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CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR JAMES W. CLARK  
DISTRICT COUNSEL CC:WR:PNW:SEA

FROM: DEBORAH A. BUTLER  
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)  
CC:DOM:FS

SUBJECT: Special Use Valuation Election

This Field Service Advice responds to your memorandum dated December 23, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

D	=
H	=
P	=
p	=
q	=
r	=
s	=
t	=
u	=
v	= \$
w	= \$
x	= \$
y	= \$
Year 1	=

Year 36	=
Year 41	=
Year 45	=
Year 46	=

### ISSUES:

1. Whether the estate is entitled to special use valuation under I.R.C. § 2032A with respect to the decedent's timberland and timber.
2. In determining the special use value of timber under I.R.C. § 2032A(e)(8), whether the recapture provision set forth in I.R.C. § 2032A(c) can be considered.

### CONCLUSION:

1. The estate is entitled to special use valuation with respect to the decedent's timberland and timber.
2. In determining the special use value of timber, the recapture provision cannot be considered.

### FACTS:

In Year 1, H obtained a p acre timberland parcel which was covered primarily with q-year old Douglas-fir. H maintained the property as timberland by removing downed trees and broken limbs, purchasing at least r Douglas-fir seedlings and planting them on the property to reforest an area of approximately s acres, periodically planting other seedlings, performing thinning operations as needed, making daily inspections to guard against diseased trees and timber theft, cleaning up debris to guard against fire and create better growing conditions and paying all property taxes. H periodically explored the feasibility of logging the property, but concluded that harvesting was not sufficiently profitable.

On December 28, Year 36, H died, and D, H's wife, became the sole owner of the parcel. Subsequent to H's death, D continued to maintain the property as timberland. She regularly inspected the property for timber theft and disease and arranged a network of neighbors to guard against timber theft.

In Year 41, the county condemned a part of the parcel to provide a road right-of-way. D harvested t logs containing about u board feet, which sold for \$v, from the portion of the parcel which was condemned. With the exception of a small harvest

resulting from a timber trespass by an adjoining landowner, no other commercial harvesting occurred during Year 1 to Year 45.

On March 2, Year 45, D died. At the time of D's death, the timber was mature and suitable for harvest. On November 29, Year 45, a Form 706, United States Estate (and Generation-Skipping Transfer Tax) Return was filed. The Form 706 included the p acre timberland parcel valued at \$w. A section 2032A protective election for special use valuation was made.

On November 26, Year 46, an amended Form 706 was filed electing the special use valuation under section 2032A for the p acre timberland parcel and the qualified woodlands election under section 2032A(e)(13) for the timber. Using the valuation method set forth in section 2032A(e)(8), the timber was valued at \$x, resulting in an overpayment of estate tax in the amount of \$y. In determining the value of the timber, the appraiser estimated yearly income from the annual timber growth on the property and estimated the harvest of the timber in a single year. In both of the forecasting models, the appraiser estimated no income for the first ten years following the decedent's death.

## LAW AND ANALYSIS

### Qualified Use of Property

The value of the gross estate includes the value of all property, to the extent of the decedent's interest, at the time of decedent's death. I.R.C. § 2031(a). In general, the value of property is included in the gross estate at its fair market value based on its highest and best use as of the date of the decedent's death. I.R.C. § 2031; Treas. Reg. § 20.2031-1(b).

In order to alleviate liquidity problems faced by the surviving family of a person who dies owning real property used as a farm or in a closely held business, Congress added section 2032A. Tax Reform Act 1976, Pub. L. No. 94-455, § 2003(a), 90 Stat. 1520, 1856 (1976). This statute provides that, to the extent real property is used in farming operations or other closely held businesses, rather than including the real property at its fair market value, it is included at its current use value as a farm or in the closely held business. I.R.C. § 2032A(e)(7), (8); Estate of Johnson v. Commissioner, 89 T.C. 127, 129 (1987).

For property to be eligible for special use valuation, the estate must meet a number of conditions. The decedent must have been a citizen or resident of the United States (I.R.C. § 2032A(a)(1)(A)), and the property must be located in the United States (I.R.C. § 2032A(b)(1)). Fifty percent or more of the adjusted value of the

gross estate must consist of the adjusted value of real or personal property which, on the date of decedent's death, was being used for a qualified use by the decedent or a member of his family and was acquired from or passed from the decedent to a qualified heir. I.R.C. § 2032A(b)(1)(A). Twenty-five percent or more of the adjusted value of the gross estate must consist of the adjusted value of real property which passes to a qualified heir. I.R.C. § 2032A(b)(1)(B). During a period aggregating five years or more during the eight year period ending on decedent's date of death, the property must have been owned by the decedent or member of the decedent's family, used for a qualified use and the decedent or a member of decedent's family must have materially participated in the operation. I.R.C. § 2032A(b)(1)(C).

If the property meets the above requirements and the executor intends to use the special use valuation, the executor must elect special use valuation on the Federal estate tax return in the manner set forth in the regulations. The executor must also file an agreement consenting to the application of section 2032A(c) (tax treatment of dispositions and failures to use for qualified use). I.R.C. §§ 2032A(a)(1)(B), (d)(1) and (d)(2); Treas. Reg. § 20.2032A-8.

Based on the information provided, the parties agree that all the above requirements have been satisfied with the exception of whether the parcel was, on the date of decedent's death, being used for a qualified use by the decedent or a member of her family. "Qualified use" includes the devotion of the property to use as a farm for farming purposes. I.R.C. § 2032A(b)(2)(A). The term "farm" includes woodlands and the term "farming purposes" includes planting, cultivating, caring for, or cutting of trees or the preparation (other than milling) of trees for market. I.R.C. §§ 2032A(e)(4), (5)(C).

Where a taxpayer controls and supervises the acreage by paying the local property taxes each year; inspecting the timberland several times each year; regularly contacting adjoining landowners to ascertain what needs to be done to protect the timber from trespassers, fire, insects, and disease; and deciding from time to time whether the investment should remain in the acreage, the taxpayer is conducting an active farm business which consists primarily of planting, cultivating, growing, and caring for timber. Estate of Sherrod v. Commissioner, 82 T.C. 523, 532-36 (1984), rev'd on other grounds, 774 F.2d 1057 (11<sup>th</sup> Cir. 1985). The fact that conducting the business does not consume a great deal of time does not alter the conclusion that the taxpayer is conducting an active farm business. Estate of Sherrod, 82 T.C. at 536.

In contrast, where a parcel is designated under state law as forest cropland, and the state provided a forest management schedule which established a minimum

plan for implementing sound forestry, but neither decedent nor a member of his family planted, cultivated, cut, or cared for trees, or prepared trees for market, the taxpayer is not conducting an active farm business. Estate of Holmes v. Commissioner, T.C. Memo. 1991-477, aff'd, 978 F.2d 1261 (7<sup>th</sup> Cir. 1992).

Under the given facts, H maintained the property as timberland by removing downed trees and broken limbs, purchasing seedlings and planting them on the property, periodically planting other seedlings, performing thinning operations as needed, making daily inspections to guard against diseased trees and timber theft, cleaning up debris to guard against fire and create better growing conditions and paying all property taxes. H periodically explored the feasibility of logging the property, but concluded that harvest was not sufficiently profitable. Upon H's death, D continued to maintain the property as timberland. She regularly inspected the property for timber theft and disease and arranged a network of neighbors to guard against timber theft.

Based on their activities, H and D had the acreage under their exclusive control and made every management decision with respect to the property during the entire period. Furthermore, there is no indication that the activities performed by D and H were not consistent with the principles of good land management as recommended to, and practiced by, the owners of other property of similar nature, size, and location, or recommended by state and federal forestry agencies. See Estate of Sherrod, 82 T.C. at 534. Nor is there an indication that the state set forth requirements with respect to timber operations with which D or H failed to comply. Based on this, it is our opinion that the parcel was used for planting, cultivating, caring for, or cutting of trees or the preparation of trees for market; that the parcel was used for a qualified use; and, accordingly, that special use valuation may be utilized.

#### Qualified Woodlands Election

For qualified woodlands, an executor may elect to have trees growing on woodlands not treated as a crop. I.R.C. § 2032A(e)(13)(A). "Qualified woodland" is any real property which-

- (i) is used in timber operations, and
- (ii) is an identifiable area of land such as an acre or other area for which records are normally maintained in conducting timber operations.

I.R.C. § 2032A(e)(13)(B). "Timber operations" include:

- (i) the planting, cultivating, caring for, or cutting of trees, or
- (ii) the preparation (other than milling) of trees for market.

I.R.C. § 2032A(e)(13)(C). Based on our conclusion above that the p acre parcel was used for planting, cultivating, caring for, or cutting of trees or the preparation of trees for market, it is our opinion that the executor was entitled to elect to have the trees growing on the parcel not treated as a crop.

### Valuation of Timber

Section 2032A provides that, to the extent real property is used in farming operations, rather than including the real property at its fair market value, it is included at its current use value as a farm. I.R.C. § 2032A(e)(7), (8); Estate of Johnson v. Commissioner, 89 T.C. 127, 129 (1987). The method of valuation under section 2032A is an integral part of the statutory scheme. Estate of Thompson v. Comm'r, T.C. Memo. 1998-325; Estate of Sequeira v. Comm'r, T.C. Memo. 1995-450. Where there is no comparable land from which the average annual gross cash rental may be determined or where the executor makes an election, the value of the farm may be determined under section 2032A(e)(8). I.R.C. § 2032A(e)(7)(C). Based on the information provided, there is no comparable land from which the average annual gross cash rental may be determined and the executor elected to value the property under section 2032A(e)(8). Section 2032A(e)(8) provides that the following factors applying in determining the value of any qualified real property:

- (A) The capitalization of income which the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and similar factors,
- (B) The capitalization of the fair rental value of the land for farmland or closely held business purposes,
- (C) Assessed land values in a State which provides a differential or use value assessment law for farmland or closely held business,
- (D) Comparable sales of other farm or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price, and

(E) Any other factor which fairly values the farm or closely held business value of the property.

I.R.C. § 2032A(e)(8). An executor may not select one of the five factors set forth above as the exclusive basis for the farm valuation, but must utilize all of the factors and accord appropriate weight to each factor. Rev. Rul. 89-30, 1989-1 C.B. 274. Because there are various recognized methods of harvesting trees when managing a timber operation, ranging from selective cutting to clear cutting, the history of the timber operations with respect to the subject property must be considered in order to determine the weight to be placed on each of the various factors.

In determining the value of the timber, the appraiser estimated yearly income from the annual timber growth on the property and estimated the harvest of the timber in a single year. In both of the forecasting models, however, the appraiser estimated no income for the first ten years following the decedent's death based on the recapture provision set forth in section 2032A(c).

If within ten years after the decedent's date of death and before the death of the qualified heir, the heir disposes of any interest in qualified real property or the qualified heir ceases to use for the qualified use the qualified real property which was acquired from the decedent, then a recapture tax is imposed. I.R.C. § 2032A(c). With respect to qualified woodland to which an election under section 2032A(e)(13) is made, if the qualified heir disposes of, or severs, any standing timber on the qualified woodland, the disposition or severance is treated as a disposition of a portion of the interest of the qualified heir in the property and the amount of recapture tax is determined according to section 2032A(c)(2)(E)(ii). I.R.C. § 2032A(c)(2)(E).

In valuing property, an encumbrance on the property will be taken into account. Conversely, where there is no encumbrance at the time of transfer, there is no reduction in value. Ripley v. Commissioner, 105 T.C. 358, 367-68 (1995), rev'd on other grounds, 103 F.3d 332 (4<sup>th</sup> Cir. 1996) (in determining the value of a gift, the fair market value of the gift is not reduced by the amount of the gift tax liability). In this case, there was no encumbrance on the timber at the time it was transferred from the decedent to the beneficiaries. Rather, the liability for recapture of the tax under section 2032A(c)(2)(E) will not arise unless a beneficiary disposes of an interest in timber. Accordingly, there is no basis for reducing the value of the timber based on the potential application of the recapture provision.

Furthermore, the purpose of special use valuation is to alleviate liquidity problems faced by the surviving family of a person who dies owning real property used as a

farm. H. Rept. 94-1380 at 21-22 (1976), 1976-3 C.B. (Vol. 3) 735, 755-56; S. Rept. 94-938 (Part 2), at 15 (1976), 1976-3 C.B. (Vol. 3) 643, 657. It is intended to allow the family to continue operating the farm or other business, rather than the family being forced to sell the land to pay estate taxes. H. Rept. 94-1380, supra, 1976-3 C.B. (Vol. 3) at 755-56; S. Rept. 94-938 (Part 2), supra, 1976-3 C.B. (Vol. 3) at 657; Stovall v. Commissioner, 101 T.C. 140, 146-47 (1993). The provision was not intended to allow an estate to escape taxation by making the election and having the beneficiaries discontinuing farming operations for the length of the recapture period. To the contrary, under the special use valuation provisions, the farm was intended to be a continuing operation. The value should reflect this fact. Accordingly, the value of the timber cannot be discounted based on discontinued operations during the time the recapture tax is potentially applicable.

To determine the correct value of the timber based on the factors set forth in section 2032A(e)(8), it is our recommendation that you obtain an appraisal. Because the timber is ready for harvest, it is likely that application of section 2032A(e)(8) will result in a value that closely approximates the fair market value of the timber. Such a value would be consistent with the timber being utilized as part of a continuing timber operation.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Your memorandum adopts the position that section 2032A(e)(13)(B)(ii) imposes an additional or higher recordkeeping requirement than that necessary to establish a timber operation. "Qualified woodland" is any real property which-

- (i) is used in timber operations, and
- (ii) is an identifiable area of land such as an acre or other area for which records are normally maintained in conducting timber operations.

I.R.C. § 2032A(e)(13)(B). It is our opinion that the records referred to in section 2032A(e)(13)(B)(ii) are those related to the identification of land on which timber operations are conducted. [REDACTED]

[REDACTED] such a position arguably would be inconsistent with the legislative history of section 2032A(e)(13), discussing partial dispositions. The House Conference Report states:

For purposes of these rules on partial dispositions, an identifiable portion of land is defined as an acre or such other area of land by which the taxpayer normally maintains his business records.

H. Rept. No. 201, 97<sup>th</sup> Cong., 1<sup>st</sup> Sess. at 175 (1981). See also Joint Committee on Taxation Staff, General Explanation of the Economic Recovery Act of 1981, 97<sup>TH</sup> Cong. at 249 (1981). This language supports the position that the records referenced in the statute are those by which an identifiable portion of land is determined.

Your memorandum adopts the position that a taxpayer making an election under section 2032A(e)(13) must establish that he is in a trade or business through the use of accounting records, tax records, and timber operation records. Under section 2032A, to establish that the p acres are used for a qualified use, the executor must be establish that the property is devoted to use as woodlands for purposes of planting, cultivating, caring for, or cutting of trees or the preparation (other than milling) of trees for market. I.R.C. §§ 2032A(e)(4), (5)(C). Records are required only to the extent necessary to establish that the property is used for such a qualified use. 

Please call if you have any further questions.

By: \_\_\_\_\_  
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