Consequences of a Lower Basis for Special Use Valuation Property

Neil E. Harl
Iowa State University

Follow this and additional works at: http://lib.dr.iastate.edu/aglawdigest

Part of the Agricultural and Resource Economics Commons, Agricultural Economics Commons, Agriculture Law Commons, and the Public Economics Commons

Recommended Citation
Available at: http://lib.dr.iastate.edu/aglawdigest/vol24/iss22/1

This Article is brought to you for free and open access by the Journals at Iowa State University Digital Repository. It has been accepted for inclusion in Agricultural Law Digest by an authorized editor of Iowa State University Digital Repository. For more information, please contact digirep@iastate.edu.
The lower income tax basis from electing special use valuation has always been an important consideration in whether the election to use or not to use special use valuation should be made but a recent Tax Court case has emphasized just how important -- for a potentially lengthy time period -- that election can be with a resultant low income tax basis. That factor can affect financial decisions for decades and decades to come.

The consequences of the election on basis

Special use valuation was enacted to provide a modicum of estate tax relief for owners of farmland with the provisions limited to those who, either personally or through a family member, are and continue to be involved in the farming operation. However, one decidedly negative feature of special use valuation, although arguably justified, is the lower income tax basis for the real property subject to the special use valuation election with the income tax basis established by the special use value.

Thus, if real property is purchased (or otherwise acquired) by a qualified heir from the estate (or trust) the qualified heir’s income tax basis is the special use value established in the estate or trust, increased by the amount of any post-death gain recognized by the estate or trust. The estate does not recognize gain on the sale for income tax purposes except to the extent the fair market value on sale exceeds the fair market value of the property on the date of the decedent’s death.

Example 1: Assume land held by the decedent at death has a fair market value of $8,000 per acre. Special use valuation (which provides the income tax basis) is $4500 per acre. A qualified heir purchases the land from the estate when the fair market value on sale was also $8000 per acre. The estate would have no gain but the purchaser’s income tax basis would be $4500 per acre, not the fair market value of $8,000. This is the only instance, in all of tax law, where the purchase price does not establish the income tax basis.

Example 2: If, in the above example, the estate is settled with the real estate distributed to all of the heirs and then one purchases the interests of the other heirs, the selling heirs would have gain to report for income tax purposes, based on the $4500 figure, and the heir who ultimately purchases the interests of the other heirs would have a basis for the purchased portion (but not the inherited portion) equal to the purchase price.

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.
Later impact of the low basis

In a 2013 Tax Court case,\textsuperscript{7} years after the death in which special use valuation was elected, the trust holding the special use valued land entered into an agreement to impose a conservation easement on the real property for which the trust received $900,000.\textsuperscript{8} The $900,000 payment for the conservation easement passed through to the beneficiaries to be reported on their income tax return.\textsuperscript{9} The beneficiaries did not report their shares of the gain for income tax purposes. On audit, IRS took the position that the original special use valuation, rather than the fair market value at death, fixed the income tax basis and assessed capital gains tax on the beneficiaries. The beneficiaries, shocked by that development, hired an appraiser to determine the fair market value at death which was, as would be expected substantially higher than the special use value.

The Tax Court properly, in our view, held that the special use valuation was the proper determinant of the income tax basis for purposes of the taxation of the conservation easement payments for all beneficiaries, including for one beneficiary who was a minor. The court stated that the signature of the guardian \textit{ad litem} was sufficient to establish the necessary representation on the special use valuation election. In that regard the Tax Court applied the doctrine of consistency which prevented the beneficiaries from changing their positions which were clearly established in the special use evaluation election and the agreement of personal liability and the statute of limitations for assessment of estate tax had expired.\textsuperscript{10}

The Tax Court upheld the imposition of a 20 percent accuracy-related penalty on the beneficiaries.

Message of the decision

The decision in \textit{Van Alen v. Commissioner}\textsuperscript{11} seems to make it clear that the special use value establishes the income tax basis for the qualified heirs as well as all of the successors who derive their income tax basis from the qualified heirs. That would appear to include donees,\textsuperscript{12} transfers to trust where no gain or loss is recognized,\textsuperscript{13} parties to like-kind exchanges,\textsuperscript{14} tax-free exchanges to a corporation\textsuperscript{15} tax-free exchanges to a partnership\textsuperscript{16} and determinations of basis for items of income in respect of decedent such as where sale or exchange occurred before death as with an installment sale.\textsuperscript{17} Likewise, it appears to include the handling of basis adjustments in discharge of indebtedness for solvent farm debtors\textsuperscript{18} and reduction of basis for easements of 30 or more years to run (which was not mentioned in \textit{Van Alen v. Commissioner}\textsuperscript{19}) even though the case involved income derived from a conservation easement.\textsuperscript{20} Income tax basis derived from a special use valuation election is eliminated or changed only by death or a sale or exchange in which gain or loss is recognized.

Those who obtain real property under circumstances in which there was no gain or loss recognized, which was earlier subjected to a special use valuation election, should be duly advised of the income tax basis of the real property which previously qualified for a special use valuation election if the basis so established continues to be the current basis.

\textbf{ENDNOTES}


4 I.R.C. § 1014(a)(3).

5 I.R.C. § 1040(c).

6 I.R.C. § 1040(a), (b).


8 \textit{Id}.

9 \textit{Id}.

10 \textit{Id}.

11 T.C. Memo. 2013-235.

12 I.R.C. § 1015(a).

13 I.R.C. § 1015(b).

14 I.R.C. § 1031(d).

15 I.R.C. § 351(a).

16 I.R.C. § 721(a).

17 I.R.C. § 691.

18 I.R.C. § 108(g).


20 I.R.C. § 170(h)(1). See, \textit{e.g.}, \textit{Glass v. Comm’r}, 471 F.3d 698 (6th Cir. 2006). See also Rev. Rul. 68-291, 1968-1 C.B. 212 (for permanent easements (30-years or more to run) payments are first treated as a return of basis with remaining gain qualifying as long-term capital gain if the land has been held for more than one year).