

interest or estate so affected. The application of this paragraph is illustrated in subparagraphs (1) and (2) of this paragraph:

(1) *Life estates, remainders, and similar interests.* The values of life estates, remainders, and similar interests are to be obtained by applying the methods prescribed in § 20.2031-7, using (i) the age of each person, the duration of whose life may affect the value of the interest, as of the date of the decedent's death, and (ii) the value of the property as of the alternate date. For example, assume that the decedent or his estate was entitled to receive property upon the death of his elder brother who was entitled to receive the income therefrom for life. At the date of the decedent's death, the property was worth \$50,000 and the elder brother was 31 years old. The value of the decedent's remainder interest at the date of the decedent's death would, as explained in § 20.2031-7A(d)(4), be \$2,373 ($\$50,000 \times 0.04746$). If, because of economic conditions, the property declined in value and was worth only \$40,000 6 months after the date of the decedent's death, the value of the remainder interest would be \$1,898.40 ($\$40,000 \times 0.04746$), even though the elder brother may be 32 years old on the alternate date.

(2) *Patents.* To illustrate the alternate valuation of a patent, assume that the decedent owned a patent which, on the date of the decedent's death, had an unexpired term of ten years and a value of \$78,000. Six months after the date of the decedent's death, the patent was sold, because of lapse of time and other causes, for \$60,000. The alternate value thereof would be obtained by dividing \$60,000 by 0.95 (ratio of the remaining life of the patent at the alternate date to the remaining life of the patent at the date of the decedent's death), and would, therefore, be \$63,157.89.

(g) *Effect of election on deductions.* If the executor elects the alternate valuation method under section 2032, any deduction for administration expenses under section 2053(b) (pertaining to property not subject to claims) or losses under section 2054 (or section 2106(a)(1), relating to estates of non-residents not citizens) is allowed only to the extent that it is not otherwise in

effect allowed in determining the value of the gross estate. Furthermore, the amount of any charitable deduction under section 2055 (or section 2106(a)(2), relating to the estates of nonresidents not citizens) or the amount of any marital deduction under section 2056 is determined by the value of the property with respect to which the deduction is allowed as of the date of the decedent's death, adjusted, however, for any difference in its value as of the date 6 months (1 year, if the decedent died on or before December 31, 1970) after death, or as of the date of its distribution, sale, exchange, or other disposition, whichever first occurs. However, no such adjustment may take into account any difference in value due to lapse of time or to the occurrence or nonoccurrence of a contingency.

(h) *Effective date.* Paragraph (b) of this section is applicable to decedents dying on or after January 4, 2005. However, pursuant to section 7805(b)(7), taxpayers may elect to apply paragraph (b) of this section retroactively if the period of limitations for filing a claim for a credit or refund of Federal estate or generation-skipping transfer tax under section 6511 has not expired.

[T.D. 6296, 23 FR 4529, June 24, 1958, as amended by T.D. 7238, 37 FR 28718, Dec. 29, 1972; T.D. 7955, 49 FR 19995, May 11, 1984; T.D. 8540, 59 FR 30103, June 10, 1994; T.D. 8819, 64 FR 23229, Apr. 30, 1999; T.D. 9172, 70 FR 296, Jan. 4, 2005]

§ 20.2032A-3 Material participation requirements for valuation of certain farm and closely-held business real property.

(a) *In general.* Under section 2032A, an executor may, for estate tax purposes, make a special election concerning valuation of qualified real property (as defined in section 2032A(b)) used as a farm for farming purposes or in another trade or business. If this election is made, the property will be valued on the basis of its value for its qualified use in farming or the other trade or business, rather than its fair market value determined on the basis of highest and best use (irrespective of whether its highest and best use is the use in farming or other business). For the special valuation rules of section 2032A to apply, the deceased owner and/or a

member of the owner's family (as defined in section 2032A (e) (2)) must materially participate in the operation of the farm or other business. Whether the required material participation occurs is a factual determination, and the types of activities and financial risks which will support such a finding will vary with the mode of ownership of both the property itself and of any business in which it is used. Passively collecting rents, salaries, draws, dividends, or other income from the farm or other business is not sufficient for material participation, nor is merely advancing capital and reviewing a crop plan or other business proposal and financial reports each season or business year.

(b) *Types of qualified property*—(1) *In general.* Real property valued under section 2032A must pass from the decedent to a qualified heir or be acquired from the decedent by a qualified heir. The real property may be owned directly or may be owned indirectly through ownership of an interest in a corporation, a partnership, or a trust. Where the ownership is indirect, however, the decedent's interest in the business must, in addition to meeting the tests for qualification under section 2032A, qualify under the tests of section 6166 (b) (1) as an interest in a closely-held business on the date of the decedent's death and for sufficient other time (combined with periods of direct ownership) to equal at least 5 years of the 8 year period preceding the death. All specially valued property must be used in a trade or business. Directly owned real property that is leased by a decedent to a separate closely held business is considered to be qualified real property, but only if the separate business qualifies as a closely held business under section 6166 (b) (1) with respect to the decedent on the date of his or her death and for sufficient other time (combined with periods during which the property was operated as a proprietorship) to equal at least 5 years of the 8 year period preceding the death. For example, real property owned by the decedent and leased to a farming corporation or partnership owned and operated entirely by the decedent and fewer than 15 members of the decedent's family is

eligible for special use valuation. Under section 2032A, the term trade or business applies only to an active business such as a manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities, as distinguished from passive investment activities. The mere passive rental of property to a party other than a member of the decedent's family will not qualify. The decedent or a member of the decedent's family must own an equity interest in the farm operation. A trade or business is not necessarily present even though an office and regular hours are maintained for management of income producing assets, as the term "business" is not as broad under section 2032A as under section 162. Additionally, no trade or business is present in the case of activities not engaged in for profit. *See* section 183.

(2) *Structures and other real property improvements.* Qualified real property includes residential buildings and other structures and real property improvements occupied or used on a regular basis by the owner or lessee of real property (or by employees of the owner or lessee) for the purpose of operating the farm or other closely held business. A farm residence occupied by the decedent owner of the specially valued property is considered to be occupied for the purpose of operating the farm even though a family member (not the decedent) was the person materially participating in the operation of the farm as required under section 2032A (b) (1) (C).

(c) *Period material participation must last.* The required participation must last—

(1) For periods totalling 5 years or more during the 8 years immediately preceding the date of the decedent's death; and

(2) For periods totalling 5 years or more during any 8 year period ending after the date of the decedent's death (up to a maximum of 15 years after decedent's death, when the additional estate tax provisions of section 2032A(c) cease to apply).

In determining whether the material participation requirement is satisfied, no exception is made for periods during

which real property is held by the decedent's estate. Additionally, contemporaneous material participation by 2 or more family members during a period totalling a year will not result in that year being counted as 2 or more years for purposes of satisfying the requirements of this paragraph (c). Death of a qualified heir (as defined in section 2032A(e)(1)) before the requisite time has passed ends any material participation requirement for that heir's portion of the property as to the original decedent's estate if the heir received a separate, joint or other undivided property interest from the decedent. If qualified heirs receive successive interests in specially valued property (e.g. life estate and remainder interests) from the decedent, the material participation requirement does not end with respect to any part of the property until the death of the last qualified heir (or, if earlier, the expiration of 15 years from the date of the decedent's death). The requirements of section 2032A will fully apply to an heir's estate if an election under this section is made for the same property by the heir's executor. In general, to determine whether the required participation has occurred, brief periods (e.g., periods of 30 days or less) during which there was no material participation may be disregarded. This is so only if these periods were both preceded and followed by substantial periods (e.g. periods of more than 120 days) in which there was uninterrupted material participation. See paragraph (e)(1) of this section which provides a special rule for periods when little or no activity is necessary to manage fully a farm.

(d) *Period property must be owned by decedent and family members.* Only real property which is actually owned by any combination of the decedent, members of the decedent's family, and qualified closely held businesses for periods totalling at least 5 of the 8 years preceding the date of decedent's death may be valued under section 2032A. For example, replacement property acquired in like-kind exchange under section 1031 is considered to be owned only from the date on which the replacement property is actually acquired. On the other hand, replacement property acquired as a result of an involuntary

conversion in a transfer that would meet the requirements of section 2032A(h) if it occurred after the date of the decedent's death is considered to have been owned from the date in which the involuntarily converted property was acquired. Property transferred from a proprietorship to a corporation or a partnership during the 8-year period ending on the date of the decedent's death is considered to be continuously owned to the extent of the decedent's equity interest in the corporation or partnership if, (1) the transfer meets the requirements of section 351 or 721, respectively, and (2) the decedent's interest in the corporation or partnership meets the requirements for indirectly held property contained in paragraph (b)(1) of this section. Likewise, property transferred to a trust is considered to be continuously owned if the beneficial ownership of the trust property is such that the requirements of section 6166(b)(1)(C) would be so satisfied if the property were owned by a corporation and all beneficiaries having vested interests in the trust were shareholders in the corporation. Any periods following the transfer during which the interest in the corporation, partnership, or trust does not meet the requirements of section 6166(b)(1) may not be counted for purposes of satisfying the ownership requirements of this paragraph (d).

(e) *Required activities—(1) In general.* Actual employment of the decedent (or of a member of the decedent's family) on a substantially full-time basis (35 hours a week or more) or to any lesser extent necessary personally to manage fully the farm or business in which the real property to be valued under section 2032A is used constitutes material participation. For example, many farming operations require only seasonal activity. Material participation is present as long as all necessary functions are performed even though little or no actual activity occurs during nonproducing seasons. In the absence of this direct involvement in the farm or other business, the activities of either the decedent or family members must meet the standards prescribed in this paragraph and those prescribed in the regulations issued under section 1402(a)(1). Therefore, if the participant

(or participants) is self-employed with respect to the farm or other trade or business, his or her income from the farm or other business must be earned income for purposes of the tax on self-employment income before the participant is considered to be materially participating under section 2032A. Payment of the self-employment tax is not conclusive as to the presence of material participation. If no self-employment taxes have been paid, however, material participation is presumed not to have occurred unless the executor demonstrates to the satisfaction of the Internal Revenue Service that material participation did in fact occur and informs the Service of the reason no such tax was paid. In addition, all such taxes (including interest and penalties) determined to be due must be paid. In determining whether the material participation requirement is satisfied, the activities of each participant are viewed separately from the activities of all other participants, and at any given time, the activities of at least one participant must be material. If the involvement is less than full-time, it must be pursuant to an arrangement providing for actual participation in the production or management of production where the land is used by any nonfamily member, or any trust or business entity, in farming or another business. The arrangement may be oral or written, but must be formalized in some manner capable of proof. Activities not contemplated by the arrangement will not support a finding of material participation under section 2032A, and activities of any agent or employee other than a family member may not be considered in determining the presence of material participation. Activities of family members are considered only if the family relationship existed at the time the activities occurred.

(2) *Factors considered.* No single factor is determinative of the presence of material participation, but physical work and participation in management decisions are the principal factors to be considered. As a minimum, the decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all

final management decisions alone, the decedent and/or family members must participate in making a substantial number of these decisions. Additionally, production activities on the land should be inspected regularly by the family participant, and funds should be advanced and financial responsibility assumed for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, the furnishing by the owner or other family members of a substantial portion of the machinery, implements, and livestock used in the production activities is an important factor to consider in finding material participation. With farms, hotels, or apartment buildings, the operation of which qualifies as a trade or business, the participating decedent or heir's maintaining his or her principal place of residence on the premises is a factor to consider in determining whether the overall participation is material. Retention of a professional farm manager will not by itself prevent satisfaction of the material participation requirement by the decedent and family members. However, the decedent and/or a family member must personally materially participate under the terms of arrangement with the professional farm manager to satisfy this requirement.

(f) *Special rules for corporations, partnerships, and trusts—(1) Required arrangement.* With indirectly owned property as with property that is directly owned, there must be an arrangement calling for material participation in the business by the decedent owner or a family member. Where the real property is indirectly owned, however, even full-time involvement must be pursuant to an arrangement between the entity and the decedent or family member specifying the services to be performed. Holding an office in which certain material functions are inherent may constitute the necessary arrangement for material participation. Where property is owned by a trust, the arrangement will generally be found in one or more of four situations. First, the arrangement may result from appointment as a trustee. Second, the arrangement may result from an employer-employee relationship in which

the participant is employed by a qualified closely held business owned by the trust in a position requiring his or her material participation in its activities. Third, the participants may enter into a contract with the trustees to manage, or take part in managing, the real property for the trust. Fourth, where the trust agreement expressly grants the management rights to the beneficial owner, that grant is sufficient to constitute the arrangement required under this section.

(2) *Required activities.* The same participation standards apply under section 2032A where property is owned by a qualified closely held business as where the property is directly owned. In the case of a corporation, a partnership, or a trust where the participating decedent and/or family members are employees and thereby not subject to self-employment income taxes, they are to be viewed as if they were self-employed, and their activities must be activities that would subject them to self-employment income taxes were they so. Where property is owned by a corporation, a partnership or a trust, participation in the management and operation of the real property itself as a component of the closely held business is the determinative factor. Nominally holding positions as a corporate officer or director and receiving a salary therefrom or merely being listed as a partner and sharing in profits and losses will not alone support a finding of material participation. This is so even though, as partners, the participants pay self-employment income taxes on their distributive shares of partnership earnings under § 1.1402(a)-2. Further, it is especially true for corporate directors in states where the board of directors need not be an actively functioning entity or need only act informally. Corporate offices held by an owner are, however, factors to be considered with all other relevant facts in judging the degree of participation. When real property is directly owned and is leased to a corporation or partnership in which the decedent owns an interest which qualified as an interest in a trade or business within the meaning of section 6166(b)(1), the presence of material participation is determined by looking at the activities of the par-

ticipant with regard to the property in whatever capacity rendered. During any periods when qualified real property is held by an estate, material participation is to be determined in the same manner as if the property were owned by a trust.

(g) *Examples.* The rules for determining material participation may be illustrated by the following examples. Additional illustrations may be found in examples (1) through (6) in § 1.1402(a)-4.

Example (1). A, the decedent, actively operated his 100-acre farm on a full-time basis for 20 years. He then leased it to B for the 10 years immediately preceding his death. By the terms of the lease, A was to consult with B on where crops were to be planted, to supervise marketing of the crop, and to share equally with B in expenses and earnings. A was present on the farm each spring for consultation; however, once planting was completed, he left for his retirement cottage where he remained until late summer, at which time he returned to the farm to supervise the marketing operation. A at all times maintained the farm home in which he had lived for the time he had owned the farm and lived there when at the farm. In light of his activities, assumption of risks, and valuable knowledge of proper techniques for the particular land gained over 20 years of full-time farming on the land involved, A is deemed to have materially participated in the farming business.

Example (2). D is the 70-year old widow of farmer C. She lives on a farm for which special valuation has been elected and has lived there for 20 years. D leases the land to E under an arrangement calling for her participation in the operation of the farm. D annually raises a vegetable garden, chickens, and hogs. She also inspects the tobacco fields (which produce approximately 50 percent of farm income) weekly and informs E if she finds any work that needs to be done. D and E share expenses and income equally. Other decisions such as what fields to plant and when to plant and harvest crops are left to E, but D does occasionally make suggestions. During the harvest season, D prepares and serves meals for all temporary farm help. D is deemed to participate materially in the farm operations based on her farm residence and her involvement with the main money crop.

Example (3). Assume that D in example (2) moved to a nursing home 1 year after her husband's death. E completely operated the farm for her for 6 years following her move. If E is not a member of D's family, material participation ceases when D moves; however, if E is a member of D's family, E's material

participation will prevent disqualification even if D owns the property. Further, upon D's death, the section 2032A valuation could be elected for her estate if E were a member of her family and the other requirements of section 203A were satisfied.

Example (4). F, a qualified heir, owned a specially valued farm. He contracted with G to manage the farm for him as F, a lawyer, lived and worked 15 miles away in a nearby town. F supplied all machinery and equipment and assumed financial responsibility for the expenses of the farm operation. The contract specified that G was to submit a crop plan and a list of expenses and earnings for F's approval. It also called for F to inspect the farm regularly and to approve all expenditures over \$100. In practice, F visited the farm weekly during the growing season to inspect and discuss operations. He actively participated in making important management decisions such as what fields to plant or pasture and how to utilize the subsidy program. F is deemed to have materially participated in the farm operation as his personal involvement amounted to more than managing an investment. Had F not regularly inspected the farm and participated in management decisions, however, he would not be considered to be materially participating. This would be true even though F did assume financial responsibility for the operation and did review annual crop plans.

Example (5). Decedent I owned 90 percent of all outstanding stock of X Corporation, a qualified closely-held business which owns real property to be specially valued. I held no formal position in the corporation and there was no arrangement for him to participate in daily business operations. I regularly spent several hours each day at the corporate offices and made decisions on many routine matters. I is not deemed to have materially participated in the X Corporation despite his activity because there was no arrangement requiring him to act in the manner in which he did.

Example (6). Decedent J was a senior partner in the law firm of X, Y, and Z, which is a qualified closely held business owning the building in which its offices are located. J ceased to practice law actively 5 years before his death in 1977; however, he remained a full partner and annually received a share of firm profits. J is not deemed to have materially participated under section 2032A even though he still may have reported his distributive share of partnership income for self-employment income tax purposes if the payments were not made pursuant to any retirement agreement. This is so because J does not meet the requirement of actual personal material participation.

Example (7). K, the decedent, owned a tree farm. He contracted with L, a professional forester, to manage the property for him as

K, a doctor, lived and worked in a town 50 miles away. The activities of L are not considered in determining whether K materially participated in the tree farm operation. During the 5 years preceding K's death, there was no need for frequent inspections of the property or consultation concerning it, inasmuch as most of the land had been reforested and the trees were in the beginning stages of their growing cycle. However, once every year, L submitted for K's approval a proposed plan for the management of the property over the next year. K actively participated in making important management decisions, such as where and whether a pre-commercial thinning should be conducted, whether the timber was adequately protected from fire and disease, whether fire lines needed to be plowed around the new trees, and whether boundary lines were properly maintained around the property. K inspected the property at least twice every year and assumed financial responsibility for the expenses of the tree farm. K also reported his income from the tree farm as earned income for purposes of the tax on self-employment income. Over a period of several years, K had harvested and marketed timber from certain tracts of the tree farm and had supervised replanting of the areas where trees were removed. K's history of harvesting, marketing, and replanting of trees showed him to be in the business of tree farming rather than merely passively investing in timber land. If the history of K's tree farm did not show such an active business operation, however, the tree farm would not qualify for special use valuation. In light of all these facts, K is deemed to have materially participated in the farm as his personal involvement amounted to more than managing an investment.

Example (8). Decedent M died on January 1, 1978, owning a farm for which special use valuation under section 2032A has been elected. M owned the farm real property for 15 years before his death. During the 4 years preceding M's death (January 1, 1974 through December 31, 1977), the farm was rented to N, a non-family member, and neither M nor any member of his family materially participated in the farming operation. From January 1, 1970, until December 31, 1973, both M and his daughter, O, materially participated in the farming operation. The material participation requirement of section 2032A(b)(1)(C)(ii) is not satisfied because material participation did not occur for periods aggregating at least 5 different years of the 8 years preceding M's death.

[T.D. 7710, 45 FR 50739, July 31, 1980, as amended by T.D. 7786, 46 FR 43037, Aug. 26, 1981]