decedent, the legal practitioner must remember that the statute was designed to provide estate tax relief in the traditional family farm situation.[8] Woodlands are included in the provisions of the statute merely as a type of farming operation.[9] Because the long-term, relatively passive operation involved in timber growing bears little similarity to traditional farming methods, some confusion and frustration on the part of the attorney who tries to meet the timberland requirements of section 2032A is inevitable.[10]

The most recent major congressional consideration of estate and gift tax reform began as early as February 1973[11] and culminated in the introduction of H.R. 14844 in late July 1976.[12]

The version of section 2032A presented in H.R. 14844 is the

---

8. The House Report on H.R. 14844, the original estate and gift tax section of the Tax Reform Act of 1976, states that changes made by the bill "are intended to preserve the family farm and other family businesses, two very important American institutions, both economically and culturally." H.R. REP. No. 1380, 94th Cong., 2d Sess. 5, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3359. *See also* 122 Cong. Rec. H10230-31 (daily ed. Sept. 16, 1976) (remarks of Rep. Conte).

9. I.R.C. § 2032A(e)(4).

10. The confusion arises because of the extremely complicated interaction of I.R.C. § 2032A with other Internal Revenue Code sections (*e.g.*, the carryover basis provisions of I.R.C. § 1023) and because of its internal inapplicability to the typical timber growing type of operation (*e.g.*, § 2032A(e)(7), dealing with the method of valuation). The frustration arises because of the lack of official guidance up to the present time in the resolution of these problems.

11. *See generally General Tax Reform: Panel Discussions Before the House Ways and Means Comm.*, 93d Cong., 1st Sess. (1973).

12. H.R. 14844, 94th Cong., 2d Sess. (1976) was introduced into the House of Representatives by Rep. Evins of Tennessee on July 26, 1976, and referred that day to the House Ways and Means Committee. 122 CONG. REC. H7758 (daily ed. July 26, 1976).

same as that incorporated into the final bill;[13] its rather obscure references to woodlands and timber production were adopted by the Congress in favor of the more inclusive provisions of the Senate version of the bill.[14] Compared with the stream of witnesses who, during congressional hearings held on the Tax Reform Act, decried the devastating effect of estate taxes on the traditional family agricultural operation, the relative dearth of testimony and discussion concerning the estate problems of timberland owners shows clearly that the plight of these owners was not foremost in the minds of the authors of section 2032A.[15] Therefore, although the statute itself specifies timberland as a type of real property to which its provisions apply, it is not surprising that the statute is not designed to deal with the peculiar problems associated with ownership of timberland.

1. *Pressures for Enactment.*—Prior to the effective date of section 2032A,[16] all real property included in the gross estate of a decedent was valued for federal estate tax purposes under section 2031[17] at its fair market value; that is, at "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[18] The price real estate is deemed to bring in such a theoretical setting depends upon the situation of the particular parcel involved and the valuation method, or methods, employed. The actual use of the property at the time of the decedent's death is, however, irrelevant for purposes of valuation under section 2031. Thus, timberland or other farm property owned by the decedent at the time of his death and located, for example, in a developing resi-

13. H.R. 10612, 94th Cong., 2d Sess. § 2003(a), 90 Stat. 1520 (1976) (codified at I.R.C. § 2032A).

14. *See* note 140 *infra.*

15. Testimony concerning the hardships imposed upon the traditional "family farm" by the previous tax laws was presented to the House Ways and Means Committee by scores of witnesses over a period of several days. In contrast, only four timber growers and their representatives were found to have testified before the committees, and those only briefly. *See generally House Hearings on Federal Estate and Gift Taxes, supra* note 5.

16. The effective date of the Tax Reform Act of 1976 was January 1, 1977. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003(e), 90 Stat. 1520 (1976) (codified at I.R.C. § 2032A).

17. I.R.C. § 2031.

18. Treas. Reg. § 20.2031-1(b) (1965). *See* I.R.C. § 2031. The same formula applies generally to all property owned by the decedent at the date of his death. In the case of farms, the regulations state specifically: "Livestock, farm machinery, harvested and growing crops must generally be itemized and the value of each item separately returned." Treas. Reg. § 20.2031-1(b) (1965).

dential or commercial suburban area was valued not on the basis of its agricultural use, but on the basis of the price it would bring under the fair market value test. This test assumes the land was purchased for the highest and best use to which such property might be put.[19] Since speculation over possible development affects the highest and best use of real estate in a developing area, such real estate might well be valued at an amount far greater than its worth for farming purposes alone.[20]

Primarily because of the rapid rise in the average fair market value of the American family farm over the past twenty to thirty years, the gross estate and, as a result, the federal estate tax liability of the average American farmer have increased dramatically.[21] At the same time, the $60,000 estate tax exemption provided by section 2052[22] suffered a steady devaluation because of the effects of inflation.[23] Consequently, sale of the family farm in order to pay estate taxes became an increasingly common situation.[24] Congressional sensitivity to the inequities of this situation and the congressional view that, as a matter of national policy, it is generally desirable "to encourage the continued use of property for farming and other small business purposes"[25] gained official recognition in the drafting and enactment of the relief provisions of section 2032A. These provisions provide an alternate, lower valuation on the basis of actual farm use rather than on the basis of the highest and best use to which the land could be put.[26]

---

19. It is the "highest and best use" from a purely economic point of view upon which the fair market value test is based. Other considerations, such as environmental or cultural benefits to be derived from a particular use of real estate, are not taken into account, although it has been suggested that perhaps these considerations will play a part in property valuation in the future. R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION 4-7 (3d ed. 1974). Perhaps with the advent of I.R.C. § 2032A that time has come. *See* note 8 *supra*.

20. *See also* Estate of John C. Mitchell, 27 T.C.M. (CCH) 1568 (1968).

21. According to Senator Mondale, "the average value of farm assets has increased from around $50,000 in 1960 to $170,000 in 1974." *Impact of Federal Estate and Gift Taxes on Small Businessmen and Farmers: Joint Hearing Before the Senate Select Comm. on Small Business and the Joint Economic Comm.* 94 Cong., 1st Sess. 2 (1975) [hereinafter cited as *Senate Hearings on Federal Estate and Gift Taxes*]. *See also id.* appendices A-H; *id.* at 3 (statement of Sen. Gaylord Nelson).

22. Int. Rev. Code of 1954, ch. 11, § 2052, 68A Stat. 389 (repealed 1976).

23. The Tax Reform Act of 1976 repealed the $60,000 exemption of I.R.C. § 2052, providing instead a "phased-in" estate tax credit which will reach a maximum of $47,000 in 1981, an amount equal to an exclusion of approximately $175,625. I.R.C. § 2010.

24. *See generally Senate Hearings on Federal Estate and Gift Taxes, supra* note 21.

25. H.R. REP. No. 1380, *supra* note 8, at 22.

26. I.R.C. § 2032A(a)(1)(B).

2. *Requirements.*—Section 2032A provides that if certain requirements set forth in the statute are met,[27] real property that is a part of the decedent's estate may be valued on a basis approximating its actual use at the date of the decedent's death rather than on the basis of its fair market value at this date.[28] A section 2032A election cannot, however, for purposes of section 2031, decrease the aggregate value of all qualifying real property included in the gross estate by more than $500,000.[29]

Property that otherwise qualifies for section 2032A treatment will come under its provisions only if (1) the decedent was a citizen or resident of the United States at the time of his death, and (2) the executor elects to apply section 2032A and files with the Internal Revenue Service an agreement specifying the property involved and signed by each person with an interest in the property.[30] This agreement must signify consent of the parties to

---

27. *See* text accompanying notes 30-40 *infra*.

28. The statute fails to specify what forms of ownership by the decedent's estate other than a fee interest in the real property will qualify for the application of I.R.C. § 2032A. I.R.C. § 2032A(g), however, directs the Secretary of the Treasury to prescribe regulations setting forth the application of the statute and the accompanying lien provisions of I.R.C. § 6324B to interests in real property held by the decedent's estate through a partnership, corporation, or trust. The House Report provides insight on what direction such regulations can be expected to take:

> Your committee intends that a decedent's estate generally should be able to utilize the benefits of special use valuation where he holds the qualifying real property indirectly, that is, through his interest in a partnership, corporation or trust, but only if the business in which such property is used constitutes a closely held business (as defined in [new § 6166(b)(1)]) and the real property would qualify for special use valuation if it were held directly by the decedent.

H.R. REP. No. 1380, *supra* note 8, at 24.

29. I.R.C. § 2032A(a)(2). To insure that the small family farm directly benefits from application of the statute, a $500,000 limit has been placed on the allowable decrease in real property value for estate tax purposes.

The following hypothetical situation may serve as a point of reference for purposes of illustration throughout this article: *D*, a widower, dies on April 1, 1977, leaving an estate containing as one of its major assets an unencumbered 1000 acre tract of timberland that is qualified real property under § 2032A. On April 1, 1977, the qualified real property left by *D* has a fair market value of $400 per acre for the land and of $200 per acre for the standing timber. Under § 2032A, the qualified real property has a use value of $400,000 (an average value of $200 per acre for the land and $200 per acre for the timber). The fair market value of all other assets in *D*'s estate on April 1, 1977, is $400,000, giving *D* a gross estate with a fair market value of $1,000,000 ($600,000 qualified real property and $400,000 other assets) and a § 2032A value of $800,000 ($400,000 and $400,000). The decrease in the value of the qualified real property that results from the application of § 2032A is $200,000 ($600,000 fair market value, less $400,000 § 2032A value), which is within the $500,000 reduction-in-value limit of § 2032A(a)(2).

The remaining question of whether the standing timber is to be treated as qualified property or as personalty is addressed below. *See* text accompanying notes 63-80 *infra*.

30. I.R.C. §§ 2032A(a)(1)(B), (d)(2). The election of § 2032A must be made by the

the tax recapture provisions of the statute.

Furthermore, to obtain the special valuation benefits of section 2032A, the property that passes to a qualified heir of the decedent must be real property located in the United States and must meet the definition of qualified real property.[31] A rather complicated statutory formula consisting of several separate qualifying tests is made available in order to determine whether the statute will apply to the property in question. The first test of qualification, the percentage test, actually consists of two percentage requirements. Both are based upon the fair market valuation concept of section 2031.[32] These tests are as follows:

> (1) The fifty percent test[33]—at least fifty percent of the adjusted value of the decedent's gross estate[34] must consist of the adjusted value of the real or personal property[35] that was being used for a qualified use[36] on the date of the decedent's death and that passed from the decedent to a qualified heir;[37] and
> (2) the twenty-five percent test[38]—at least twenty-five percent of the adjusted value of the decedent's gross estate must consist of the adjusted value of real property that passed to a qualified heir and that meets the time period test of section 2032A(b)(1)(C).[39]

The time period test requires that, during the eight years

executor within the time prescribed by I.R.C. § 6075(a) for filing the estate tax return (within nine months after the date of the decedent's death, if no extensions are allowed). *Id.* § 2032A(d)(1). No filing period requirement is given by the statute on the heir's agreement, but it is probable that the regulations will specify the same nine month period.

31. *Id.* § 2032A(b)(1).

32. *Id.* § 2031(a).

33. *Id.* § 2032A(b)(1)(A).

34. The adjusted value of the gross estate is the value of the gross estate reduced by any unsatisfied mortgages or other indebtedness. *Id.* § 2032A(b)(3)(A).

35. The adjusted value of real or personal property is the value of such property reduced by any unsatisfied mortgages or other indebtedness. *Id.* § 2032A(b)(3)(B).

36. Timberland or woodland is included within the term qualified use through a somewhat circuitous definitional process. I.R.C. § 2032A defines qualified use as "devotion of the property to any of the following: (A) use of a farm for farming purposes, or (B) use in a trade or business other than the trade or business of farming." *Id.* § 2032A(b)(2). Farm is further defined as including orchards and woodlands, and farming purpose is stated to include "(i) the planting, cultivating, caring for, or cutting of trees, or (ii) the preparation (other than milling) of trees for market." *Id.* §§ 2032A(e)(4), (5)(C).

37. A qualified heir is, generally, a member of the decedent's family who acquired the property from the decedent. *Id.* § 2032A(e)(1). See *id.* § 2032A(e)(2) for the definition of "member of family."

38. *Id.* § 2032A(b)(1)(B).

39. *Id.*

immediately preceding decedent's death, there were periods aggregating five years or more during which (1) the real property treated in the twenty-five percent test was owned by the decedent or a member of his family and was used for a qualified use; and (2) there was material participation by the decedent or a member of his family in the operation of a farm or other business to which the real property was devoted.[40]

Upon the election of section 2032A treatment a special lien arises under section 6324B[41] in the amount of the additional estate tax which will become due in the event the qualified real property, within a specified period, loses its qualified status.[42] The recapture obligation is imposed by the statute upon the qualified heir or heirs "in proportion to their respective reductions in value [of the qualified real property as determined under section 2032A]."[43] The amount of tax recaptured will be the lesser of (1) the estate tax avoided by election of section 2032A, or (2) the amount realized from the property, or interest therein, in a sale or exchange or the fair market value of such property, if otherwise disposed of, less the value of such property as determined under section 2032A.[44]

40. *Id.* § 2032A(b)(1)(C). In addition, the real property must be designated in an agreement by all persons having an interest in the property after the death of the decedent that these persons consent to the imposition of an additional estate tax should the property cease to be used for a qualified use. *Id.* § 2032A(b)(1)(D). The agreement is to be filed by the executor as directed in § 2032A(a)(1)(B). *See* text accompanying note 30 *supra.*

41. Provision for the lien arising from I.R.C. § 2032A is found in new I.R.C. § 6324B, entitled "Special Lien for an Additional Estate Tax Attributable to Farm, etc., Valuation."

42. For a discussion of the specified period referred to, see text accompanying notes 45-49 *infra.* For a discussion of what constitutes loss of qualified status, see text accompanying notes 50-52 *infra.*

43. H.R. REP. No. 1380, *supra* note 8, at 26. *See* I.R.C. § 2032A(c). The Technical Corrections Bill of 1977, as passed by the House on October 17, 1977, but not adopted by Congress as of the date of publication, provides that a qualified heir may be discharged from personal liability if he furnishes a bond meeting certain requirements. The Secretary is directed to furnish the qualified heir with a determination of the maximum amount of the additional tax that might be imposed upon recapture within one year after being requested by the qualified heir to do so. The amendment is to be in the form of a new paragraph (11) added to section 2032A(e). H.R. 6715, H.R. REP. No. 700, 95th Cong., 1st Sess. 172 (1977).

44. I.R.C. § 2032A(c)(2). Assume that the 1000 acres of timberland deemed qualified real property in the hypothetical at note 29 is sold on April 1, 1982, five years after *D*'s death. Assume further that at the time of sale the fair market value of the property is $500 per acre for the land and $300 per acre for the timber, or $800 per acre (a rise in value attributed in part to inflation and rising land values and in part to increased value of the maturing timber), for a total sales price of $800,000. In this case, the amount of estate tax avoided by election of § 2032A is $78,000, *i.e.*, a $315,800 net federal estate tax liability

Briefly, under section 2032A(c), recapture of the additional tax arises if the qualified real property, or some part thereof, is disposed of to one who is not a member of the family or if, within fifteen years of the date of decedent's death, the property otherwise ceases to be used for the qualifying use existing at that date.[45] The entire amount of the additional tax is subject to recapture if disposition or cessation of qualified use occurs within ten years of the decedent's death.[46] Recapture is also appropriate if, within an eight year period ending after the decedent's death and before the qualified heir's death, there was no material participation by the decedent, qualified heir, or by any member of their family for periods aggregating three years or more.[47] If disposition or cessation occurs more than ten years after the death of the decedent, the amount of tax subject to recapture is reduced at the rate of one-sixtieth per month[48] until, at the end of the fifteen year period beginning with the decedent's death, this amount has completely disappeared.[49]

on the $1,000,000 fair market value of the estate, less a $237,800 net federal estate tax liability on the $800,000 value of the estate as determined with § 2032A [taking into account in both cases the $30,000 I.R.C. § 2010 credit available in 1977]. The difference between the amount realized for the property and the value of the property determined under § 2032A is $400,000 ($800,000 less $400,000). Thus, the tax recaptured as a result of the sale will be $78,000, the amount of estate tax avoided by use of § 2032A and, in this case, the lesser of the two amounts specified in § 2032A(c)(2).

The rather complicated formulas given in § 2032A(c)(2) for determining the amount of additional tax recaptured on the cessation of qualified use or partial disposition of the qualified property are stated in language that is less than crystal clear. One question arising from such language is whether the "value of the interest" being disposed of, which is otherwise the subject of the formula, is the value at the date of the decedent's death or at the date of sale or other disposition. As use of the latter date at any point in the formulas would distort the amount of additional tax to be recaptured, and in the case of total disposition, would retroactively alter the sum of such amount, logic would dictate use of value at the date of decedent's death in all cases.

45. The additional tax due by reason of the recapture event "shall become due and payable on the day which is 6 months after the date of the disposition or cessation referred to in paragraph (1)." I.R.C. § 2032A(c)(5).

46. *Id.* § 2032A(c)(3).

47. *Id.* §§ 2032A(c)(7)(B), (e)(6).

48. *Id.* § 2032A(c)(3).

49. The lien on the amount of tax subject to recapture is also apparently intended to terminate automatically at the end of the fifteen year period. *Id.* § 6324B(b)(1). Recapture may also be avoided by the death of the qualified heir. *Id.* § 2032A(c)(1). The House Report, however, seems to state that the avoidance by death of the heir applies only to heirs holding a presently enjoyable interest in the qualified real property at the time of their death. For example, if one of the two qualified heirs who hold the property as tenants in common dies within the fifteen year period, his share is freed from recapture. If the holder of the first of successive estates in the property (*e.g.*, the life tenant) dies, however, nothing is freed from recapture. H.R. REP. No. 1380, *supra* note 8, at 26. *See generally*

The statute, by referring to a cessation of the qualified use, indicates that a change in qualified use from that existing at the date of decedent's death to another qualified use probably constitutes a "cessation of qualified use" and triggers recapture of the additional tax saved by section 2032A treatment.[50] The House Report, however, states that recapture will occur if "the property is disposed of to nonfamily members or *ceases to be used for farming or other closely held business purposes*. . . ."[51] Because the report refers generally to the cessation of any qualified use of the real property as the recapture trigger, an argument can be made that a mere change by the heir from a particular qualified use to another qualified use should not cause the additional tax to become due.[52]

B. *Benefits*

The chief advantage in the application of section 2032A to an estate containing qualified timberland is, of course, the opportunity for reducing the total value of the gross estate by an amount not to exceed $500,000.[53] While this reduction in value lacks the dollar-for-dollar effect of a direct tax credit in reducing ultimate estate tax liability, it acts precisely like an exemption or exclusion in reducing the value of the total gross estate. It lowers the top marginal tax rate and reduces the total effective tax rate.[54]

Avery and Benjamin, *Valuation of Farm and Closely Held Business Property: Recapture: Special Lien*, in 2 ALI-ABA STUDY OUTLINE, TAX REFORM ACT OF 1976, at 59 (1976).

50. I.R.C. § 2032A(c)(7)(A).

51. H.R. REP. No. 1380, *supra* note 8, at 25 (emphasis added).

52. The argument requires close syntactical reasoning, but the point may become an important one in some situtations. From a purely practical point of view, it would be unreasonable for a mere change or rotation of a general class of crop to trigger recapture (*e.g.*, of one annual crop, such as cotton, to another annual crop such as soybeans). Such rotation may be dictated by agricultural principles and would generally serve to protect the federal estate tax lien on the real property by contributing to the economic soundness of the farming operation, rather than by jeopardizing the lien in any way. A change from one class of crops to another (*e.g.*, from harvesting hardwoods to raising Christmas trees, or, more drastically, from timber growing to cattle raising or truck farming) may have, however, a more profound effect upon the nature of the operation itself and even upon the value of the underlying land. The problem, of course, is where the line should be drawn within the area of change of qualified use or, indeed, whether it should be drawn at all within the area. The regulations might be expected to provide some guidance where Congress has seemingly failed to consider the question.

53. I.R.C. § 2032A(a)(2).

54. In the hypothetical situation at note 29, for example, federal estate tax on the gross estate with a fair market value of $1,000,000 is $345,800 (before application of the I.R.C. § 2010 credit), giving an effective tax rate of 34.58% of the fair market value of the gross estate. Federal estate tax on the gross estate valued with election of I.R.C. § 2032A

Section 2032A provides a statutorily approved method of valuation for qualified real property.[55] The precise "farm method" formula for valuation based on use set out in the statute[56] has a dual purpose. One purpose is to exclude speculative and other nonfarm factors from the valuation process.[57] This formula is also designed to provide a degree of certainty and uniformity in the results of valuation by the use of quantities that are, at least in theory, fairly fixed and readily available.[58]

Additionally, section 2032A is not intended to be limited in application to personal ownership of qualified property by individuals, but it may be applied to a wider range of ownership interests.[59] Congress has instructed the Secretary of the Treasury to prescribe regulations setting forth the application of the section to closely held partnerships, corporations, and trusts.[60] Congress has also clearly indicated that it intends that the statute apply with certain restrictions to such forms of ownership.[61]

C. *General Problems and Pitfalls*

While section 2032A will undoubtedly prove to be of benefit to those estates that happen to fit precisely within its confines, for the majority of estates containing qualified real property, election of the statute will most likely be made with reservations on both its availability and its actual benefits. Hopefully, many of the definitional, administrative, and substantive questions raised by the statute will be dealt with in forthcoming regulations by the Department of the Treasury. Certain conceptual aspects of the statute and its interrelation with other provisions of the Internal Revenue Code, however, raise problems that may require further statutory guidance.[62]

---

at $800,000 is $267,800, giving an effective tax rate of 26.78% of the fair market value of the gross estate.

55. I.R.C. §§ 2032A(e)(7), (8).

56. *Id.* § 2032A(e)(7).

57. *See generally* H.R. REP. No. 1380, *supra* note 8, at 24. Whether such certainty will in fact result remains to be seen, but attorneys and executors who have previously wrestled with the problems of real estate valuation for estate tax purposes will appreciate the attempt.

58. *Id.*

59. I.R.C. § 2032A(g).

60. *Id.*

61. H.R. REP. No. 1380, *supra* note 8, at 24; H.R. REP. No. 1515, 94th Cong., 2d Sess. 610, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4249. *See also* text accompanying note 25 *supra*.

62. Consider, for example, the problems which may arise if the I.R.C. § 1023 car-

A basic question regarding the use of section 2032A in connection with qualified timberland is whether standing timber was intended to be included within the term "real property," as this term is used in the statute.[63] For purposes of valuing the gross estate, the Treasury Regulations direct that "growing crops must generally be itemized and the value of each item separately returned."[64] This itemization of growing crops as distinct property separate from the land supporting them and inclusion of the crops with personal property suggests that the Department of the Treasury regards growing crops as personalty for purposes of the estate tax.[65]

Two questions immediately arise. The first is whether standing timber is also to be regarded as a growing crop for federal estate purposes.[66] Second, if standing timber is not included within the definition of a growing crop, the inquiry is whether it is to be regarded as realty or as personalty for federal estate purposes. No specific federal statutory answer to these questions exists,[67] and one must look to common law in order to determine

---

ryover basis of qualified real property, which is valued for estate tax purposes under I.R.C. § 2032A, is found not to have been the correct carryover basis of the property, because of a late determination of the inapplicability of § 2032A to the property or to a later sale or other disposition of the property. Query whether the use value of the property is retroactively replaced by its fair market value for estate tax valuation purposes. *See generally* I.R.C. §§ 1023, 6039A, 6694.

63. I.R.C. § 2032A.

64. Treas. Reg. § 20.2031-1(b) (1965).

65. State law may, however, provide otherwise. In South Carolina, for example, unsevered crops are generally treated as realty. Big Robin Farms v. California Spray-Chemical Corp., 161 F. Supp. 646 (D.S.C. 1958); Norwood v. Carter, 176 S.C. 472, 180 S.E. 453 (1935).

66. I.R.C. § 2032A refers to "woodlands" and, even more generally, "trees," terms which would seem to include everything from timber to fruit trees and nursery shrubs. I.R.C. §§ 2032A(a)(4), (5)(C). This article is confined, however, to the application of the statute to "standing timber," a term which is generally held to mean growing trees of present or potential commercial value. *See generally* G. THOMPSON, 1 COMMENTARIES ON THE MODERN LAW OF REAL PROPERTY § 98 (1964). *See also* Marshall v. Georgia Power Co., 134 Ga. App. 479, 214 S.E.2d 728 (1975).

67. Perhaps a clue to the conceptual status of standing timber under general notions of federal taxation can be gleaned from the disparate treatment afforded capitalization of production expenses of farm crops on the one hand and trees on the other. I.R.C. § 447 provides generally that (with the exception of small businesses and family corporations) farming "preproductive period expenses" shall be capitalized. A specific exception is made for the "trade or business of . . . harvesting trees. . . ." I.R.C. § 447(a). Likewise, I.R.C. § 464 limits deductions of prepaid expenses by farming syndicates for farming operations, but specifically excludes trees from the definition of "an agricultural or horticultural commodity." *Id.* § 464(e)(1). *Cf. id.* § 278(a) (which makes provision for expenses incurred in planting and cultivating citrus and almond groves to be charged as capital expenditures). The distinction made in these cases between traditional farming activities,

the status of timber as real or personal property.[68]

Generally, under common law, a crop is an annual product of the soil, requiring cultivation by man.[69] Standing timber is not normally held to be a crop under common law, since it is considered a natural product of the earth, not requiring annual cultivation.[70] Furthermore, the general American rule is that timber is a part of the realty until severed from the soil;[71] when so severed, however, it becomes personalty.[72] Thus, under local law, timber standing upon land that is qualified real property under section 2032A will generally be a part of the real property. It follows, therefore, that under common-law principles standing timber should be combined with the land that supports it in computing the total value of the real property for the determination of the value of the gross estate under section 2031[73] and for the determination of the value based on the use of such real property under section 2032A.[74]

---

normally involving the production of short term crops, and timber growing follows the general common-law treatment of crops as personalty and standing timber as realty.

68. "State law creates legal interests and rights. The federal revenue acts designate what interests and rights, so created, shall be taxed." Morgan v. Commissioner, 309 U.S. 78, 80 (1940). *See generally* M. FERGUSON, J. FREELAND, & R. STEPHENS, FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES, ch. 2 (1st ed. 1970).

69. *Ex parte* Gray, 204 Ala. 358, 86 So. 96 (1920); Evans Marketing Agency v. Federated Growers Credit Corp., 175 Ga. 294, 165 S.E. 114 (1932).

70. *See* Brittain v. McKay, 23 N.C. 265 (1840).

71. *See* Alexander v. Herndon, 84 S.C. 181, 65 S.E. 1048 (1909); Marion County Lumber Co. v. Tilghman Lumber Co., 84 S.C. 505, 66 S.E. 877 (1910). See also U.C.C. § 2-107, which treats a contract for the sale of standing timber as only a contract to sell such timber, unless such contract would be effective as a transfer of an interest in land. S.C. CODE ANN. § 36-2-107(1) (1976). A contract for the sale of growing crops attached to the soil, however, is treated as a contract for the sale of goods. *Id.* § 36-2-107(2). *Cf. id.* § 21-35-130 (South Carolina's Revised Uniform Principal and Income Act takes a rather ambiguous approach to the treatment of receipts from the sale of timber which has been severed from the land). *See also* S.C. CODE ANN. § 12-37-680 (1976).

72. Northern Pac. R. Co. v. Paine, 119 U.S. 561 (1887). *Accord,* Big Robin Farms v. California Spray-Chemical Corp., 161 F. Supp. 646 (D.S.C. 1958); Walters v. Sheffield, 75 Fla. 505, 78 So. 539 (1918); Shirling v. Security Loan & Abstract Co., 167 Ga. 489, 145 S.E. 840 (1928); South Miss. Elec. Power Ass'n. v. J.F. Miller Timber Co., Inc., 314 So. 2d 346 (Miss. 1975); Ingold v. Phoenix Assur. Co., 230 N.C. 142, 52 S.E.2d 366 (1949).

73. I.R.C. § 2031.

74. Perhaps the American common-law concept of standing timber as real property may be expected to follow the shift in forestry practices from treatment of timber as an inexhaustible natural resource to a renewable crop which must be planted, cultivated, and harvested in continuing cycles. The notion that trees should be treated as an integral part of the land until severed arose in a time when land which had been cleared for the planting of crops was of more value than timbered land. Trees were regarded more as a natural byproduct of the soil than as the cultivated crop it has become in modern America. *But see* Poole v. Union Trust Co., 191 Mich. 162, 157 N.W. 430 (1916).

The use valuation methods provided by section 2032A, however, apparently do not contemplate that standing timber is to be included in the term "qualified real property." Section 2032A(e)(7) provides a formula that determines the use value of a farm by reference to the rental value of comparable land.[75] Where there is no comparable rental land or where the executor so elects, an alternate method of use valuation will be employed.[76] This alternate, the multiple factor method, consists of a list of factors to be applied in determining the value of qualified real property.[77] These factors refer in succession to "the property," "land for farmland," "assessed land values . . . for farmland," "land," and, again, "the property."[78] This indiscriminate use of terminology leads one to consider whether common-law distinctions between land and the more encompassing term of real property were less than sharply defined in the minds of the drafters of the statute—if not ignored altogether.

Congress may have failed to consider that under general common-law principles growing timber is actually a part of the qualified real property and simply neglected to include it in the use valuation methods provided by the statute. Another possibility is that it specifically intended that the use value of the land alone, without regard to the value of the timber, should be considered under section 2032A valuation methods.[79] In either case, for purposes of valuation under section 2032A, the statutory lan-

---

It is not unlikely that Treasury regulations to be promulgated under I.R.C. § 2032A will recognize the shift in forestry practices toward treatment of trees as a renewable crop in their application of the material participation requirements to timber growing. Query whether in application of the requirements distinctions should be drawn between large unmanaged areas and small highly managed tracts, between hardwood growth (often requiring 80 or more years) and pulpwood production, etc.

75. I.R.C. § 2032A(e)(7), termed the "farm method" in H.R. REP. No. 1380, *supra* note 8, at 24.

76. I.R.C. §§ 2032A(e)(7)(B), (8).

77. *Id.* §§ 2032A(e)(8)(A)-(E).

78. I.R.C. § 2032A(e)(8), termed the "multiple factor method" in H.R. REP. No. 1380, *supra* note 8, at 25. Because rental of land for timber growing purposes is relatively uncommon in most areas of the country, the farm method of valuation will be unavailable for use valuation of qualified timberland.

79. In other words, it may be the intent of Congress that standing timber is to be regarded as a growing crop and, regardless of the provisions of local law, must be separately itemized for estate tax purposes from the land upon which it stands, as per Treas. Reg. § 20.2031-1(b) (1965). *See* note 18 *supra*. An argument that Congress is actually referring to "land" when it uses the term "real property" in § 2032A can be made on the basis of § 2032A(d)(3), a provision which allows, only under specific circumstances, the term "qualified real property" to include certain structures and improvements upon the land which are normally included per se in the common-law definition of real property.

guage appears presently to require that the value of standing timber be excluded from a determination of the use value of qualified real property, even though as a matter of basic property law standing timber is an integral part of real property.[80]

One of the prime risks of electing section 2032A is the possibility of recapture of the estate tax originally avoided by application of the section. Because of the fifteen year lien and the recapture problem[81] that lurk within the application of section 2032A, the executor or estate planner considering using the statute to reduce federal estate taxes should attempt to learn what use will most likely be made of the qualified timberland after the decedent's death. Any expressions of intent by the client cannot, of course, be relied upon with certainty. It may become clear, however, that the existing qualified use will cease within a ten to fifteen year period where, for example, encroaching development may soon raise fair market values to a level too high for heirs or devisees to resist sale of the property. On the other hand, the client may make it clear that it is likely that qualified timber growing operations will continue on the property for the foreseeable future.[82] If it is obvious that the property will very shortly be sold to a nonfamily member for development or other purposes, there is seemingly little advantage in electing section 2032A, because the additional tax will become due through recapture at an early date.[83] If, however, it is likely that the property will continue to be qualified under section 2032A for a num-

---

80. If land alone is to be the qualified real property to which I.R.C. § 2032A applies, it is obvious that the 25% requirement test of § 2032A(b)(1)(B) will become far more difficult to meet in most cases. However, if standing timber is deemed not to be real property, it must necessarily be personal property, and thus will serve to aid in qualifying for the 50% test of § 2032A(b)(1)(A).

At any rate, although a technical reading of the statute appears to exclude standing timber from the definition of qualified real property, the Treasury may adopt a logical approach to the question by providing that the value of "qualified real property" is to consist of the value of the land and the enhancement value of the timber standing upon it. *See* Letter from S.C. Att'y Gen. to S.C. Tax Comm'n (Mar. 1967) *reprinted in* S.C. TAX COMM'N RULES & REGS. P-OAG-30 (1976) (states that "standing trees should be considered as real property or a part of the land" for ad valorem tax purposes.)

81. *See* text accompanying notes 41-49 *supra*.

82. Relevant factors to consider will be: (1) Are the heirs willing and able to carry on the qualified use? (2) Will there be sufficient liquidity in the estate to allow the executor to pay debts and estate taxes without having to sell all or part of the qualified real property? (3) Is the timber growing operation sufficiently profitable to warrant its retention by the heirs? (4) Will encroaching development make sale of the qualified real property likely?

83. I.R.C. § 2032A(c)(1).

ber of years, it would normally be advantageous to elect section 2032A with the intention of avoiding some or all of the additional tax by waiting the required ten to fifteen year period.[84]

In attempting to determine whether recapture might be avoided within this fifteen year period following the decedent's death, the practitioner should remember that cessation of the qualified use can occur by means other than a sale, exchange of qualified property to a nonfamily member, or voluntary decision of the qualified heir to cease using the property for the qualified use. The statute provides no exceptions to the cessation of qualified use in the case of an ordinarily nontaxable event. As a result, treatment of the qualified real property under a section 1031 tax-free exchange[85] or under a section 1033 involuntary conversion[86] will normally trigger recapture to the extent to which the interest in the property is affected—just as in the case of a voluntary sale or exchange.[87]

Congress, however, did evidence an intent to provide a means of relief for the heir who faces recapture of the additional tax triggered by an involuntary conversion of a segment of the qualified real property.[88] The House Report provides that the

> recapture provision is to apply not only if the qualified real property is sold (or exchanged in a taxable transaction) to non-

84. Deferment rather than avoidance of the additional tax may be a significant advantage of election of § 2032A. Additionally, if it seems likely that the land might depreciate in value over the next ten to fifteen years, it is possible that no additional tax will be due upon cessation of qualified use, because of the decline in fair market value. *See* I.R.C. § 2032A(c)(2)(A).

85. I.R.C. § 1031.

86. *Id.* § 1033. Whether a forest fire, or even pest damage, would constitute involuntary conversion and trigger recapture of the additional tax raises the fundamental question of whether standing timber is to be regarded as an element of qualified real property. If it were so regarded for the purposes of I.R.C. § 2032A, it would seem that such a natural disaster to the timber should indeed trigger recapture.

87. Query whether placement of a mortgage or other lien upon the qualified real property is a disposition of a portion of the interest of the heir under I.R.C. § 2032A(c)(2)(D), and is consequently a recapture event. State property law principles may indicate that a mortgage is a partial disposition of the interest of the owner. But see I.R.C. § 6324B(c), which, by reference to I.R.C. § 6324A(d)(3), provides that certain specified liens shall have prior right to the government's lien under § 6324B even though such specified liens shall have arisen subsequent to the filing of the government's lien. For example, a mortgage placed upon the qualified real property in order to secure a commercial loan made for crop financing or improvement of the real property is accorded priority over the § 6324B estate tax lien, whether it comes into existence before or after the filing of the estate tax lien. Similarly, local property tax liens or assessments upon the qualified real property by a local taxing authority will not trigger recapture of the additional tax due. I.R.C. §§ 6324B(c), 6324A(d)(3), 6323(b)(6), (c)(3).

family members, but also where the property is disposed of to nonfamily members in a tax-free exchange (under section 1031), or where the property is disposed of under an involuntary conversion, rollover, or similar transaction (which is nontaxable by reason of section 1033 or 1034). *The preceding sentence does not apply to an involuntary conversion or condemnation if the proceeds are reinvested in the real property which originally qualified for special use valuation.*[89]

The legislative history indicates that recapture upon the cessation of a qualified use may be avoided only if the cessation is due to "involuntary conversion or condemnation" and if the proceeds therefrom are reinvested in the remaining qualified real property. But if all of the qualified property is taken by involuntary conversion or condemnation, leaving no qualified property in which to reinvest the proceeds, the heir is liable for the full amount of the additional tax due.[90] It would seem that the heir who is involuntarily subject to the full additional tax would merit a means of escaping or deferring that tax as much as, if not more than, the heir who involuntarily becomes liable for only a portion of such tax.[91] Neither the statute nor the committee report, however, allows escape from the additional tax when the entire tract of qualified real property has been involuntarily converted.[92] It would be appropriate to amend the statute to permit continued

88. H.R. REP. No. 1380, *supra* note 8, at 25.

89. *Id.* (emphasis added). If, however, there is partial recognition of gain under I.R.C. § 1033(a)(2) when cash or similar consideration is included in a § 1033 involuntary conversion, there is no reason not to apply the recapture provisions so that an amount of additional tax becomes due which is equal to the lesser of the amount of § 1033(a)(2) "boot" received or the entire amount of additional tax due under I.R.C. § 2032A(c).

90. I.R.C. § 2032A(c)(6).

91. The heir who has suffered involuntary conversion or condemnation of the entire amount of qualified real property will normally have sufficient funds arising out of the conversion or condemnation to pay the additional tax due. However, equitable principles, based on the same foundation that prompted the House Committee to specify that recapture will not be triggered when condemnation or conversion proceeds are reinvested in the same qualified real property, *i.e.*, a desire to allow the heir to continue the qualified use without a tax penalty when such use has been interrupted through no fault of his own, should apply in the case of the heir who has had all of his qualifying real property taken from him.

92. In the case of involuntary conversion of all of the standing timber, as by forest fire, the land still remains for reinvestment of the remaining proceeds. The question is whether such proceeds must be reinvested for the original qualifying use, *i.e.*, reforesting, or whether the proceeds might be put into other nonqualifying uses so long as they are conducted or erected upon the qualified land. The literal language of the House Report, quoted above, seems to indicate that any reinvestment in the qualified land would avoid recapture.

avoidance[93] of the additional tax for one who takes the proceeds of an involuntary conversation or condemnation and reinvests in real property that is similar in service or use or of a like kind to the property converted.[94]

A troublesome question is whether the lien and recapture provisions of section 6324B are intended to apply to standing timber as a part of the land, thereby collectively constituting the qualified real property. Although the general common-law rule is that standing timber is a part of the realty,[95] section 2032A seems to exclude the value of standing timber from the definition of qualified real property for use valuation purposes. If this exclusion is applied to the lien and recapture provisions of the statute,[96] the section 6324B lien would not apply to timber standing upon the qualified real property.[97] It follows that any disposition solely of the timber, either by sale, involuntary conversion, or otherwise, would not trigger recapture of any part of the additional tax. Such consistency in the exclusion of the standing timber from the definition of qualified real property throughout section 2032A provides both equitable treatment for the heir and protects the government's interest, for disposition of the timber normally would not significantly affect the value of the land to which the trees are attached.[98]

If, however, the government takes the position that, for purposes of the lien, standing timber will be treated as part of the qualified real property, the heir clearly will be in a more restricted position. Even if a harvest of such timber is dictated by the forestry plan or principles under which the heir operates the quali-

---

93. A procedure for transferring the lien imposed by I.R.C. § 6324B to the newly acquired real property will become necessary if such an amendment was made. Transfer of the lien to similar real property purchased with the proceeds from involuntary conversion of the entire qualified tract will result in more adequate security for the government's lien in many instances than reinvestment in the original qualifying real property, which may have become quite insignificant after conversion. Such a procedure could be set forth in the regulations called for by § 6324B(d) regarding the furnishing of security in substitution for the lien imposed by § 6324B.

94. I.R.C. §§ 1033(a), (f).

95. *See* note 71 and accompanying text *supra*.

96. *See* text accompanying notes 41-49 *supra*.

97. I.R.C. § 6324B defers to I.R.C. § 2032A(b) for a definition of qualified real property. I.R.C. § 6324B(a).

98. If qualified real property is held to consist of the land alone, disposition of timber standing upon that land should not have a material adverse effect on the value of that land.

If qualified real property is land and the timber standing thereon, disposition of the timber, however, could substantially affect the value of the qualified real property.

fied real property, any disposition of part or all of such timber, whether voluntary or not, will constitute a partial disposition of qualified real property,[99] thereby triggering partial recapture of the additional tax. On the other hand, reforesting of portions of the qualified land after the decedent's death will serve to increase the government's security for payment of the lien, as will the mere passive maturity of young trees existing at the date of death.

Exclusion of standing timber from the definition of qualified real property for valuation purposes and inclusion of such timber for lien and recapture purposes would constitute overreaching by the Internal Revenue Service. Any need for additional lien protection cannot justify the severe restrictions this interpretation would place on the heirs' operation of the timberland in accordance with sound forestry practice. That Congress intended this approach is doubtful, and, preferably, the Department of the Treasury will not adopt it.

Another aspect of the recapture and lien provisions of the statute is that a sale, exchange, or other disposition of the qualified property by one qualified heir to another qualified heir does not trigger recapture, but rather substitutes for recapture and lien purposes the transferee-heir for the transferor.[100] This transfer of liability along with the transfer of title takes place even if full value is paid for the qualified real property by the transferee-heir.[101] This situation seems at first to disadvantage a qualified heir, who wishes to purchase from other qualified heirs in order to take over management of the qualified real property, vis-à-vis the nonfamily purchaser, who pays the fair market value and takes the property free of the estate tax lien. The informed transferor-heir will, however, realize that transfer of his interest in the property to a nonfamily member will trigger recapture of the additional tax ascribed to his share, while transfer to another qualified heir will involve no such personal recapture liability. As a result, he should be willing to reduce the price to the purchasing qualified heir.[102] The purchasing qualified heir and the nonfamily

99. Even if the timber should be retained by the heir or members of his family, the very act of cutting it could be termed a disposition of a portion of the qualified real property since, under general property law precepts, cutting of standing timber transforms it from realty to personalty. Such a transformation is, in effect, an exchange of the real property for personal property. *See generally* G. THOMPSON, *supra* note 66, at § 97.

100. I.R.C. §§ 2032A(c)(1)(A), (e)(1).

101. H.R. REP. No. 1380, *supra* note 8, at 26-27.

102. For example, if the selling heir's interest in the qualified real property has a fair market value of $100 and the additional tax due from him upon disposition of his interest

purchaser would thus be on an even footing regarding price.[103]

Another major problem with election of section 2032A treatment may arise not from the statute itself but from one of its supposed beneficiaries, the surviving spouse.[104] Consider the case of a decedent who leaves his wife the maximum amount that will qualify for the section 2056 marital deduction[105] and whose adjusted gross estate for purposes of computing such marital deduction is $1,000,000.[106] Under section 2056, the widow's share is $500,000, or "50 percent of the value of the adjusted gross estate."[107] If section 2032A is properly elected, however, the value of the qualified real property is decreased. This in turn decreases the value of the adjusted gross estate[108] and the value of the widow's share as computed under section 2056.[109]

is $20, he will net $80 upon disposition of his interest to a nonfamily member. If, however, he sells his interest to a second qualified heir, recapture of the $20 additional tax is avoided (as the liability for such tax passes to the purchasing heir), so a sale to the purchasing heir for $80 will have the same net economic effect to the selling heir as will a sale to an outsider for $100.

103. The purchasing heir may even be said to have a bargaining advantage over the nonfamily member; if he purchases the qualified real property and holds it for the remainder of the required fifteen year period, the lien for additional tax disappears without the tax ever having been paid by anyone. He might be willing to pay, for example, $90 for the property, knowing that if he keeps it for the required period and continues the qualified use he will have acquired the property for $10 less than market value. The nonfamily member, however, would have to pay $110 for the property ($10 over the market value) in order for the selling heir to wind up with $90 net.

It is unclear whether Congress fully considered the effect of this situation in light of one of the major policy arguments in favor of replacement of the I.R.C. § 1014 stepped-up basis with the "transferred basis" of new I.R.C. § 1023, *i.e.*, the encouragement of free allocation of capital in a competitive market in order to promote the most economically efficient use of capital.

104. For convenience, the surviving spouse will often be referred to hereinafter as the widow, as the typical case would involve ownership of the real property by the decedent husband who is survived by his wife.

105. I.R.C. § 2056(a).

106. *Id.* § 2056(c)(2).

107. *Id.* § 2056(c)(1)(A)(ii). It is assumed that no gifts had been made to the wife after December 31, 1976. *See* I.R.C. § 2056(c)(1)(B).

108. Election of I.R.C. § 2032A indirectly affects the value of the adjusted gross estate through its effect on the value of the qualified real property for estate tax purposes. If election of § 2032A is made, "then, for purposes of this chapter [ch. 11], the value of qualified real property shall be its value for the use under which it qualifies . . . as qualified real property." *Id.* § 2032A(a)(1).

109. For example, in an adjusted gross estate of $1,000,000, subject to the maximum marital deduction of which $600,000 constitutes the fair market value of real property qualifying and valued at $400,000 under I.R.C. § 2032A, the widow's share will decrease from $500,000 (one-half of $1,000,000) to $400,000 (one-half of $800,000, being the total sum of the $400,000 use valuation of the qualified real property and the fair market value of the other estate assets).

In the event the widow is left no interest in the qualified real property, her consent is not required in order to make use of section 2032A,[110] and, regardless of her wishes, the adjusted gross estate, along with the marital deduction, may accordingly be shrunk by consent of only those heirs who actually receive an interest in the qualifying property. In the more usual case, however, the widow will receive an interest in the qualified real property either by will, under local intestacy laws,[111] or by an in-kind distribution in satisfaction of a pecuniary bequest.[112] If this is the case, consent of the surviving spouse, along with the consent of all others who receive an interest in the qualified real property, is required for application of section 2032A—consent that the spouse may understandably be reluctant to give. In the predeath planning situation, it may be possible either to structure composition of the gross estate, disposition of its assets, or both so that the surviving spouse will receive no interest in the qualified real property or, if she is to receive an interest in the property, to arrange matters so that she is amply provided for, whether or not her share of the estate is reduced by the election of section 2032A treatment.[113] Predeath planning also allows the testator and the estate planner to discuss the situation with the spouse, thereby

110. I.R.C. § 2032A(a)(1)(B), (d)(2).

111. Even if the widow is not specifically devised an interest in the qualified real property, an interest in the qualified real property may have to be distributed to her by the executor in order to satisfy her marital deduction share. In the example used above, the widow's share of the estate is $500,000. Thus, even if all of the nonqualifying assets (worth $400,000) are distributed to her, she still must be deemed to take an interest worth $100,000 in the qualified real property, so that her total share will equal $500,000, which means her consent to election of I.R.C. § 2032A is required. The anomaly is that once § 2032A is elected, the value of the adjusted gross estate is reduced to $800,000, and the widow's share is, as explained in note 110, reduced to $400,000. At this point it would seem that the executor could satisfy her $400,000 share from the nonqualifying assets alone and not distribute any interest in the qualifying real property to the widow. See note 117 *infra* for a discussion of further aspects of this problem.

112. See text accompanying note 118 *infra* for a brief discussion of the satisfaction of a pecuniary bequest with I.R.C. § 2032A qualified real property.

113. For example, typical "A-B" marital deduction trusts could be set up, with the widow receiving all of the income of trust A and having general power of appointment over its corpus, and, at the same time, being a discretionary beneficiary of the income and corpus of trust B with a special power of appointment limited to qualified heirs (*e.g.*, the children). If all of the qualified real property can be put into trust B, income therefrom is available for payment to the widow when needed, and, if the property is managed by and passes to a child, recapture will be avoided. "The conferees intend to make it clear that the rules for special valuation apply to property which passes in trust. Trust property shall be deemed to have passed from the decedent to a qualified heir to the extent that the qualified heir has a present interest in that trust property." H.R. REP. No.1515, *supra* note 61, at 610.

explaining to her the tax advantage of election of the statute to the family and the estate.

Any estate plan that includes election of section 2032A should also attempt to satisfy the desires of the spouse so that her later consent to utilization of the statute is assured. Certainly the chances for gaining the consent of the spouse to the use of section 2032A will be greater if she has been made to feel that her interests were as much a factor in the estate planning process as were tax saving considerations, rather than if she is presented after her husband's death with the proposition that she should decrease her share of the estate in order to make use of a tax loophole of little or no pecuniary advantage to her.

Even if the spouse does not receive an interest in the qualified real property and her consent to the application of section 2032A is not required, or if she receives an interest and agrees to the application of the statute, a further problem arises from the interplay of sections 2056 and 2032A. Once section 2032A has been elected, the effect of cessation of a qualified use of the qualified real property within the fifteen year period and the resulting recapture of the additional tax on the value of the adjusted gross estate and the spouse's marital deduction share must be determined.

Assume that section 2032A is applied to the adjusted gross estate with a value of $1,000,000 cited in the example above.[114] The adjusted gross estate for purposes of computing the marital deduction has thus become $800,000 after the application of section 2032A, and the spouse has received $400,000 as her share of the estate.[115] Five years later there is a sale of all of the qualifying real property to a nonfamily member, causing the cessation of the qualified use of the property and triggering recapture of the entire additional tax due. At this point, an issue is whether the actual estate tax due is figured and collected on the basis of the value of the adjusted gross estate as determined without regard to section 2032A; that is, on the fair market value of $1,000,000. This means that, for purposes of section 2056, the adjusted value of the gross estate has suddenly become $1,000,000 instead of $800,000 and the surviving spouse's marital deduction share is now $500,000 instead of the $400,000 she received upon election of section 2032A and subsequent settlement of the estate. The prob-

114. *See* text accompanying notes 105-106 *supra*.
115. *See* note 109 *supra*.

lem in this situation is determining the source of the spouse's additional $100,000 and the liability for its payment.

The statute provides no solution to this problem. Because of the statute's silence, it is reasonable to assume that the possibility of an additional marital deduction share arising upon the cessation of qualified use was not considered by Congress. It is reasonable to assume further that this lack of consideration was because Congress intended that once section 2032A is utilized in figuring the value of the gross estate and the value for marital deduction purposes, the section 2032A value becomes the only value of the gross estate for federal tax purposes. Thus, although the traditional section 2031 fair market valuation might be referred to later for the purpose of figuring an additional tax due, this valuation after the election and application of section 2032A is purely theoretical and useful only for computational purposes; it in no way increases the spouse's share of the estate pursuant to the marital deduction.

This reasoning is not contradicted by the language of the statute itself, which provides that, once section 2032A is elected and the necessary agreement is filed, "for purposes of [chapter 11], the value of qualified real property shall be its value for the use under which it qualifies, under subsection (b), as qualified real property."[116] The use value of qualified real property is designated as the sole value of such property for purposes of chapter 11 and not as a tentative or contingent value, which remains in effect until the occurrence of a recapture event causes it to be replaced *nunc pro tunc* by the fair market value pursuant to section 2031.

Both sides can make a reasonable argument on the question of whether the widow's share can be increased in the situation described above. The problem can be expected to be dealt with in future regulations and, possibly even before such regulations are promulgated, by the courts. The problem, however, will not be avoided either by a ruling that upon cessation of a qualified use, section 2032A use valuation is replaced by section 2031 fair market valuation or by a ruling that, once section 2032A is properly elected, it alone finally determines the value of qualified property and of the gross estate. In the former instance, if the value of the gross estate is retroactively increased upon cessation of a qualified use, some provision must be made for payment of

116. I.R.C. § 2032A(a)(1). *See* note 108 *supra*.

the additional share due the surviving spouse, and someone must be held liable for such payment. On the other hand, if it is determined that the lower, section 2032A use value is the final value of the qualified real property for estate tax purposes, the surviving spouse can be expected to be less amenable to its use, and in situations where it is used, the election of section 2032A treatment may have unexpected and detrimental economic effects for the spouse.[117]

Another problem that may arise in connection with the surviving spouse occurs with the satisfaction of a pecuniary bequest with an interest in qualified real property.[118] In its present form, new section 1040(a)[119] provides that if the executor satisfies a pecuniary bequest with appreciated, carryover basis property (property in which the heirs take the decedent's basis), then the gain on the exchange shall be recognized "to the extent that, on the date of such exchange, the fair market value of such property exceeds the value of such property for purposes of chapter 11."[120]

Section 1040 was introduced into the Internal Revenue Code in the Tax Reform Act in order to mollify the effect of new section 1023 upon the "*Kenan* gain" doctrine.[121] If section 2032A is

117. Assume that in the example in note 111 *supra* the surviving spouse is left by will a one-half interest in the qualified real property, which, together with a portion of the assets, satisfies her marital deduction share of 50% of the value of the adjusted gross estate, and that the remaining assets are left to the children. Assume further that under the provisions of the will (and applicable state law) all estate taxes are payable out of the children's share of the estate so that the widow might receive her full 50% share. If the surviving spouse consents to election of I.R.C. § 2032A, her share will be reduced from $500,000 to $400,000, as discussed in note 109. If, within ten years after the date of death of the decedent, condemnation proceedings are begun against the qualified real property and it is subsequently condemned, the widow must pay one-half of the additional tax due, for § 2032A makes the qualified heir "personally liable for the additional tax imposed with . . . respect to his interest," presumably without regard to testamentary direction to the contrary. I.R.C. § 2032A(c)(6). By consenting to election of § 2032A, the widow has allowed her share to shrink from $500,000, with no reduction by federal estate taxes, to $361,000 (her § 2032A share of $400,000, less $39,000—one-half of the $78,000 additional tax due, for which she is liable upon a cessation of qualified use).

118. This is a situation in which the will directs that a specific sum of money, or a share of the estate that can be expressed as a certain sum at the decedent's death, shall pass to the surviving spouse, and the sum is "paid" by distributing to the spouse a portion or all of the qualified real property.

119. I.R.C. § 1040(a).

120. *Id.*

121. *See General Explanation of the Tax Reform Act of 1976: Report Prepared by the Joint Economic Comm. on Taxation*, 94th Cong., 2d Sess. 562-63 (1976); Kenan v. Commissioner, 114 F. 217 (2d Cir. 1940). A distribution by an estate of property other than cash in satisfaction of a testamentary bequest of a fixed amount may result in gain to the estate where the value of the property at the date of distribution exceeds the estate's basis

elected, however, and there is a disposition of qualified real property in satisfaction of a pecuniary bequest, section 1040 in its present form would cause a gain to be figured on the chapter 11 value of the real property after reduction through the application of section 2032A. Thus, section 2032A and section 1040, when combined, cause an automatic taxable gain to the estate in an amount at least equal to the section 2032A reduction in value for estate tax purpose.[122]

Obviously, the drafters of section 1040 were not mindful of section 2032A when they provided that the gain be added to the "value of such property for purposes of chapter 11."[123] The problem will hopefully be resolved, however, if Congress enacts the Technical Corrections Act,[124] which provides that the phrase "determined without regard to section 2032A" be inserted after "chapter 11" at the end of section 1040(a).[125] By requiring that the "*Kenan* gain" on the satisfaction of a pecuniary bequest by the

---

in such property. *Cf.* Rev. Rul. 60-87, 1960-1 C.B. 286 (held that an estate realizes a gain or loss when the executor of the estate distributes property to a marital deduction trust comprising a portion of the residue of a decedent's estate, when the portion distributed is determined by a percentage of the adjusted gross estate) (clarifying Rev. Rul. 56-270, 1956-1 C.B. 325). Under I.R.C. § 1014 the estate took a stepped-up basis in the property equal to its fair market value at the date of the decedent's death. I.R.C. § 1023, however, provides that the estate shall take a "transferred" basis equal to the decedent's basis in the property. The potential for appreciation between date of purchase by the decedent (or earlier, if the decedent had acquired the property by gift) and date of disposition by the estate is greater than between the date of death of the decedent and disposition by the estate. Since the value of estate property for purposes of chapter 11 is its fair market value at the date of death (Treas. Reg. § 20.2031-1(b) (1965)). I.R.C. § 1040(a), in effect, retains the § 1014 stepped-up basis for the purpose of testing for and recognizing *Kenan* gain.

122. In other words, if I.R.C. § 2032A is elected and the value of the qualified real property is reduced from its fair market value of $400,000 to a use value of $100,000, it is the lower value which becomes the value of the property for purposes of chapter 11. I.R.C. § 2032A(a). If the property appreciates by $5,000 between the date of the decedent's death and the date of distribution, the estate will recognize a gain of $305,000 (*i.e.*, $405,000 less its $100,000 § 2032A use value on date of death), instead of recognizing a gain of $5,000 (*i.e.*, its $405,000 fair market value on date of distribution less its $400,000 § 2031 fair market value on date of death).

123. I.R.C. § 1040(a).

124. H.R. 6715, H.R. REP. No. 700, 95th Cong., 1st Sess. 172 (1977).

125. The section would then read:

> If the executor of the estate of any decedent satisfies the right of any person to receive a pecuniary bequest with appreciated carryover basis property (as defined in section 1023(f)(5)), then gain on such exchange shall be recognized to the estate only to the extent that, on the date of such exchange, the fair market value of such property exceeds the value of such property for purposes of chapter 11 determined without regard to section 2032A.

H.R. 6715, H.R. REP. No. 700, 95th Cong., 1st Sess. 172 (1977). *See* note 43 *supra*.

distribution of section 2032A property be figured on the fair market value of such property at date of death, rather than on its use value, this change should eliminate the disparities caused by the statute as presently drafted.[126]

III. USING THE STATUTE

A. *Basic Requirements*

1. Activity.—Although the requirements for application of section 2032A initially seem rather straightforward, the estate planner or executor attempting to determine its usefulness in connection with timberland held by the client soon discovers that several of the tests that must be met[127] are vague and present serious problems in determining whether the relief offered by the statute is available.

Two of these, the "qualified use"[128] and "material participation"[129] tests involve problems of definition.[130] The language of the statute, regarding both the qualified use and the material participation tests, implies the necessity of some degree of activity in relation to the land in question. In neither case, however, does section 2032A give more than a hint about the required extent or nature of such activity where timberland is involved.

"Qualified use" regarding timberland is rather broadly defined in the statute.[131] Future regulations can be expected to indicate what activities the Department of the Treasury feels are encompassed by the phrase "preparation . . . of trees for market."[132] Without the aid of such regulations, the phrase seems to include any activity from seeding to shipping, and certainly seems to include the four specified activities of planting, cultivating, caring for, and cutting of trees.[133] The statute leaves unclear the extent of activity required to obtain Internal Revenue Service recognition that woodland is used for the requisite farming purposes, that is, for the planting, cultivating, caring for, cutting, or

126. H.R. REP. No. 700, 95th Cong., 1st Sess. 171 (1977).
127. *See* text accompanying notes 31-40 *supra.*
128. I.R.C. §§ 2032A(b)(1)(A)(ii), (B), (b)(2).
129. *Id.* §§ 2032A(b)(1)(C)(ii).
130. The third test, the two-pronged percentage requirement, deals with the valuation of the land vis-à-vis the valuation of the whole estate. *Id.* § 2032A(b)(1)(A), (B). *See* note 34 *supra.*
131. I.R.C. § 2032A(b)(2). *See also* note 36 *supra.*
132. I.R.C. § 2032A(e)(5)(C)(iii).
133. *Id.* § 2032A(e)(5)(C)(i).

otherwise preparing of trees for market.

To what extent a hybrid or dual use of the qualified real property affects qualification under one or more of the requirement tests is likewise unanswered by the statute. If, for example, a tract of real property included in the estate supports, in part, growing timber and, in part, an operating farm, the issue remains open whether the activities of the farming operation and the participation therein by the decedent and his heirs can be ascribed to the timberland for purposes of meeting the qualified use and material participation tests. Also unanswered is whether the value of the timbered portion of the tract can be aggregated with the value of the farmland for purposes of meeting the percentage value tests,[134] even when no active management of the timberland was undertaken by the decedent.

While all real property that is used for some qualifying use or uses[135] might be lumped together in order to meet the fifty percent and twenty-five percent tests, it is less certain that the activity and material participation attributed to one tract or portion thereof will serve to qualify all tracts, or the entire hybrid tract, when the qualified use and material participation requirements are applied against the aggregate of the real property for which qualification is sought.[136] The question becomes even closer when the same area is used simultaneously for two or more different purposes, each of which would meet some of the requirements of section 2032A(b), but no one of which alone would meet all of this section's requirements.[137]

134. *See* text accompanying notes 33-39 *supra.*

135. I.R.C. § 2032A(b)(2). *See also* text accompanying notes 131-33 *supra.*

136. The "qualified use" and "material participation" requirements of the statute seem to be imposed upon the total amount of real property that qualifies under I.R.C. § 2032A. *See* I.R.C. §§ 2032A(b)(1)(A), (B), (C).

137. For example, consider a tract of timberland held by the decedent at his death that is of sufficient value relative to the value of the adjusted gross estate to meet the percentage requirements, but that, because of lack of any type of management activity on the part of the decedent, does not by itself meet the qualified use and material participation requirements. Will the fact that the decedent also used such timberland for another qualified use which does require active participation (*e.g.*, grazing cattle or raising fodder among the trees) cause the land, with all its uses taken together, to meet all of the requirements of § 2032A? Stated differently, could the decedent have insured the availability of § 2032A by combining his passive timberland investment with a second qualifying use that would be more certain to meet the qualified use and material participation tests of the statute? It is difficult to raise any statutory or policy objections to such a practice. In cases in which a timberland owner is advised to carry on such a second qualified use upon the real property in order to make future qualification under § 2032A more certain, he may find not only that he has benefitted his beneficiaries through estate tax savings after he has passed on, but also that he is in a position to reap some tax benefits himself

Until the necessary regulations are promulgated, the estate planner's judgment of what Congress intended is his only guide. The legislative history of the statute provides some assistance in determining its scope and in predicting the direction that future regulations may take. There is a lack of authority and guidance, however, on the issue of timberland as qualified property.

The legislative history of the statute reveals that, while estate tax relief to the family farmer was of wide concern during the evolution of the Tax Reform Act, the family farm was generally viewed in traditional terms, that is, as a unit for production of annual crops, livestock, or both.[138] The inclusion of timberland in H.R. 10612[139] seems to have been more of a congressional afterthought than a thoroughly considered decision. Therefore, most available information on what activities will cause the Service to view a farm as being used for farming purpose is of little value where timberland is concerned.[140] The statute covers the traditional farm operation, where constant activity is necessary either in the planting, cultivating, or harvesting of crops or in the caring for livestock. In the case of timber growing, where long periods of inactivity are often the rule,[141] the question of the extent and nature of required activity becomes more important and more difficult to answer.

Congress clearly intended for application of section 2032A to timberland to depend on some bona fide timber growing activity.[142] Fears were expressed during the evolution of the bill that

---

before he dies by running two tax shelter operations (timber growing and cattle feeding) on the same piece of real estate. See also I.R.C. § 464(c), which provides that limitations on deductions for farming operations will generally not apply to individuals personally involved in such operations.

138. *See generally House Hearings on Federal Estate and Gift Taxes, supra* note 5.

139. H.R. 10612, 94th Cong., 2d Sess. § 2003(a), 90 Stat. 1520 (1976) (codified in I.R.C. § 2032A).

140. The Senate seems to have more carefully considered the ramifications of including nontraditional farming operations in the Tax Reform Act of 1976 than did the House. The Senate version of H.R. 10612 defined qualified real property as property

> devoted to (A) farming (including the production of agricultural commodities and the raising of livestock), (B) woodland (including land used for the commercial production of trees and land publicly used for undeveloped scenic or outdoor recreational purposes), (C) open space, or (D) any use, provided that the property is listed in the National Register of Historic Places, either separately or as part of a district so listed.

Id. at § 2201(c), 122 Cong. Rec. S13797. The final draft of H.R. 14844 as incorporated into the Tax Reform Act followed the House, rather than the Senate version in all respects.

141. *See House Hearings on Federal Estate and Gift Taxes, supra* note 5, at 569.

142. Real property may qualify for special use valuation if it is located in the United States and if it is devoted to either (1) use as a farm for farming

the statute might be abused in the case of timberland in two ways: (1) By individuals who see in its valuation provisions a sufficiently advantageous estate tax shelter to make worthwhile the buying and holding of timberland as a major estate asset[143] and (2) by those who own timberland only as an incidental or purely investment asset (perhaps making infrequent casual sales or cuttings) so that their holdings and participation in tree farming activities do not merit the relief provisions of the statute.[144]

Various proposals for prevention of abuse by those seeking an estate tax shelter were advanced during the course of the hearings.[145] The most frequently proffered proposals, now incorporated into the statute, were the holding period requirement[146] and the recapture provision.[147]

The degree of timber growing activity required in order to trigger the application of section 2032A is not dealt with in the statute. Discussions of the problem during the congressional hearings,[148] the exclusion of clearly inactive land uses from the

---

> purposes, or (2) use in a trade or business other than farming. In the case of either of these qualifying uses, your committee intends that there must be a trade or business use. The mere passive rental of property will not qualify.

H.R. REP. No. 1380, *supra* note 8, at 23. *See generally Senate Hearings on Federal Estate and Gift Taxes, supra* note 21; H.R. REP. No. 1380, *supra* note 8, at 23 (summary of H.R. 14844).

143. *See House Hearings on Federal Estate and Gift Taxes, supra* note 5, at 569 (statement of Rep. Steiger).

144. *Id.* at 583 (remarks of Rep. Conable).

145. *See, e.g., id.* at 728 (statement of A. Edward McGinty, Esq.); *id.* at 553 (statement of Bradford S. Wellman).

146. I.R.C. § 2032A(b)(1)(C).

147. *Id.* § 2032A(c).

148. A way of determining whether a woodland owner is actively engaged in the production of timber is by questioning the amount of long term planning in which he has engaged. Factors suggested by the chairman of the Estate and Property Taxation Subcommittee of the Forest Industries Committee on Timber Valuation and Taxation are as follows:

> Does he have a forestry management plan? Is he under some sort of contract with either firms such as ours or—again I am talking about New England—New England Forestry Foundation? Is he a member of the tree farm system? What is the record of his efforts in this regard?
>
> You are quite correct that it might be in certain instances sound forestry management to do nothing. But I think the taxpayer—the decedents in my example—in five years ought to be able to prove, or his executor ought to be able to prove, that he was doing nothing based on some sort of rational plan and recommendation.

House Hearings on Federal Estate and Gift Taxes, supra note 5, at 569 (statement of Bradford S. Wellman).

final bill,[149] and the vague allusions to "material participation"[150] in the statute itself, however, all indicate clearly that something more than the casual ownership of wooded land is required to bring such land within the scope of section 2032A.

There is little doubt that the qualified use test of section 2032A is satisfied by those whose chief source of income is derived from the personal, active management and cutting of family-owned timberland.[151] Timberland owners who are not personally involved in the direct management of such timberland can expect the Internal Revenue Service to require proof from their executors that the timberland was in fact being used for active farming purposes during the required period. Legislative history indicates that the burden of proof will be considerably easier to satisfy if the timberland is being managed according to a professionally drawn management plan.[152]

2. *Material Participation.*—The second test for qualification involves the extent of participation by the owner in the management of the farming operations. Because the duties involved in managing timberland are not on the same scale as those involved in operating a farm, the amount of participation necessary for a finding of materiality seems to be minimal. The application of the owner participation requirement in connection with traditional farming operations may, by inference, prove helpful in attempting to predict what the Internal Revenue Service will require regarding timberland management.

---

149. *See* note 140 *supra.*

150. I.R.C. §§ 2032A(b)(1)(C)(ii), (e)(6). *See also* text accompanying note 47 *supra.*

151. *See* I.R.C. § 2032A(e)(1).

152. Future regulations may be enacted requiring proof that a woodland owner is engaged in the active production of timber. Mr. Wellman may have given a preview of these in response to Rep. Steiger's request for a test concerning such activity:

> To qualify for . . . [recommended special estate tax treatment] . . . lands held by a private estate, a private landowner, a private trust, or a family-owned corporation must be regulated according to prescriptions in a forest management plan, prepared or approved by a licensed forester (in states where forestry license laws exist) or by professional forestry graduates of a four year college or university forestry curriculum (in states without forestry license laws). The management plan should include a cutting schedule based on the silvicultural needs of the forest or upon the capability of the forest to produce sustained yield under the plan. The cutting schedule must be followed to retain eligibility, unless a forester qualified to prepare or approve forest management plans recommends an amendment to the active plan because of changes in the timber market which make the recommended amendment more applicable than earlier recommended activity to achieve the silvicultural objectives.

House Hearings on Federal Estate and Gift Taxes, supra note 5, at 570.

While the statute purports to define the term "material participation," it merely refers to use of the term in section 1402(a)(1),[153] leaving any real definition to drafters of the Treasury Regulations. The reference to section 1402(a)(1), which deals with net earnings from self-employment, is confusing, for in that section the term "material participation" is used only in connection with income derived from farm rentals.[154] Relating the treatment of material participation under section 1402(a)(1) to timberland operations strains the imagination and makes hazardous any predictions on what future regulations will require in the case of timberland.[155]

Present Treasury Regulations for section 1402(a)(1) are relevant, however, to the extent they provide that services performed by the employee or agent of the landowner are considered to be services performed by the owner or tenant in determining whether the material participation test has been satisfied.[156] That principle, a reflection of prior rulings[157] and case law,[158] seems to encom-

153. I.R.C. § 1402(a)(1). "Material participation shall be determined in a manner similar to the manner used for purposes of paragraph (1) of section 1402(a) (relating to net earnings from self-employment)." I.R.C. § 2032A(e)(6).

154. Regulations adopted pursuant to I.R.C. § 1402(a)(1) provide that there must be (1) an agreement between the owner and another person providing that there shall be material participation by the owner in the production of the "agricultural or horticultural commodities" involved, and (2) actual material participation by the owner with respect to the production or management of the production of such commodities. Treas. Reg. § 1.1402(a)-4(b) (1963). See Rev. Rul. 57-58, 1957-1 C.B. 270, for guides on whether income derived from farm rentals should be considered when computing net earnings from self-employment.

155. The author suggests that in the case of a timber growing operation, if the required owner activity level is found, the material participation requirement be deemed satisfied. The test supplied by Mr. Wellman, note 152, *supra* would be a good starting point for drafting such a test.

156. Treas. Reg. § 1.1402(a)-4(b)(5) (1963).

157. *See generally* Rev. Rul. 64-32, 1964-1 C.B. 319; Rev. Rul. 61-42, 1961-1 C.B. 399; Rev. Rul. 57-58, 1957-1 C.B. 270.

158. *See* Harper v. Fleming, 288 F.2d 61 (4th Cir. 1961) (court held that the activities of a local bank employed by the farm owner to supervise sharecropping operations constituted material participation by the owner); Henderson v. Fleming, 283 F.2d 882 (5th Cir. 1960) (activities of the landowner's son were taken into account in determining material participation). See also Charles D. McAllister, 42 T.C. 948 (1964), involving income derived from orange groves owned by the petitioner but wholly operated by a management firm retained by the petitioner. In *McAllister,* the Tax Court held that the acts of the firm, as agent for the owner, constituted sufficient participation by the owner to subject him to self-employment tax on self-employment income derived from farming operations.

Such judicial authority should forestall possible attempts by the Internal Revenue Service to exclude activities of a professional forester or timber manager from the definition of material participation by the owner on the basis that the professional is an independent contractor and, therefore, is neither an employee nor an agent of the owner.

pass the owner whose timberland is either managed partially or entirely by an employee or agent of the owner. Treasury Regulation section 1.1402(a)-4(b)(5)[159] does not, however, reflect a relatively recent statutory amendment that directs that the activities of an employee or agent of the owner will no longer be treated as the owner's activities for purposes of determining material participation in connection with section 1402(a)(1).[160]

As with the qualified use test,[161] woodland owned by an individual who personally operates an active timber growing business probably meets the material participation test with relative ease.[162] Timberland owned by someone not personally active in its management or by someone not involved in the production of income will surely be subject to closer scrutiny. Probably the majority of privately held timber tracts fall into this latter category. Such tracts are typically held in a family for long periods, often passing through one or more generations before completion of a crop.[163] Harvests may or may not be carried out under a long-term management plan and, in most cases, the active conduct of the management and harvesting operations will be carried out

159. Treas. Reg. § 1.1402(a)-4(b)(5)(1963).

160. Act of July 31, 1974, Pub. L. No. 93-368, § 10, 88 Stat. 420 (1974) provides as follows:

> (b) Section 1402(a)(1) of the Internal Revenue Code of 1954 (relating to definition of net earnings from self-employment) is amended by inserting after "material participation by the owner or tenant" each time it occurs the following: "(as determined without regard to any activities of an agent of such owner or tenant)".
>
> (c) The Amendments made by this section shall apply with respect to taxable years beginning after December 31, 1973.

161. *See* note 31 and accompanying text *supra.*

162. Personal participation by the owner is not required if the necessary participation is performed by a "member of the decedent's family. . . ." I.R.C. § 2032A(b)(1)(C)(ii). The phrase "member of the decedent's family" is defined rather broadly, extending to first cousins, their wives, and progeny:

> The term "member of the family" 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.

Id. § 2032A(e)(2). Whether the term "ancestor" is intended to include only lineal ancestors is unclear. Uncles and aunts are included in the definition, however, rendering the question academic, as the issue of material participation by the decedent should rarely hinge on the activities of his great uncles and aunts or their more remote forebearers within "the 8-year period ending on the date of the decedent's death. . . ." *Id.* § 2032A(b)(1)(C).

163. *See generally House Hearings on Federal Estate and Gift Taxes, supra* note 5, at 559-87 (statements of J. Gordon Powell, forest economist, and William E. Towell, forester, and subsequent open discussion).

under supervision of an independent forester employed by the landowner or with the advice of a government or other consulting forester.[164] In this type of situation, the material participation guidelines of the present Treasury Regulations[165] for section 1402(a)(1) offer little information on what will be required of the owner of timberland for the purposes of satisfying section 2032A's requirement of material participation by the owner.

Four basic levels of owner activity exist in connection with the operation of timber producing land: (1) the owner plants, cultivates, cares for, and cuts the timber himself; (2) the owner personally engages in one or more, but not all, of the above activities, but employs another, typically a professional forester, to perform the remaining activities; (3) the owner performs none of the operations himself, but hires a manager or independent forester to manage the land; and (4) the owner leases the land to another for the production of timber.

Assuming that the timberland meets the qualified use test, the timberland will, in most cases, meet the material participation test in the situation where all activities are in fact performed by the owner, as in owner activity level number (1) above. The land is not rented and none of the necessary activities are performed by any party other than the owner. In this situation section 1402(a)(1) and the accompanying Treasury Regulations[166] are largely irrelevant.

In owner activity level number (4) above, the land is timber growing property rented to another, a situation analogous to that dealt with in section 1402(a)(1). The Treasury Regulations in this case may be somewhat more relevant insofar as rental property is involved. A rather strained inference, however, must be made in applying principles connected with an active farming operation to the more passive type of operation involved in woodland management.[167] In addition, rental of privately held timber growing

164. A 1972 survey by the American Forestry Institute revealed that 50% of the timberland owners surveyed relied, at least in part, on technical professional forestry assistance. *Profile of a Tree Farmer, supra* note 6, at 4.

165. Treas. Reg. § 1.1402(a)-4(a)(1963).

166. *Id.*

167. Case law that focuses on the degree and nature of participation required by the owner of rental farm land to satisfy the requirements of material participation may prove more helpful than the regulations in determining what will be required regarding timberland. The courts have taken a more liberal stance toward the question than has the Internal Revenue Service. *See* McCormick v. Richardson, 460 F.2d 783 (10th Cir. 1972); Celebrezze v. Miller, 333 F.2d 29 (5th Cir. 1964); Celebrezze v. Wifstad, 314 F.2d 208 (8th

tracts, in contrast to farm rental or share cropping arrangements, is an infrequent practice in most areas of the country.

Owner activity level numbers (2) and (3), however, best describe the typical operations of a small wood lot owner. As to such situations, use of the term "material participation" in section 1402(a)(1) has little or no relevance, and its present Treasury Regulations[168] offer almost no guidance on how the phrase will eventually be defined with respect to timber producing land held by the owner and managed in whole or in part by another.[169]

In light of the actual practices of most small wood lot owners, it would be unduly restrictive and unrealistic for the Department of the Treasury to require, in regard to timberland, that activities that constitute material participation on the part of the owner must be performed by the owner personally and not by an agent such as an independent forester. Such a requirement would eliminate a large, if not the major portion of private timberland holdings from the aegis of section 2032A and would run counter to the intent of Congress in including woodland in the statute.[170]

Since Congress expressed an intent to provide a measure of estate tax relief to owners of privately held timberland,[171] a ruling by the Department of the Treasury in effect denying such relief to a large number of such owners would be untenable. The estate planner whose client holds timberland that is under the management of a professional forester or other competent manager[172]

Cir. 1963); Foster v. Celebrezze, 313 F.2d 604 (8th Cir. 1963); Conley v. Ribicoff, 294 F.2d 190 (9th Cir. 1961). *But see* Hoffman v. Ribicoff, 305 F.2d 1 (8th Cir. 1962).

168. Treas. Reg. § 1.1402(a)-4(a)(1963).

169. Treas. Reg. § 1.1402(a)-4(b)(5) (1963) is helpful to the extent that the requirements therein suggest that the Treasury may take a two-pronged approach regarding the timberland owner's requisite material participation in the timber growing operations—that is, he must show some degree of participation in the management decisions affecting the operation, and that he physically participated to a certain extent in those operations. The degree of participation that is required in the relatively passive operation of growing trees is, however, not addressed in the I.R.C. § 1402 regulations.

170. S. REP. No. 938 (pt. 2), 94th Cong., 2d Sess. 15 (1976) states:

> The Committee believes that, when land is actually used for farming, woodlands, scenic or historic purposes (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential "highest and best use." Valuation on the basis of highest and best use rather than actual use may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, etc., activities not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes.

171. *See* text accompanying note 3 *supra*.

172. *See* notes 148 and 152 and accompanying text *supra*.

should be able to use section 2032A without fear that the irrelevant material participation notions of section 1402(a)(1) will be blindly applied in the case of woodlands. Until the Department of the Treasury indicates, however, that the different nature and needs of timber, as opposed to farm operations, will be recognized by appropriate regulations, this confidence cannot be justified.

3. Percentage Requirements.—Aside from valuation problems, the percentage tests[173] pose few practical difficulties in application. The traditional section 2031 concepts of date of death and fair market valuation are used to value the property. At least fifty percent of the adjusted value of the gross estate passing to a qualified heir must consist of the adjusted value of real and personal property used as a farm, or for some other qualified use. In addition, at least twenty-five percent of the adjusted value of the gross estate must consist of the adjusted value of qualified real property alone;[174] this real property must pass to a qualified heir and must further meet the material participation and period of use requirements of section 2032A.[175]

Although the fifty percent requirement applies to the aggregate adjusted value of real and personal property used for a qualified use and passed to a qualified heir,[176] in the case of privately held timberland, there will most often be little or no qualified personal property to be added to the real property in determining the total value of such property vis-à-vis the value of the gross estate.[177] Thus, it will normally be the real property alone that must meet both the fifty percent and twenty-five percent tests, thereby applying, in effect, the more extensive participation and period of use requirements of the twenty-five percent test to the higher value requirement of the fifty percent test. The two tests will in effect merge into one requiring (1) that fifty percent of the adjusted value of the gross estate consist of the adjusted value of the qualified property; (2) that the material participation re-

173. I.R.C. §§ 2032A(b)(1)(A), (B). *See* text accompanying notes 33-39 *supra.*

174. *See* notes 34 and 35 and accompanying text *supra.*

175. I.R.C. § 2032A(b)(1)(C).

176. *Id.* § 2032A(b)(1)(A).

177. Valuation of farms, barns, owners' and tenants' houses, tractors, and other equipment and machinery will frequently be available to increase the value of qualified real or personal property for the purposes of meeting the 50% test. Such items of realty or personalty will be infrequently used in the valuation of timberland holdings, where it is less usual for the landowner himself to own and operate the necessary equipment. On whether the timber itself might have to be classified as personal property, see note 80 and accompanying text *supra.*

quirement be satisfied; and (3) that the period of use requirement be met.

As noted, the language of the statute does not seem to require separate application of the percentage tests to each parcel of qualified real property, or even to each different qualified use to which specific parcels may be put. Thus, it is the aggregate adjusted value of all qualifying real property that will be compared against the adjusted value of the gross estate.[178] Several geographically diverse parcels of timberland might be combined with a farm and with other real property held for any other qualified use by the decedent at his death in order to obtain the required percentages.

Although the mechanics of the percentage requirements are relatively easy to understand, their application may cause problems for both the executor and the qualified heir because the availability of section 2032A depends in part upon meeting the specific requirements of the percentage tests. Meeting such requirements depends in turn upon the correct valuation of all assets in the decedent's gross estate under the principles of section 2031 and upon the correct use valuation of all qualified real and personal property under section 2032A. Because the fair market value of many of the assets of the decedent's estate[179] and the use value of all qualified real and personal property can be set by appraisal only, the corrrectness of such valuations will be in doubt until the valuations are challenged by the Internal Revenue Service and a mutual agreement or final judicial determination is reached[180] or, alternatively, until the statute of limitations has made the question moot.[181]

---

178. I.R.C. § 2032A(b)(1).

179. Assets requiring appraisals are those whose fair market value cannot be readily or mechanically determined. *See* Treas. Reg. §§ 20.2031-1 to -10.

180. Both the fair market value and the I.R.C. § 2032A use value of qualified real property may be given on the estate tax return. A subsequent audit of the return may consequently result in some assurance that the original valuations, or those agreed upon subsequent to the audit, are acceptable to the Internal Revenue Service and that the amount of the additional tax is fixed. If only the § 2032A use value is shown on the return, however, (as may be the case when the difference in value of the qualified real property is $500,000 or less) an audit may not consider fair market value of the property, leaving the value and the amount of the additional tax open to question.

181. The statute of limitations may never run if there is a disposition or cessation of use within the 15-year period following the decedent's death, and the Secretary of the Treasury is not so notified. I.R.C. § 2032A(f)(1). It is an open question whether it is the executor's or the heir's duty to notify the Secretary of the Treasury. Neither § 2032A nor the legislative history provides an answer.

Determination of the value of qualified timberland without regard to section 2032A is made in the same manner as prior to enactment of the statute.[182] The executor should obtain one or more appraisals by qualified appraisers.[183] Appraisals must also be obtained on the section 2032A use value of the timberland on the basis of the farm method[184] or multiple factor method[185] prescribed by the statute.[186] In cases where either method may be used, the executor is normally obliged to have appraisals made using each procedure in order to determine the method of use valuation most favorable to the estate. That the more precise farm method valuation will be of practical use to the executor in most cases, however, is doubtful; it is based on comparable rental values which are not available in many areas of the country since, traditionally, most privately owned timberland is not leased by the owner. While various sorts of farm rental or sharecropping arrangements are common in most areas, it is less usual for land to be leased specifically for growing timber, which requires twenty to sixty year growing periods. Where such leases exist, they are often the result of special situations that do not reflect true current commercial rental values of the land involved.

The goal of Congress in adopting the farm method of appraisal was to reduce subjectivity and controversy in farm valuation.[187] If the executor elects the multiple factor method, he will be faced with an open-ended list of traditional appraisal techniques sure to produce any result but a reduction of subjectivity and controversy. In addition to providing several options to use valuation appraisal methods that the executor and his appraiser might employ,[188] the multiple factor method muddies the waters

---

182. The legislative history makes this clear:

> Where the fair market value of real property is the subject of dispute, there are several valuation techniques which the courts tend to accept. These methods include the income-capitalization technique, the reproduction-cost minus depreciation technique, and the comparative sales technique. Courts will generally use one of these methods, or a combination of these methods, in determining fair market value.

H.R. REP. No. 1380, *supra* note 8, at 21.

183. *See generally* Kelley, *Farmland Values for Estate Tax Purposes*, 22 PRAC. LAW. no. 1 at 71-80 (1976).

184. *See* note 75 and accompanying text *supra*.

185. *See* note 76 and accompanying text *supra*.

186. I.R.C. §§ 2032A(e)(7),(8).

187. H.R. REP. No. 1380, *supra* note 8, at 21.

188. Allowable is "[a]ny other factor which fairly values the farm or closely held business value of the property." I.R.C. § 2032A(e)(8)(E).

by referring to land and property as seemingly interchangeable terms in the determination of the use value of qualified real property.[189] Furthermore, by opening the door to the use of state differential or use value assessment law as a factor for use valuation under section 2032A, the statute seems to have guaranteed, or at least sanctioned, the undesired subjectivity and controversy.[190]

B. *Premortem Planning*

1. *Opportunities and Problems.*—Section 2032A provides the practitioner with a new estate planning tool, albeit not one which he can use with certainty. Primarily because of the percentage tests[191] and valuation problems[192] implicit in the statute, the practitioner in many cases cannot be sure that election of section 2032A is actually proper in connection with the determination of the value of the client's gross estate.

Once the estate planner has determined that the client's timberland is managed or operated so that it will meet the active use and material participation tests[193] and that the land is to pass to the proper qualified heirs, he must attempt to structure the client's assets in such a way that the estate will meet the percentage tests and that section 2032A will be elected at the proper time. The estate planner will most often need to look very closely at the composition of the client's holdings in attempting to determine whether fifty percent or more of the adjusted value of the client's gross estate will consist of the adjusted value of qualifying real property at the date of the client's death.[194] At this point, the planning process becomes, at best, controlled speculation. Not only must the fair market values of all of the client's assets be determined so that it can be seen whether the percentage tests will be met, but those values must be determined as of some unknown date in the future—that is, at the date of the decedent's death. More simply stated, the estate planner must consider the most likely composition of the client's estate and what the fair market value of the estate's assets will be at the time of the client's death.

189. I.R.C. § 2032A(e)(8).

190. *E.g., compare* S.C. CODE ANN. § 12-43-220(d) (Supp. 1977) *with* FLA. STAT. § 193.011 (Harrison Cum. Supp. 1977).

191. *See* text accompanying notes 33-39 *supra.*

192. *See* text accompanying notes 63-80 *supra.*

193. *See* text accompanying note 153 *supra.*

194. I.R.C. § 2032A(b)(1).

At least one appraisal of the qualified real property and any of the client's other significant assets for which the value cannot be readily determined[195] will be necessary so that the attorney can be reasonably confident that the fifty percent test will be met.[196] The attorney must then try to determine what plans the client may have for changing the composition of his assets prior to his death as well as the likelihood that events beyond the client's control will render such changes.[197] Estimates must then be made of the expected fair market value of the assets of the client's estate at the time of the client's death. Assessment should also be made of the various factors that will affect valuation of the qualified real property under section 2032A at whatever date the client might die.[198]

The final step in preparing for the use of section 2032A in an estate plan is to assist the client in structuring his assets so that the statute will be available for use at his death. This will not always be necessary, as, for example, where qualified real property owned by the client represents significantly more than fifty percent of the value of his estimated gross estate or, possibly, where economic and other considerations demand retention by the client of his assets in their present form. In a large number of cases, however, it will be obvious that appraisals and estimates of current and future property values can provide only guidelines for planning toward the use of section 2032A and that any positive actions that might be taken to help further assure availability of the statute should be taken if feasible.

To ensure the availability of section 2032A, the client might either acquire more qualified real property, divest himself of non-qualifying property, or do both in order to meet the percentage

195. *See* note 179 and accompanying text *supra*.

196. In a situation where it seems obvious that the qualified real property will represent the great bulk of the total value of a client's estate, a premortem appraisal will not be necessary.

197. *E.g.*, inheritances, gifts, and involuntary conversions.

198. These factors include the average annual gross cash rental of comparable timberland (if available), local real property taxes and the average annual effective rate for Federal Land Bank loans. I.R.C. §§ 2032A(e)(7), (8). At this point the attorney will likely discover the need for an opinion letter to his client noting the possible estate tax benefits to be derived from use of § 2032A. This opinion letter, however, should fully explain that § 2032A's availability depends on several factual matters to be determined in the future, over which neither the attorney nor the client has control, *i.e.*, the value and nature of various assets owned by the client at the date of his death. The client should be apprised that whatever efforts and money are expended in planning for the use of § 2032A may well prove to have been spent in vain.

tests. Although acquisition of more timberland by the client before death in an attempt to boost the percentage of qualified real property in his final estate may be feasible in some cases,[199] the holding period of section 2032A(b)(1)(C) requiring an aggregate of five out of eight years of active use and material participation in connection with the property will make such a move risky in the normal situation.[200]

Divestiture of nonqualifying assets would seem to be the safer course of action, for while the client cannot be certain that the real property that he acquires before his death will qualify under section 2032A, he does know which assets will definitely not be treated as qualified real property in his final estate. Assets to be divested and the best means of so doing must be selected by the individual client with the advice of his attorney. As a general rule, however, the most logical course of action will be to make gifts of the most rapidly appeciating nonqualifying assets. This plan has the dual advantages of lower potential net estate tax and of divesting assets that, simply because they are appreciating, will represent an even larger share of the client's estate at his death than they presently represent.[201]

---

199. When the client has paid cash or has acquired a substantial equity in order to acquire additional real property, and the property becomes qualified real property in his estate for purposes of I.R.C. § 2032A, he has actually taken two steps to promote the availability of § 2032A: (1) he has raised the total value of qualifying real property, and (2) he has simultaneously lowered the value of nonqualifying assets by the amount of cash or other assets that were converted to acquire the real property. Since § 2032A(b)(3) excludes the amount of any unpaid mortgages or other indebtedness on the qualified real property from the percentage tests, whether the decedent was personally liable for such indebtedness acquisition of heavily mortgaged real property by the client will serve little or no purpose in an attempt to meet the percentage requirements.

200. For the average age of timberland owners, and for the advantages of timberland as a tax shelter device, advantages that may somewhat offset the risks inherent in the § 2032A holding period requirements, see notes 6-7 *supra.*

201. Modifying somewhat the example given in note 29 *supra,* assume the client while living has assets with an aggregate value of $1,000,000, $600,000 of which represents the fair market potential of qualifying property. One of the nonqualifying assets is appreciating at a fairly rapid rate, *e.g.,* a beach house in a developing resort area, and is worth $75,000 at the time the client decides to give it to his children. The gift of the house raises the ratio of qualifying to nonqualifying property from 60:40 ($600,000: $400,000) to approximately 65:35 ($600,000: $325,000). If it is further assumed that, when the client dies in ten years, the value of the beach house has risen to $150,000 and the total value of the client's estate and distribution between qualifying and nonqualifying property has remained the same, it can be seen that in the event the beach house had been retained by the client its appeciation would have caused the percentage of nonqualifying property to rise from 40% to approximately 44% ($600,000 qualifying and $475,000 nonqualifying).

Similarly, when the house is given to the children, the I.R.C. § 2001 rates will be applied against its $75,000 value. If it remains in the estate, those rates are applied against its appreciated value of $150,000.

Of course, before embarking upon a program of divestiture of nonqualifying assets, the client and his attorney must carefully consider the effect these gifts will have upon the basis of such assets in the hands of the donees. Until the "fresh start" basis allowed by section 1023(h)[202] has been effectively made obsolete by the passage of time,[203] property owned by the decedent on December 31, 1976, that subsequently passes through his estate will generally increase in basis. Since section 1015[204] contains no similar basis step-up provision, a predeath gift of property acquired by the decedent prior to December 31, 1976, will lose the step-up in basis provided by section 1023(h). Thus, potential estate tax savings through predeath gifts of appreciating property that will be subject to the benefits of section 1023(h) upon death of the owner may be more than counterbalanced by the tax on the gain when such property is eventually sold by the heirs.[205]

The corollary to divestiture of nonqualifying assets is the retention of potentially qualifying real property. Obviously, at least enough timberland must be retained by the client so that the percentage requirements of section 2032A will be met upon his death. Possibly, these requirements will dictate how the timberland should be managed until the client's death, for where the ratio of qualifying real property to nonqualifying property is al-

202. I.R.C. § 1023(h). This provision generally provides that to determine the amount of gain upon the eventual sale of appreciated property that has passed through an estate and was owned by the decedent on December 31, 1976, the basis of such property in the hands of the beneficiary shall be its fair market value on such date rather than the lower basis of the decedent. *Id.* For property other than marketable bonds and securities, the fair market value of the property on December 31, 1976, is set by means of a mechanical formula that assumes an even daily rate of appreciation from the date of acquisition of the property by the decedent until the date of the decedent's death. *Id.* § 1023(h)(2)(C).

203. When no more property exists with a holding period that begins before December 31, 1976, I.R.C. § 1023(h) will have no further effect.

204. I.R.C. § 1015 provides the rules for determining the basis of property acquired by gift. The basis of such property to the donee will generally be determined by the donor's basis.

205. For example, if the beach property given to the children in note 201 *supra*, was acquired by the parents for $35,000 before December 31, 1976, it will have a basis equal to $35,000, plus gift tax paid in the hands of the children after the gift. *Id.* § 1015(d). If the children sell the property when it is worth $150,000, they will realize a long-term capital gain of $115,000. If, however, the house is retained by the parent until his death and then passed to the children, it will acquire a stepped-up basis equal to its assumed value on December 31, 1976. *Id.* § 1023. If this value is $100,000, the estate will be taxed on the additional $100,000, or less, since the value of the property on the date it is given to the children may still be included in the taxable estate under I.R.C. § 2001(b)(2), but the children will realize only $50,000 of long-term capital gain upon the sale of the property.

most equal and the qualifying real property consists of heavily timbered land, cutting of such timber may lower the value of the qualifying real estate below the required fifty percent mark.[206] In this situation, the necessity of not cutting so that the percentage requirements might be met may well conflict with the program of forestry management required by the active use and material participation requirement. The timberland will have been converted, in effect, from a qualifying timber farm to purely an estate planning device.[207]

2. *Planning Alternatives.*—It may become obvious in some cases that, although the estate tax relief provisions of section 2032A will be available at the time of the client's death, post-death factors, such as probable disposition by the heirs within fifteen years, make it likely that the full tax avoidance benefit of the statute will not be realized. In such situations, it may still be advantageous to elect section 2032A treatment where possible cessation of the qualified use will most likely not take place until several years after the client's death. Until cessation takes place and recapture of the additional tax is triggered, the heirs will enjoy the interest-free use of such additional tax.[208]

Furthermore, if it is likely that the heirs will sell the qualified timberland in several parcels over a period of time while continuing to use the remaining portion of the qualified property, section 2032A may provide an extrastatutory means of paying the additional tax in installments by allowing the heirs to pay a portion of the additional tax as each parcel is sold and the qualifying use

206. Harvesting of timber will decrease the value of the qualified real property if timber is regarded as an element of real property for purposes of I.R.C. § 2032A. *See* note 98 *supra.* If it is so regarded, the retention of the qualified real property with the standing timber will be advantageous to the estate planner and his client since continued timber growth will serve to increase the value of the qualified real property and the likelihood of satisfying the percentage requirements.

207. A further reason for not harvesting the crop on qualified real property prior to the client's death is to reserve the timber as a potential source of liquidity for payment of the estate taxes.

208. The interest on any unpaid amount shall be paid from "the last date prescribed for payment." I.R.C. § 6601(a). The last date for payment of the additional tax due under I.R.C. § 2032A is "6 months after the date of the disposition or cessation" of the qualified use of the qualified real property. *Id.* § 2032A(c)(5). Because advantages may be gained in some instances through election of § 2032A even though it is known at the time of election that the real property will cease to qualify at some point within the fifteen year recapture period, if election is not made it would be wise for the practitioner to obtain from his clients a written statement that they were advised of the advantages and disadvantages of election and had purposefully failed to elect § 2032A treatment, or that they are specifically withholding the consent required by §§ 2032A(a)(1)(B), (d)(2).

of that parcel ceases.[209]

Even if it is certain that section 2032A will be available to the estate and that recapture of the additional tax during the fifteen year period is extremely unlikely, the practitioner should consider the alternative planning route offered by sections 6166 and 6166A.[210] In very general terms, these provisions allow an extended period for payment of the estate tax where the estate consists largely of an interest, or interests, in a "closely held business."[211] In certain cases, interest of only four percent of the tax due will be charged to the estate.[212] The purpose behind the statutes is to allow estates composed largely of illiquid assets time to generate enough income to pay estate taxes without resorting to a sale of such assets.[213] The provisions might be used in con-

---

209. *See id.* § 2032A(c)(2)(D). An obvious danger of selling individual parcels in order to pay the estate taxes is that the Internal Revenue Service may claim the heirs have ceased to use the qualified tract as a whole for the qualified use and have become dealers in real estate, triggering recapture of the entire additional tax due.

210. *Id.* §§ 6166, 6166A.

211. Generally, if the value of an interest in a closely held business included in the gross estate of a decedent exceeds 65% of the adjusted gross estate, the executor may elect to pay the estate tax attributable to the closely held business interest over a period of 15 years, with the first principal payment being deferred for as long as 5 years, and payable thereafter in equal annual installments over the next 10 years. I.R.C. § 6166. This section was part of the Tax Reform Act of 1976 and applies to estates of decedents dying after December 31, 1976.

If the value of an interest in a closely held business included in the gross estate of a decedent exceeds either (1) 35% of the gross estate of such decedent or (2) 50% of his taxable estate, the executor may elect to pay the estate tax attributable to the closely held business interest over a maximum period of 10 years. The first installment of principal and interest would be due on the last date prescribed for payment of the tax under I.R.C. § 6151(a). *Id.* § 6166A.

For purposes of § 6166, a closely held business includes a proprietorship carrying on a trade or business, an interest in a partnership carrying on a trade or business in which there are 15 or fewer partners or if 20% or more of the capital interest in the partnership is included in the estate, or a corporation carrying on a trade or business if it has 15 or fewer shareholders or if 20% or more of the stock in the corporation is included in the estate. *Id.* § 6166(b)(1). A similar definition of a closely held business is found in § 6166A, with the exception that 10 or fewer partners or stockholders are allowed rather than 15. *Id.* § 6166A(c).

212. Where I.R.C. § 6166 is elected, an interest rate of 4% shall be allowed on the tax attributable to the first $1 million in value of a farm or other closely held business property. *Id.* § 6601(j).

213. The House Report stated:

> The present provisions have proved inadequate to deal with the liquidity problems experienced by estates in which a substantial portion of the assets consist of a closely held business or other illiquid assets. In many cases the executor is forced to sell a decedent's interest in a farm or other closely held business in order to pay the estate tax. This may occur even when the estate qualifies for the 10-year extension provided for closely held businesses [by

junction with section 303[214] (which generally allows the redemption from the decedent's estate of stock in a closely held corporation in an amount sufficient to pay state and federal estate taxes, administration expenses, and funeral expenses) to qualify for capital gains rates rather than to be treated as a dividend to the estate.[215]

The House Committee Report on section 6166[216] specifies that if section 2032A is elected with regard to property in the estate, the use value of the property is to be taken into account for purposes of computing qualification for section 6166 application.[217] Thus, the "65 percent of the adjusted gross estate" test of section 6166(a)(1) must be met with property valued at an artificially low figure.[218] The extended time for payment benefits of section 6166 will obviously be more difficult to obtain if the estate has elected section 2032A.

What can be a close planning choice between election of section 2032A and section 6166 could become a disaster if the executor opts for section 2032A and recapture of the additional tax is subsequently triggered within ten years of the decedent's death. As the entire amount of additional tax will become due under section 2032A within six months after recapture is triggered,[219] the extension for payment allowed by section 6166 may have been lost forever.[220]

The executor faced with a situation where election of section

---

> I.R.C. § 6166A]. In these cases, it may take several years before a business can regain sufficient financial strength to generate enough cash to pay estate taxes after the loss of one of its principal owners.

H.R. REP. No. 1380, *supra* note 8, at 30.

214. I.R.C. § 303.

215. *Id.*

216. H.R. REP. No. 1380, *supra* note 8, at 32.

217.
> [T]he bill provides that the value included in these computations is to be the value as determined for purposes of the estate tax. Thus, in the case of a farm where the executor has elected special use valuation (under section 2032A), the special use valuation is to be treated as the "value" for purposes of the extended payment provision (section 6166).

Id.

218. It is reasonable to assume that the same construction will apply where I.R.C. § 2032A is elected in conjunction with I.R.C. § 6166A. *Compare* § 6166(b)(4) *with* § 6166A(a).

219. I.R.C. § 2032A(c)(5).

220. If recapture of the additional tax is triggered prior to the last date prescribed by I.R.C. § 6075(a) for filing the estate tax return, it seems likely that the election of I.R.C. § 6166 would still be available to the executor. *Id.* § 6166(d). Additionally, as the additional tax may be deemed to be a deficiency, a late election may well be available under § 6166(h). *See also* I.R.C. §§ 6166A(a), (i), 6211, 6212.

2032A for all qualifying real property would make section 6166 unavailable might attempt to "straddle" the statutes by an election of section 2032A for only so much of the qualifying real property as will meet the precentage requirements of the section. The remainder of the qualifying real property would continue to be valued, for purposes of the section 6166 sixty-five percent tests,[221] at its higher fair market value at the date of death.[222] In this manner, the combined use and fair market valuations of the two portions of qualifying real property might meet the sixty-five percent requirement, whereas a use valuation of the entire property would fail to do so.[223]

There is no provision in either section 2032A or section 6166 that prohibits a partial election of section 2032A for qualifying real property, nor can any intent to deny such an election be found in the legislative history of either statute. On the other hand, nowhere is a partial election specifically allowed. Only the bold may wish to make such an election in advance of regulatory or judicial authority for doing so. The Internal Revenue Service could conceivably determine, after the date for filing the estate tax return has expired, that the partial election is not allowed

221. *Id.* § 6166A(a)(1).

222. *I.e.*, as determined under I.R.C. § 2031.

223. Consider a gross estate valued under I.R.C. § 2031 at $200,000 and composed of qualified real property with a fair market value of $150,000 and an I.R.C. § 2032A use value of $50,000, and, of other assets with a total fair market value of $50,000. The qualified real property meets the § 2032A percentage requirements (assuming that the qualified use and material participation requirements are satisfied), because over 50% of the adjusted value of the gross estate ($100,000) consists of the adjusted value of the real property ($150,000). I.R.C. § 2032A(b)(1)(A). The property also meets the I.R.C. § 6166 65% test, before application of § 2032A, as the $150,000 fair market value of the real property exceeds 65% of the adjusted gross estate ($130,000).

Once § 2032A is elected, however, the value of the gross estate becomes $100,000 ($50,000 use value of the real property and $50,000 fair market of other assets). Sixty-five percent of $100,000, *i.e.*, $65,000, is greater than the $50,000 use value of the real property, and election of § 6166 is foreclosed.

If the executor is able to elect § 2032A for one-half of the qualified real property, and allows the other one-half to be valued at its § 2031 fair market value, both the § 2032A 50% test and the § 6166 65% requirement will be met as follows:

> The adjusted gross estate is now composed of other assets valued at $50,000, one-half of the qualified real property valued at its use value (½ x $50,000 = $25,000), and one-half of the qualified real property valued at fair market value (½ x $150,000 = $75,000), for a total value of $150,000. The combined value of the real property, $100,000, is greater than 50% of the value of the adjusted gross estate ($75,000), so the § 2032A percentage tests are met. Likewise, the $100,000 value of the real property is greater than 65% of the adjusted gross estate (.65 x $150,000 = $87,500), so the § 6166 65% requirement is met.

under section 2032A. At that point, it may be too late to elect section 6166 for the additional tax then due.[224]

If it appears to the practitioner that postdeath factors will make election of section 2032A of little or no benefit to the client's estate, more traditional means of estate planning regarding the client's timberland may be considered. Examples include sale to the heirs of the remainder interest in the property, as well as others devices not within the scope of this article.[225]

One final aspect of the use of section 2032A in estate planning hardly needs to be mentioned to the practicing attorney: the importance of a will. Many of the problems connected with election of the statute and considered above can be alleviated or avoided entirely through proper use of testamentary dispositions. If the client has determined, for example, that only one of his several children is likely to retain and manage the client's qualified timberland and has decided that he desires to leave the timberland to that child, a specific devise of the qualified timberland to that child will avoid the necessity for the surviving spouse and the other children to consent to the application of section 2032A. A testamentary disposition will further avoid putting the devisee child through the process of buying up the interests of the spouse and other children in order to make full use of tax avoidance benefits of the statute.

224. *See* I.R.C. § 6166(d) and note 220 *supra.* One possibility is for the executor to apply to the Internal Revenue Service for a ruling on whether a partial election is available to the estate in the situation described. Should the Service take the position that the election is not available and, therefore, issue an unfavorable ruling, however, the executor is faced with the choice of abandoning the attempt to make the election or of making it with almost certain knowledge that he is steering the estate into litigation over the issue. An additional question which arises upon the election of I.R.C. § 2032A treatment for less than all of the qualified real property concerns the portions of such property to be covered by liens. I.R.C. § 6324B. If election of § 2032A is validly made on one or more tracts of qualifying real property, the lien would only be on those tracts given § 2032A treatment. When election is made on a portion of any single tract of qualifying real property, however, it appears that the lien would have to apply to the entire tract, even though the full amount of estate tax attributable to a portion of that tract shall have been paid. Perhaps if the Internal Revenue Service will agree to election of § 2032A on a portion of a single tract, it will also agree to allow the executor and heirs to have the tract divided by a recorded survey so that the portion which is to be covered by the lien might be split off from the remainder of the tract. The portion of the tract not covered by the lien could then be used or disposed of as the heirs might see fit, without triggering recapture as to the "secured" portion.

225. *See, e.g.,* I.R.C. §§ 170(f)(3), 2522(c)(2) (regarding charitable contributions by the transfer for conservation purposes of partial interests in property).

C. *Postmortem Planning*

While the executor and estate planner face many of the same problems and considerations connected with the use of section 2032A, the executor of an estate containing qualified timberland has one advantage over the premortem estate planner in that death has made certain those factors which before could only be estimated. Fair market value of the decedent's assets at the date of death are now subject to appraisal rather than speculation.

While the premortem estate planner will concern himself with how he might make section 2032A available to the executor, the executor must determine first whether the timberland in the estate fulfills the requirements of that section and, if so, whether election of the section will be advantageous to the estate. As to the latter determination, the executor faces many of the same problems faced in predeath planning; for example, possible adverse economic effects on the surviving spouse, likelihood that the qualified use will continue for a reasonable length of time and the like. Again, however, the certainties resulting from death make the executor's job somewhat less difficult than that of the estate planner in that the actual amount of the additional tax that may become due can be determined with reasonable accuracy[226] and can be weighed against possible disadvantages arising from use of the statute.

Facing the executor, however, are some new problems that do not directly confront the estate planner. One such problem is the question of whether it is necessary to file an estate tax return where the value of the gross estate, after election and application of section 2032A, equals $175,000 or less.[227] Section 2032A specifies that the use value of qualified real property shall be its value for purposes of chapter 11.[228] If election of section 2032A reduces the value of the gross estate for the purposes of chapter 11 from a figure higher than $175,000 to $175,000 or below, it is the lower

226. All determinations of the use and fair market values and the amount of the additional tax due are subject to later challenge by the Internal Revenue Service and to deficiency claims. I.R.C. §§ 6211-6216. For a proposal that would require the Secretary of the Treasury to furnish the qualified heir a statement of the maximum additional tax due, see note 43 *supra*.

227. I.R.C. § 6018(a)(1) requires that, in all cases where the gross estate exceeds $175,000, the executor shall file an estate tax return. This $175,000 threshold is phased in over a five-year period beginning with $120,000 in 1977 and reaching $175,000 after 1980. I.R.C. § 6018(a)(3). *See generally id.* §§ 6018(a)(4), 2010(c).

228. *Id.* § 2032A(a)(1).

figure that is the value of the gross estate as adopted for federal estate tax purposes. Thus, it seems that no return would be required under section 6018.[229] Until the answer has been authoritatively stated, however, and in all cases where the value of the gross estate, determined with or without regard to section 2032A, is in the neighborhood of $175,000, the executor would be well advised to file both the estate tax return and the necessary heir's agreement.[230]

IV. CONCLUSION

The ability to avoid a significant amount of federal estate taxes through the special use valuation provisions of section 2032A may constitute a substantial benefit for estates to which application of the statute is available. The difficulties in applying the statutory language to traditional private timber growing operations, and the lack of clues of the intent of Congress on application, leave the attorney considering its use in an estate containing timberland uncertain about both its availability and its potential consequences.

At this point, it is certain that some degree of active conduct of the timber growing operation will be required, as will some degree of material participation by the owner or his agent in the operation. Management of the timberland under the provisions of a comprehensive long-range forestry management plan is likely to be an important factor in qualification of the property. If the material participation requirements of section 2032A are extended much beyond the necessity of following a comprehensive

229. For example, the gross estate of a decedent dying in 1981, the estate having a total fair market value of $300,000, might include qualified real property with a fair market value of $250,000 and an I.R.C. § 2032A use value which is determined to be $124,000. If § 2032A is elected, the value of the gross estate is $174,000 less $124,000 use value of § 2032A property and $50,000 fair market value of all other assets. Under a literal construction, I.R.C. § 6018(a)(1) does not require filing in this case. The chief problem in this situation, of course, is that the valuation of any of the assets in the estate might be challenged at a later date. If the assets are found to have been undervalued by only $1001, the value of the gross estate will have exceeded $175,000. Thus, a return is required to be filed under § 6018; in addition, interest and penalties may now be due. *Id.* §§ 6601, 6651.

230. A further problem confronting the executor concerns the extent of his responsibility in monitoring the heir's material participation in the property for eight years after the decedent's death, as well as the responsibility of continuing the qualified use for fifteen years after the date of the decedent's death. *Id.* §§ 2032A(c)(7)(B), (C)(1). Unless the regulations specify that this responsibility shall rest with the heirs, who may be required to consent thereto by the agreement, *id.* § 2032A(d)(2), the executor's reliance upon the discharge provisions of I.R.C. § 2204 may be unjustified.

management plan, however, the statute will become largely irrelevant to the passive type of management traditionally involved in private timber growing operations.[231]

Other uncertainties permeate the statute's application to timberland. Three involve the characterization of the timber. First is the question of whether standing timber will be regarded as an integral element of qualified real property. Second is the possibility that timber may be characterized as real property for the lien and recapture provisions and as personalty for the valuation and percentage requirements. Last is the possibility that timber will be treated as an altogether separate estate asset to which section 2032A is not applicable.

Unless and until the fundamental differences between the traditional type of farming operation and private timber growing operations are officially recognized by statutory amendment or by Treasury Regulations, section 2032A may well prove to be of very limited benefit to the large number of private timberland owners. If such amendments or regulations are not forthcoming, the uncertainties and dangers of applying the statute to the typical private timber growing operation may so discourage estate planners and executors from its use that private timberland owners will be effectively denied the estate tax relief that Congress apparently intended for them.

231. It is hoped that while drafting regulations for promulgation under I.R.C. § 2032A, the Department of Treasury will keep in mind that "only God can make a tree" and that, in spite of the dictates of Congress, man's participation in the process is not likely to be truly material.

AUTHOR'S NOTE: Proposed regulation § 20.2032A-3, entitled "Material participation requirements for valuation of certain farm and closely-held business real property" was promulgated shortly after this article went to press. The proposed regulations confirm fears that the Treasury Department might fail to distinguish between the relatively passive type of operation involved in timber farming and traditional crop farming.

As proposed, § 20.2032A-3(b) specifies that "[a]ll specially valued property must be used in a trade or business," and that the term "trade or business" is to be construed more narrowly than under § 162; it is not to encompass "management of investment assets." Because the taxpayer's treatment of timber as a capital asset may be deemed by the IRS to be an admission that no active trade or business is being conducted on the qualified property, the private timber grower may be forced to report income from his timber operations under § 631(a) or (b), which allows capital gains treatment to one in the business of growing or selling timber if he wishes to take advantage of § 2032A.

The prime factors required under § 20.2032A-3 for material participation are "physical work and participation in management decisions." If participation by the owner or a family member is less than full-time, an arrangement "formalized in some manner capable of proof" on production or management of production must be entered into with any nonfamily member using the property. The activities of an agent of the owner are not

taken into account. The proposed regulations leave open the possibility that an agreement between the owner and a professional forester or other timber manager might meet the material participation requirements if it provides that the owner or a family member must regularly consult with the manager on the operation of the business, that he regularly inspect production activities, and that he be financially responsible for a substantial proportion of the expense involved in the business. The owner must perform all of these acts to qualify. For a particularly helpful example, see § 20.2032A-3(f), example 4.