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Michigan Court Addresses CAFO Permitting Requirements

-by Terrence Centner*

In 2005, the Sierra Club Mackinac Chapter sought a declaratory ruling from the Michigan Department of Environmental Quality (MDEQ) about three aspects of the department's permitting provisions for concentrated animal feeding operations (CAFOs).[1] Dissatisfied with the agency's ruling, the Sierra Club appealed. In *Sierra Club Mackinac Chapter v. Department of Environmental Quality*, the Michigan Court of Appeals concluded that Michigan's CAFO permit program does not satisfy the requirements of the Clean Water Act.[2] Two failings were noted. First, the permit program did not require inclusion of the required minimum effluent limitations in the general permit. Second, the Michigan program did not provide for the requisite public participation.

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2008 Economic Stimulus Act

-by Philip E. Harris*

President Bush signed the 2008 Economic Stimulus Act (Act) on February 13, 2008. It includes two provisions designed to stimulate the economy. One provision is a rebate check that will be sent to qualifying taxpayers beginning in May 2008. Congress hopes that taxpayers will spend these rebate checks and thereby simulate the economy. The other provision is an increase in the deduction taxpayers can claim for property placed in service in a trade or business in 2008. Congress hopes this provision will encourage businesses to increase the amount they invest in income producing assets.

Rebate check

The rebate is actually an advance payment of a refundable credit taxpayers can claim on their 2008 income tax returns. The IRS will send rebate checks beginning in May 2008 using information from taxpayers' 2007 returns to estimate the refundable credit to which taxpayers are entitled on their 2008 returns. When the 2008 returns are filed, taxpayers will calculate their credit based on their 2008 income. If the credit based on 2008 income is less than the rebate based on 2007 income, the excess does not have to be paid back to the Department of the Treasury.

While most taxpayers are eligible for the rebate and credit, there are requirements based

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Call For Nominations for AALA Board of Directors

The AALA nomination committee is seeking recommendations from the membership for AALA members to serve on the 2009-2011 Board of Directors and for President-elect for 2009. Please send your suggestions by May 16, 2008 to Steve Halbrook: e-mail: steve@farmfoundation.org or phone (630) 571-9393.

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While the issues of *Sierra Club* involved Michigan's CAFO permitting provisions, its evaluation of federal permitting requirements provides a noteworthy extension of the findings of the Second Circuit's decision in *Waterkeeper Alliance, Inc. v. Environmental Protection Agency*.[3] The *Sierra Club* ruling enunciates the requirement that a permit's effluent limitations necessarily include the information set forth in nutrient management plans. Moreover, public participation necessarily requires an opportunity to be heard on the merits of a nutrient management plan during the permitting process. The court's conclusion that the general permitting provisions of the Michigan regulations fail to meet federal requirements suggests that other state general permitting regulations may suffer a similar fate.

Michigan's NPDES program is substantially equivalent to the federal program.[4] The MDEQ is responsible for issuing NPDES permits, and federal NPDES permits are suspended.[5] CAFO owners and operations in Michigan apply for an individualized state permit or a certificate of coverage (similar to a notice of intent) under a general permit.[6] A general permit means "a national permit issued authorizing a category of similar discharges."[7] General permits are authorized under the federal CAFO regulations, and provisions in Michigan's regulations allowed them to be used by animal feeding operations needing a permit. With the new federal CAFO Rule in place in 2003, the MDEQ proceeded to develop a new general permit for Michigan's CAFOs.[8]

The Michigan court was aware of the Second Circuit's findings in *Waterkeeper*, but needed to interpret the Michigan provisions to discern whether they satisfied the requirements of the Clean Water Act. The courts noted that the Act requires that permitted CAFO dischargers must adopt best management practices and procedures to implement applicable effluent limitations and standards.[9] For the land application of manure, this requires a nutrient management plan that minimizes nutrient movement to surface waters.

Following the EPA's losing stance in *Waterkeeper*, the MDEQ argued that a comprehensive management plan was not an effluent limitation and was not required to be submitted as part of an NPDES permit application.[10] The MDEQ adopted a semantics argument, claiming that its comprehensive nutrient management plan was not an effluent limitation but rather was "a management plan utilized by CAFOs to meet the effluent limitations."[11] Michigan's NPDES program delineated water quality standards in its general permits to prevent injurious discharges and assure compliance with federal water quality standards. A comprehensive nutrient management plan was simply a plan for use in meeting the set of minimum standards in the general permit.[12] Because nutrient management plans did not establish effluent limitations, the MDEQ argued that the plans were not part of a permit and the public information requirements of the Clean Water Act did not apply.[13]

The Michigan Court of Appeals deferred to the reasoning of the *Waterkeeper* decision. The Clean Water Act precludes the discharge of pollutants into navigable waters from point sources.[14] Because CAFOs are within the definition of a point source,[15] those with a discharge need an NPDES or similar state permit. Michigan's general permit required permittees to implement particulars concerning nutrient management, but certificates of coverage were issued without review of any nutrient management particulars.[16] In the absence of agency oversight, a self-regulatory permitting system governed discharges.[17] The MDEQ's authorization of discharges without reviewing a discharger's effluent limitations supported the conclusion that the Michigan CAFO regulations were inadequate under federal law.[18]

Under the Clean Water Act, an effluent limitation is defined as "any restriction established by a State or the Administrator on quantities, rates, and concentrations of chemical, physical, biological, and other constituents which are discharged from point sources into navigable waters."[19] Effluent limitations must be based on the application of the best practicable control technology currently available.[20] Without effluent limitations, a certificate of coverage under Michigan's general permit failed to establish pollutant levels. Thus, the program did not comply with the Clean Water Act.[21]

The *Sierra Club* court opined that the federal regulations intended that permitted discharges required oversight of effluent limitations.[22] Following *Waterkeeper and Environmental Defense Center v. EPA*, *Sierra Club* concluded that the MDEQ needed to conduct a meaningful review of each nutrient management plan prior to authorizing discharges.[23] Section 402(b) of the Clean Water Act required permitting agencies to apply effluent limitations that assure compliance.[24] For situations where CAFO owners and operators seek to be authorized under a general permit through issuance of certificates of coverage, permitting authorities are unable to authorize discharges if no required effluent limitations are enumerated.

Endnotes

1 Michigan Department of Environmental Quality, Declaratory Ruling 2005-01 [hereinafter MDEQ Ruling 2005-01].

2 Sierra Club Mackinac Chapter v. Department of Environmental Quality, 2008 Mich. App. LEXIS 142 (Mich. Ct. App. Jan. 15, 2008).

3 399 F.3d 486 (2d Cir. 2005).

4 33 U.S.C. § 1342(b); see also 40 C.F.R. § 123 (2007).

5 33 U.S.C. § 1342(c); MDEQ Ruling 2007-01.

6 Mich. Admin. Code r. 323.2196(1)(b) (2005).

7 *Id.* r. 323.2103(a).

8 MDEQ Ruling 2005-01.

9 40 C.F.R. §§ 122.42(e)(1), 412.4(c) (2007).

10 Sierra Club, 2008 Mich.App. LEXIS 142, at *14.

11 MDEQ Ruling 2005-01, at 6; Sierra Club, 2008 Mich. App. LEXIS 142, at *14.

12 MDEQ Ruling 2005-01.

13 Sierra Club, 2008 Mich. App. LEXIS 142, at *14.

14 Sierra Club, 2008 Mich. App. LEXIS 142, at *3.

15 33 U.S.C. § 1362(14) (2006).

16 Sierra Club, 2008 Mich.App. LEXIS 142, at *28.

17 See Waterkeeper, 399 F.3d at 498; Environmental Defense Center v. EPA, 344 F.3d 832, 881 (9th Cir. 2003).

18 Sierra Club, 2008 Mich. App. LEXIS 142, at *32.

19 33 U.S.C. § 1362(11).

20 Id. § 1311(b).

21 33 U.S.C. § 1311(a)–(b) (2000).

22 Sierra Club, 2008 Mich. App. LEXIS 142, at *27-28.

23 Id. at *28 n. 64, 65; Environmental Defense Center, 344 F.3d 832.

24 Waterkeeper, 399 F.3d at 498.

The Farmer is the only man in our economy who buys everything at retail, sells everything at wholesale, and pays the freight both ways.
- John F. Kennedy

on the amount of income taxpayers receive. Some taxpayers will not receive a rebate or credit because their income is too low, and others will not receive a rebate or credit because their income is too high. The 2008 rebate (based on the 2007 income tax return) and the credit on the 2008 return (based on the 2008 income tax return) include a basic credit and a qualifying child credit.

Basic credit

Eligible individuals receive a basic credit (for the first taxable year beginning) in 2008 equal to the greater of the following:

1. Net income tax liability not to exceed $600 ($1,200 in the case of a joint return).
2. $300 ($600 in the case of a joint return) if:
   a. the eligible individual has qualifying income of at least $3,000; or
   b. the eligible individual has a net income tax liability of at least $1 and gross income greater than the sum of the applicable basic standard deduction amount and one personal exemption (two personal exemptions for a joint return).

An eligible individual is any individual other than: (1) a nonresident alien; (2) an estate or trust; or (3) a dependent.

For these purposes, "net income tax liability" means the excess of the sum of the individual's regular tax liability and alternative minimum tax over the sum of all nonrefundable credits (other than the child credit). Net income tax liability as determined for these purposes is not reduced by the credit added by this provision or any credit that is refundable.

Qualifying income is the sum of the eligible individual's:

1. earned income as used in the earned income credit except that it includes certain combat pay and does not include net earnings from self-employment that are not taken into account in computing taxable income;
2. Social Security benefits (within the meaning of I.R.C. § 86(d)); and
3. veteran's payments (under Chapters 11, 13, or 15 of title 38 of the U. S. Code).

Qualifying child credit

If an individual is eligible for any amount of the basic credit the individual also may be eligible for a qualifying child credit. The qualifying child credit equals $300 for each qualifying child of such individual. For these purposes, the child credit definition of qualifying child will apply.

Limitation based on adjusted gross income

The amount of the credit (including both the basic credit and the qualifying child credit) is phased out at a rate of 5% of adjusted gross income above certain income levels. The beginning point of this phase-out range is $75,000 of adjusted gross income ($150,000 in the case of joint returns).

Valid identification numbers

No credit is allowed to an individual who does not include a valid identification number on the individual's income tax return. In the case of a joint return that does not include valid identification numbers for both spouses, no credit is allowed. In addition, a child shall not be taken into account in determining the amount of the credit if a valid identification number for the child is not included on the return. For this purpose, a valid identification number means a Social Security number issued to an individual by the Social Security Administration. A taxpayer identification number issued by the Internal Revenue Service is not a valid identification number for purposes of this credit (e.g., an ITIN).

If an individual fails to provide a valid identification number, the omission is treated as a mathematical or clerical error. As under present law, the Internal Revenue Service (the "IRS") may summarily assess additional tax due as a result of a mathematical or clerical error without sending the taxpayer a notice of deficiency and giving the taxpayer an opportunity to petition the Tax Court. Where the IRS uses the summary assessment procedure for mathematical or clerical errors, the taxpayer must be given an explanation of the asserted error and given 60 days to request that the IRS abate its assessment.

Examples of rebate determination

The following examples show the rebate amounts as calculated from the taxpayer's 2007 tax return.

Example 1. A single taxpayer has $14,000 in Social Security income, no qualifying children, and no net tax liability prior to the application of refundable credits and the child credit. The taxpayer will receive a rebate of $300 for meeting the qualifying income test.

Example 2. A head of household taxpayer has $4,000 in earned income, one qualifying child, and no net tax liability prior to the application of refundable credits and the child credit. The taxpayer will receive a rebate of $600, comprising $300 for meeting the qualifying income test, and $300 per child.

Example 3. A married taxpayer filing jointly has $4,000 in earned income, one qualifying child, and no net tax liability prior to the application of refundable credits and the child credit. The taxpayer will receive a rebate of $900, comprising $600 for meeting the qualifying income test, and $300 per child.

Example 4. A married taxpayer filing jointly has $2,000 in earned income, one qualifying child, and $1,100 in net tax liability (resulting from other unearned income) prior to the application of refundable credits and the child credit (the taxpayer's actual liability after the child credit is $100). The qualifying income test is not met, but the taxpayer has net tax liability for purposes of determining the rebate of $1,100. The taxpayer will receive a rebate of $1,400, comprising $1,100 of net tax liability, and $300 per child.

Example 5. A married taxpayer filing jointly has $40,000 in earned income, two qualifying children, and a net tax liability of $1,573 prior to the application of refundable credits and child credits (the taxpayer's actual tax liability after the child credit is $427). The taxpayer meets the qualifying income test and the net tax liability test. The taxpayer will receive a rebate of $1,800, comprising $1,200 (greater of $600 or net tax liability not to exceed $1,200), and $300 per child.

Example 6. A married taxpayer filing jointly has $175,000 in earned income, two qualifying children, and a net tax liability of $31,189 (the taxpayer's actual liability after the child credit also is $31,189 as the joint income is too high to qualify). The taxpayer meets the qualifying income test and the net tax liability test. The taxpayer would, in the absence of the rebate phase-out provision, receive a rebate of $1,800, comprising $1,200 (greater of $600 or net tax liability not to exceed $1,200), and $300 per child. The phase-out provision reduces the total rebate amount by 5% of the amount by which the taxpayer's adjusted gross income exceeds $150,000. Five percent of $25,000 ($175,000 minus $150,000) equals $1,250. The taxpayer's rebate is thus $1,800 - $1,250 = $550.

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Increased deduction for 2008 investments

This provision includes three parts:

1. an increase in the I.R.C. § 179 deduction,

2. an additional first-year depreciation deduction, and

3. an increase in the limit on the combined depreciation and I.R.C. § 179 deduction for vehicles under 6,000 pounds gross vehicle weight.

Increased I.R.C. § 179 deduction

The maximum I.R.C. § 179 deduction taxpayers can elect for qualified I.R.C. § 179 property they place in service in tax years that begin in 2008 increased to $250,000 ($285,000 for qualified enterprise zone property and qualified renewal community property).

This limit is reduced by the amount by which the cost of I.R.C. § 179 property placed in service in the tax year exceeds $800,000. For qualified I.R.C. § 179 Gulf Opportunity (GO) Zone property placed in service in certain counties and parishes of the GO Zone, the maximum deduction is higher than the deduction for most other I.R.C. § 179 property.

Example 7. A taxpayer paid $900,000 for farm machinery in 2008 and placed it in service in 2008. The taxpayer's maximum I.R.C. § 179 deduction for 2008 is $150,000. That is the $250,000 limit reduced by the $100,000 by which the $900,000 qualifying investments exceed $800,000.

Additional first-year depreciation

This provision allows an additional first-year depreciation deduction equal to 50% of the adjusted basis of qualified property. The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service. However, the additional first-year depreciation deduction is not allowed for purposes of computing earnings and profits.

The basis of the property and the depreciation allowances in the year the property is placed in service and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows.

Example 8. Assume that in 2008, a taxpayer purchased new depreciable property and placed it in service and that the cost of the property is not eligible for expensing under I.R.C. § 179. The property's cost is $1,000, and it is five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed under the provision is $500. The remaining $500 of the cost of the property is deductible under the rules applicable to five-year property. Thus, 20 percent, or $100, is also allowed as a depreciation deduction in 2008. The total depreciation deduction with respect to the property for 2008 is $600. The remaining $400 cost of the property is recovered under otherwise applicable rules for computing depreciation.

In order for property to qualify for the additional first-year depreciation deduction, it must meet all of the following requirements.

First, the property must be:

1. property to which MACRS applies with an applicable recovery period of 20 years or less,

2. water utility property (as defined in I.R.C. § 168(e)(5)),

3. computer software other than computer software covered by I.R.C. § 197, or

4. qualified leasehold improvement property (as defined in I.R.C. § 168(k)(3)).

A special rule precludes the additional first-year depreciation deduction for any property that is required to be depreciated under the alternative depreciation system of MACRS.

Second, the original use of the property must commence with the taxpayer after December 31, 2007. The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

Third, the taxpayer must purchase the property within the applicable time period. The applicable time period for acquired property is:

1. after December 31, 2007, and before January 1, 2009, but only if no binding written contract for the acquisition is in effect before January 1, 2008, or

2. pursuant to a binding written contract which was entered into after December 31, 2007, and before January 1, 2009.

Finally, the property must be placed in service after December 31, 2007, and before January 1, 2009. If property is originally placed in service by a lessor (including by operation of I.R.C. § 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale.

If a taxpayer claims the I.R.C. § 179 deduction for an asset, the I.R.C. § 179 deduction reduces the basis before the 50% additional first-year depreciation is claimed.

Example 9. Assume the taxpayer in Example 7 claimed the $150,000 I.R.C. § 179 deduction for a combine that he purchased for $250,000. His 50% additional first-year depreciation is 50% of the remaining $100,000 basis, which is $50,000 and his regular depreciation is 10.71% of the remaining $50,000, which is $5,355. Therefore, his total I.R.C. §179 and depreciation deductions for the combine are $205,355.

Increased vehicle deduction

The limitation on the amount of depreciation deductions allowed with respect to certain vehicles (I.R.C. § 280F) is increased in the first year by $8,000 for vehicles that qualify (and for which the taxpayer does not elect out of the increased first year deduction). The $8,000 increase is not indexed for inflation.

The total depreciation deduction (including the I.R.C. § 179 deduction) taxpayers can claim for a vehicle (that is not a truck or a van) they use in their business and first placed in service in 2008 is $2,960 ($10,960 for automobiles for which the additional first-year depreciation allowances applies). The maximum deduction taxpayers can take for a truck or a van they use in their business and first placed in service in 2008 is $3,160 ($11,160 for trucks or vans for which the additional first-year depreciation allowance applies).

Farm Estate Valuation in an Era of Rising Land Values

-by Roger A. McEowen*

The dramatic increase in agricultural land values over the past few years[1] raises an interesting issue concerning how property is to be valued for estate tax purposes. Normally, the date of death value controls for estate tax purposes.[2] But, when land values can be significantly higher just a few months after death, can that higher value be used to value the property for federal estate tax purposes? That is an important question for two reasons – (1) even with the increased post-death value, the decedent's estate may still be under the applicable exclusion amount and therefore not be subject to federal estate tax, but the heirs could receive a higher income tax basis in the property;[3] and (2) for years, IRS estate examiners have tried to sneak in post-death sales as date of death comparables on a rising market when an increase in tax would result. So, what are the rules, and what pre-death planning concepts can be utilized to deal with escalating land values?

Basic valuation concepts

General rule

In general, for federal estate tax purposes, the value of property[4] included in a decedent's gross estate is the value of the property as of the date of the decedent's death.[5] "Fair market value" is defined as 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 sell and both having reasonable knowledge of all relevant facts concerning the property.[6] But, there are a couple of notable exceptions to the date of death valuation rule – alternate valuation[7] and special use valuation.[8]

Alternate valuation

An executor can make an election to value the estate property as of six months after the date of the decedent's death if the value of the property in the gross estate and the estate's federal estate tax liability are both reduced by making the election and the gross estate exceeds $2,000,000 (for 2008).[9] Under an alternate valuation election, any estate property that is disposed of within six months after the decedent's death is valued as of the time it is disposed of.[10] For property that is not disposed of within six months after death, the property is valued at its value six months after the decedent's death.[11] The purpose of the provision is to lessen the federal estate tax burden if the value of the assets contained in the estate decline in the six-month period immediately following the decedent's death.[12] In that event, the estate can be valued for federal estate tax purposes at its value six months after death. So, the provision is not useful when post-death values increase – it can only be used for estates in which the tax burden will be reduced by making the election. That means that an estate's heirs cannot take advantage of a rising market, value the property at a higher value six months after death and get a higher income tax basis in the decedent's property. That might be particularly tempting when the increased post-death estate value would remain beneath the applicable federal estate tax exclusion amount ($2 million for deaths in 2008), and the higher valuation would not result in any federal estate tax being due.[13]

Special use valuation

Another major statutory exception to the date of death valuation rule allows real estate that is either used for farming purposes or in a trade or business other than farming to be valued at its business use value (i.e., farm real estate is valued at its value as farm real estate rather than fair market value which could reflect commercial development potential).[14] For deaths in 2008, the maximum reduction in value that can be achieved by the executor making a special use valuation election is $960,000. With the substantial increase in farmland values in recent years,[15] special use valuation has become increasingly important as an estate planning tool to minimize federal estate tax. But, the provision is very complex, and its use requires careful planning in advance of death.[16] In addition, the decedent's heirs who receive the property must continue to use it for its business use (farm or non-farm) for 10 years after the date of the decedent's death.[17] If all of the post-death requirements are not satisfied by the decedent's family for the entire 10-year period immediately following the decedent's death, the estate tax saved by making the election must be paid back.[18]

Impact of post-death events on valuation

While the Code and Regulations point to the date of death as the valuation date, they do not rule out the possibility that post-death events can have a bearing on the date of death value for assets in a decedent's estate. For example, claims against an estate that arise post-death are deductible (and reduce the value of the taxable estate) even though the exact amount of the claim is not known at the time of the decedent's death, provided that the claim is ascertainable with reasonable certainty, and will be paid.[19] Likewise, for estates in which an alternate valuation election is made, the Tax Court has held that post-death events can be taken into consideration in valuing estate assets.[20] So, clearly, some consideration may be given to subsequent events that are reasonably foreseeable at the date of death.

Relevant cases

Numerous cases illustrate that it is simply not true that, except for the alternate valuation election, changes in valuation after death are immaterial. In *Gettysburg National Bank v. United States*,[21] the court held that, for federal estate tax purposes, "sale subsequent to the owner's death…may be relevant to show that the initial appraisal of fair market value was incorrect…[if] there is no evidence…that the discrepancy between the appraisal and sales figures were the result of any material change in the property or the market." Under the facts of the case, property was sold to a third party in an arm's length transaction 16 months after the decedent's death (13 months after its appraisal for estate tax purposes) for less than 75 percent of the value at which it was included in the gross estate. The court allowed the estate to reduce its value, stating that the subsequent sale may be relevant evidence that the appraised fair market value was incorrect. Likewise, in *Estate of Scull*,[22] the court concluded that sales of artwork at auction 10 months after the valuation date also were the best indicators of fair market value and applied a discount to reflect appreciation in the market between the valuation date and the auction. In *Rubenstein v. United States*,[23] the court held that the best evidence of the value of a claim is the amount for which the claim was settled after the decedent's death. The Tax Court has held that a post-death sale is the best indicator of fair market value for federal estate tax purposes, notwithstanding that the market had changed in the interim, and applied a 15 percent discount factor to reflect appreciation in the market between the date of the decedent's death and the sale.[24] Similarly, in *Estate of Andrews v. United States*,[25] the court determined that post-death facts relating to a publication contract under negotiation when the decedent died were germane to the determination of what a willing buyer would pay for the right to use the decedent's name. The court held that these facts were reasonably foreseeable at death and that informed buyers and sellers would consider them in reaching an agreement regarding a purchase of the decedent's name.[26] Also, in *Estate of Necastro v. Comm'r*,[27] *five years after the decedent's death* it was discovered that real estate included in the decedent's estate had suffered environmental contamination. The estate filed a claim for refund, reducing the value from the value as reported, which was based on facts known at the date of death, when the awareness and stringent oversight devoted to environmental issues did not exist. The court noted that it was not clear when the contamination occurred, or whether a reasonable buyer could have discovered it and correspondingly discounted the value of the property. Nevertheless, based on the government's

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own expert revaluation, the court permitted a reduction of over 33 percent from the value of the property determined before the contamination was discovered.[28]

In *Estate of Jephson v. Comm'r*,[29] the court concluded that "[e]vents subsequent to the valuation date may, in certain circumstances, be considered in determining the value as of the valuation date." That was precisely the case in *Estate of Keller v. Comm'r*,[30] where the court stated that a "sale of property to an unrelated party shortly after date of death tends to establish such value at date of death. The property sold involved a farm and growing crop where both the sale of the farm and the harvesting of the crop occurred post-death. Similarly, in *Estate of Stanton*,[31] the court stated that the sale of the property shortly after death is the best evidence of fair market value. Under the facts of the case, the selling price of comparable property sold six months after the decedent's death was also considered with a downward adjustment to reflect the greater development potential of the comparable property and the 10 months of appreciation that occurred after the decedent's death in the actual estate property owned and sold. Also, in *Estate of Trompeter v. Comm'r*,[32] the court reversed the Tax Court because the Tax Court failed to sufficiently articulate the basis for its decision regarding omitted assets and the rationale for the valuation discount selected, but nevertheless considered the value of assets using post-death developments, including redemption for $1,000 per share of stock valued at $10 per share 16 months earlier, and a coin collection returned at roughly half the value subsequently assigned to it by the taxpayer's estate in an effort to enjoin auction of that asset.

Similarly, in *Morris v. Comm'r*,[33] speculative post-death commercial development events were taken into consideration in valuing farmland in the decedent's estate as of the date of the decedent's death. The decedent's farmland was approximately 15 miles north of downtown Kansas City and approximately five miles west of the Kansas City airport. At the time of death, plans were in place for a sewer line to service the larger of the two tracts the decedent owned. Also, residential development was planned within two miles of the same tract. In addition, significant roadways and the site for the planned construction of a major interstate were located close to the property. While none of these events had occurred as of the date of death, the court found them probative for determining the value of the farmland as of the date the decedent died. The decedent's son, the owner of the farmland as surviving joint tenant, tried to introduce evidence of the failed closing of some post-death sales to support his claim that the post-death events were speculative. But, the court disagreed, establishing the value of the farmland at $990,000 rather than the estate's valuation of $332,151.34

Most recently, the court in *Okerlund v. United States*,[35] dealt with the issue of stock valuation in a closely held company for stock that was gifted shortly before the company founder died and the company (a milk processing operation) suffered a salmonella outbreak. The taxpayers argued that these events should result in a lower gift tax value of the stock, with the issue being the relevance of post-death events on the value of the gifts. The court stated that "[i]t would be absurd to rule an arms-length stock sale made moments after a gift of that same stock inadmissible as post-valuation date data…. The key to use of any data in a valuation remains that all evidence must be proffered in support of finding the value of the stock on the donative date." The court ultimately affirmed the trial court's denial of a lower gift tax valuation based on the reality that the risk factors (the founder's death and matters that could materially affect the business) had already been accounted for in the valuation of the stock.

So, it is clear that post-death events and other facts that are reasonably predictable as of the date of death or otherwise relevant to the date of death value can serve as helpful evidence of value and allow either an increase (to obtain a higher basis) or decrease (to reduce federal estate tax) in value as a matter of record. While the Code and Regulations are clear that the appropriate valuation date is the date of the decedent's death, the courts have recognized that post-death events are relevant in determining the taxable value of property as of the moment of death. For farmland (and other real estate for that matter) the market is not static as of the date of death. Accordingly, an appraiser can reasonably look to the arc of sales extending from pre-death dates to post-death dates in arriving at the date-of death value. The cases referenced above provide guidance in fleshing-out the parameters of the concept.

Valuation penalties

While valuation figures can incorporate post-death factors, appraisers must not be overly aggressive and must be aware of enhanced penalties passed as part of the Pension Protection Act of 2006 (PPA).[36] Those provisions address appraisal reform and impose stiffer accuracy-related penalties for appraisers who aid or assist in the substantial valuation misstatement of tax. Prior law grouped appraisers with other professionals representing taxpayers, but the PPA places appraisers in their own class of penalties, which have significantly increased over historical penalties applied to all tax professionals. In an effort to intensify the number of investigations and likewise decrease valuation misstatements conducted by unscrupulous appraisers, the Service's staff has grown approximately four fold.

Previously, the law stated a "qualified appraiser" was someone who held themselves out as an appraiser or who regularly performed appraisals; possibly had some adequate credentials; knew about civil fraud penalties and was not a disqualified person (or, someone who was prohibited from practicing before the IRS by the Secretary of the Treasury). Under the PPA, however, a "qualified appraiser" is an individual who:

1. has earned an appraisal designation from a recognized professional appraisal organization[37] or has otherwise met minimum education and experience requirements to be determined by the IRS in regulations;
2. regularly performs appraisals for which he or she receives compensation;
3. can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed;
4. has not been prohibited from practicing before the IRS by the Secretary of the Treasury at any time during the three years preceding the conduct of the appraisal; and
5. is not excluded from being a qualified appraiser under applicable Treasury regulations.[38]

An appraiser who prepares an appraisal and knows (or reasonably should have known) that the appraisal would be used in connection with a return or a claim for refund, and the claimed value results in a substantial valuation misstatement (value of the property claimed on the return is 150 percent or more of the correct amount), or a gross valuation misstatement (value of the property claimed on the return is 200 percent or more of the correct amount) is subject to penalty.[39] For estate and gift tax purposes, penalties for a substantial valuation misstatement are triggered if the valuation is 65 percent (or less) of the correct value and 40 percent (or less) for a gross valuation misstatement.[40] The penalty is equal to the lesser of: (1) the greater of $1,000, or 10 percent of the understatement of tax, resulting from a substantial or gross valuation misstatement, or (2) 125 percent of the professional fee(s) received from the appraisal engagement.[41]

Pre-death planning

2008 is the first of four consecutive years where the applicable exclusion from federal estate tax will be different each year. The exemption is $2 million for deaths in 2008, $3.5 million in 2009, $0 in 2010 (because the federal estate tax is repealed for deaths in 2010), and $1 million in 2011. The fluctuation in the exemption amount complicates estate tax planning. The issue is further complicated by rapidly rising farmland values. Those factors may place a premium on appropriate property ownership

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patterns between spouses, creation of entities, the use of disclaimers, and pre-death gifting or sale of assets. Although the amount of the federal exemption in the year of planning may indicate that no division of property between spouses or creation of a credit trust in the first estate is needed, the potential for future inflation in farmland values may suggest that such inflation should be hedged against in the planning arrangements.

Summary

The substantial increase in farmland values in recent years presents estate planning challenges and raises issues concerning valuation of the land in a farmer's estate. While date of death normally pegs property value for estate tax purposes, and establishes income tax basis of the property in the hands of the heirs, post-death factors are relevant in determining death-time value. That is an important point, and could be used to an estate's advantage when doing so would result in an increase in estate value that remains beneath the applicable exclusion. On the other hand, IRS could use the same principles to increase values when an increase in tax would result.

Endnotes

[1] For example, Iowa farmland values have increased rapidly in recent years. For data concerning 2007 Iowa farmland values in addition to historic data concerning Iowa farmland values, see Duffy, Iowa Land Value Survey, located at http://www.extension.iastate.edu/landvalue/.

[2] I.R.C. §2031(a). The value of the decedent's estate is reported on IRS Form 706 (U.S. Estate and Generation Skipping Transfer Tax Return). Form 706 must be filed if the decedent's gross estate exceeds the exemption equivalent of the credit applicable for federal estate tax. If the value of the estate is less than the exemption equivalent, the estate may still file Form 706 to either establish a new income tax basis for the property or start the tolling of the three year statute of limitations for an IRS challenge to the estate value, or both. If the estate files a Form 706, the estate must ensure consistency in the values reported with any inheritance tax return filed.

[3] I.R.C. §1014 specifies that a person that acquires property from a decedent's estate or to whom property passes from a decedent's estate receives an income tax basis equal to the fair market value of the property as of the date of the decedent's death.

[4] The term "property" includes both real and personal property as well as tangible and intangible property. *Id.*

[5] Treas. Reg. §20.2031-1(b).

[6] *Id.* See also Treas. Reg. §1.170A-1(c)(2). The price paid for an item in the decedent's gross estate at a public auction or in response to a classified newspaper advertisement is considered the equivalent of retail price and, thus, is acceptable as a fair market valuation. Treas. Reg. §20.2031-1(b). However, the sales price is only acceptable if the sale is within a reasonable time after the applicable valuation date and there is no substantial change in market conditions between the valuation date and the date of the sale. *Id.* Rev. Proc. 65-19, 1965-2 C.B. 1002, specifically addresses the issue of items commonly sold at auction or through classified advertisements and states that the resulting sale price of such items is acceptable as fair market value if there is no dramatic change in the market between the date of the decedent's death and the date of sale.

[7] I.R.C. §2032.

[8] I.R.C. §2032A. There is a third exception (not discussed herein) for land subject to a conservation easement. I.R.C. §2031(c).

[9] I.R.C. §2032. I.R.C. §2032(c) states that an alternate valuation election cannot be made unless the election decreases both the value of the gross estate and federal transfer taxes associated with the estate.

[10] I.R.C. §2032(a)(1).

[11] I.R.C. §2032(a)(2).

[12] See Treas. Reg. §20.2032-1(b)(1).

[13] Without a change in current law, the federal estate tax exemption rises to $3.5 million for deaths in 2009. That could provide an even greater incentive to increase the estate value of assets to receive a higher basis in situations where no federal estate tax would result.

[14] I.R.C. §2032A(1)(B).

[15] For historic data concerning Iowa farmland values, see note 1 *supra*.

[16] The most important pre-death requirements are: (1) the 50 percent test–which requires that the real and personal property used in the business must make up at least 50 percent of the adjusted value of the decedent's gross estate, using fair market value figures, *and* that amount (or more) must pass to or be acquired by "qualified heirs." I.R.C. §2032A(b)(3)(A); (2) the 25 percent test–which requires that the qualified real property must make up at least 25 percent of the gross estate less secured indebtedness. I.R.C. §2032A(b)(1)(B).; (3) the qualified use test–which requires that, before the decedent's death, the decedent or a member of the decedent's family must have had an equity interest in the business at the time of the decedent's death and for five or more of the last eight years before the decedent's death. I.R.C. §2032A(a)(1), (b)(1)(C).; (4) the ownership test–which requires that the qualified real estate must have been owned by the decedent or a member of the decedent's family and held for a qualified use during five or more years in the eight year period ending with the decedent's death; and (5) the present interest test–which requires that the qualified heir receives a present interest in the property. Treas. Reg. §20.2032A-3(b)(1).

[17] I.R.C. §2032A(c)(1).

[18] This is known as "recapture." For a complete discussion of special use valuation as applied to farming operations, see, Kelley, Donald H., *Estate Planning for Farmers and Ranchers*, Thomson/West, Vol. 2, Ch. 15, current through Sept. 2007 supplement.

[19] Treas. Reg. §20.2053-4. The issue of the extent that post-death claims are relevant in determining the value of claims which may be deducted on an estate tax return has been litigated for almost 80 years. See *Ithaca Trust Co. v. United States*, 279 U.S. 151 (1929)(estate's charitable deduction determined after reducing amount of charitable contribution by surviving spouse's probable lifespan as it existed at time of decedent's death; surviving spouse died before decedent's estate tax return filed); *Jacobs v. Comm'r*, 34 F.2d 233 (8th Cir. 1929), *cert. den., sub nom., Jacobs v. Lucas*, 280 U.S. 603 (1929)(only claims presented to and allowed or otherwise determined as valid against the estate and actually paid or to be paid deductible as claim against estate; *Ithaca Trust* opinion did not mean that claims against the estate must be determined solely by the facts and conditions existing on the day of the decedent's death); but see *Estate of Smith v. Comm'r*, 198 F.3d 515 (5th Cir. 1999)(*Ithaca Trust* sets forth a broad principle that a taxable estate should be determined by considering only information known as of the date of death); *Estate of McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006); *Estate of McMorris v. Comm'r*, 243 F.3d 1254 (10th Cir. 2001); *Estate of O'Neal v. United States*, 258 F.3d 1265 (11th Cir. 2001). However, the Fifth and Eleventh Circuits have ruled that post-death events are relevant when hypothetical liabilities are involved. See *Estate of Hagmann v. Comm'r*, 492 F.2d 796 (5th Cir. 1974); *Estate of O'Neal v. United States*, 258 F.3d 1265 (11th Cir. 2001). The IRS position is that post-death events are irrelevant only when actuarial tables define fair market value. Under regulations proposed in 2007, IRS has rejected the date-of-death valuation approach as an inefficient use of resources for taxpayers, the IRS and the courts. Instead, the proposed regulations adopt rules based on the premise that an estate may only deduct amounts actually paid in settlement of claims against the estate. Thus, post-death events are to be considered when determining the amount deductible under *all* provisions of I.R.C. §2053, and such deductions are limited to amounts actually paid by the estate in satisfaction of deductible expenses and claims. *See, e.g., Gottesman v. United States*, No. 05 Civ. 8212 (BSJ), 2007 U.S. Dist. LEXIS 15043 (S.D. N.Y. Jan. 12, 2007) (estate denied tax refund claim because ex-wife had no valid claim after decedent's death under express terms of separation agreement; court reasoned that if claim cannot be enforced because of post-death events, there can be no deduction under I.R.C. §2053(a)(3) for that claim).

[20] *Kohler v. Comm'r*, T.C. Memo. 2006-152 (valuation discounts attributable to restrictions imposed on closely-held corporate stock due to post-death corporate reorganization are to be taken into account for purposes of valuing stock on alternate valuation date); but see *Flanders v. United States*, 347 F. Supp. 95 (N.D. Cal. 1972) (reduction in value of property included in decedent's estate caused by voluntary act by trustee rather than by market conditions not to be taken into account for purposes of alternate valuation). IRS did not appeal *Kohler*,

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but instead, the IRS Associate Chief Counsel's Office has recommended non-acquiescence to the *Kohler* opinion. A.O.D. 2008-01, I.R.B. 2008-9 (Mar. 3, 2008). However, the IRS objection to the Tax Court's opinion is somewhat misplaced. Stock transfers in a tax-free reorganization are not treated as having been distributed, sold or otherwise disposed of, which means that the valuation on the alternate valuation date controls. See Treas. Reg. §20.2032-1(c)(1). In addition the Tax Court did not view the valuation expert's report for the IRS as credible. IRS has proposed regulations that would amend existing regulations to clarify that the alternate valuation election is available to estates that experience a reduction in value of the gross estate after the decedent's death due to market conditions, but not due to other post-death events. The proposed regulations define the term "market conditions" as "events outside of the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect fair market value of the property being valued." The proposed regulations provide examples, which are not intended to be exclusive, but which contain an example involving the identical facts of *Kohler*. However, the Proposed Regulations do not repeal or amend Treas. Reg. §20.2032-1(c)(1). NPRM REG-112196-07 (Apr. 24, 2008), *amending* Treas. Reg. §20.2032-1(f). An important fact of *Kohler*, which the Tax Court did not address, was that the reorganization plan at issue had been considered by the Kohler family for at least two years before the decedent's death. Thus, it could be argued that the plan was in progress at the date of death and its implementation was a fact to be taken into account by the appraiser even in determining the date of death value of the corporate stock in the decedent's estate.

[21] No. 1:CV-90-1607, 1992 U.S. Dist. LEXIS 12152 (D. M.D. Pa. Jul. 17, 1992).

[22] T.C. Memo. 1994-211.

[23] 826 F. Supp. 448 (S.D. Fla. 1993).

[24] T.C. Memo. 1994-211.

[25] 850 F. Supp. 1279 (E.D. Va. 1994).

[26] That fact that a post-death ghostwriter endeavor proved to be successful was deemed not probative, however, on the question of the degree of discount that was appropriate in valuing the decedent's name to reflect the substantial risk that a ghostwriting effort would fail instead.

[27] T.C. Memo. 1994-352.

[28] The court's opinion did not, however, address the substantive issue whether facts discovered after death may influence valuation if willing buyers and sellers would not have known the relevant facts as of the valuation date.

[29] 81 T.C. 999 (1983).

[30] T.C. Memo. 1980-450.

[31] T.C. Memo. 1989-341.

[32] 279 F.3d 767 (9th Cir. 2002).

[33] 761 F.2d 1195 (6th Cir. 1985).

[34] The court's opinion makes it look like evidence to confirm an appraiser's date-of-death prediction of future events is more likely to be received than evidence adduced to prove wrong an appraiser's prediction concerning future events. In any event, however, the case stands for the proposition that post-death events are relevant for establishing death-time value – even if they are somewhat speculative.

[35] 365 F.3d 1044 (Fed. Cir. 2004).

[36] H.R. 4, P.L. 109-280.

[37] In the field of business appraisal, there are four recognized organizations that certify and educate professionals in the field of business valuation: American Society of Appraisers (ASA), Institute of Business Appraisers (IBA), National Association of Certified Valuation Analysts (NACVA) and the American Institute of Certified Public Accountants (AICPA).

[38] In addition to defining a qualified appraiser, the PPA also defines a "qualified appraisal" report as an appraisal prepared by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary of the Treasury.

[39] I.R.C. §6662(e)(1).

[40] I.R.C. §§6662(g); 6662(h)(1).

[41] I.R.C. §6695A(b). In addition to civil penalties, disciplinary action may also be imposed on appraisers and may include suspending or barring an appraiser from preparing or presenting appraisals before the U.S. Department of Labor (DOL) or the IRS as well as appearing before the DOL or the IRS as an expert witness.

From the Executive Director:

This issue introduces a new look to the *Agricultural Law Update*, necessitated by the shift to e-mail as the primary delivery method for AALA members. A large majority of members have agreed to accept delivery by e-mail, saving the association thousands of dollars annually. The low number of print copies allows me to format, print and mail the remaining copies from my office, saving most of the rest of the cost of publication. If you would like to increase our savings, and reduce my work, please send me an e-mail: (RobertA@agalw-assn.org) and I'll send you a test copy. I am working on offering an online searchable set of the *Updates* and an active-link bibliography of all articles for easy location of articles in the *Update*.

Set your calendars now for October 24-25, 2008 – AALA 29th Annual Ag. Law Symposium at the Marriott in downtown Minneapolis, MN

Robert P. Achenbach, Jr., AALA Executive Director