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# Benefits Blown Away: Farmers and Ranchers, Wind Energy Leases, and the Estate Tax

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# BENEFITS BLOWN AWAY: FARMERS AND RANCHERS, WIND ENERGY LEASES, AND THE ESTATE TAX

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SUMMARY

*With the ever-increasing desire to produce and use energy from renewable sources, electricity-producing wind turbines have sprung up throughout the country. Since the companies that erect these turbines rarely own the land the turbines are built upon, land must typically be leased from landowners—often farmers and ranchers that own a large amount of open, unobstructed property. These normally long-termed leases, however, may hamper the estate plans of such landowners. A court has recently ruled that the right to payments under leases where the lessor has the right to receive lease payments and right to own the property in fee after the term of the lease are includable in a*

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*decedent's gross estate. Additionally, an executed "wind lease" can interfere with a decedent's personal representative's ability to make an election under section 2032A of the Internal Revenue Code ("IRC"), as the use of leased portions of the property are not likely "qualified" and the value of the decedent's qualified real property in relation to the decedent's total estate is decreased. Additionally, if such election has been made and an heir of the decedent's estate executes a wind lease, the Internal Revenue Service ("IRS") may be able to recapture portions of the tax savings attained through section 2032A. These results are inconsistent with the United States' policy to support agriculture and section 2032A's legislative history that sought to limit or avoid taxing illiquid estates of farmers and ranchers. This Comment recommends a statutory amendment that would, in certain instances, allow the value of a wind lease and the property burdened by such lease to be specially valued, and disallow the IRS to recapture tax savings when a wind lease is executed by an heir of the estate.*

## I. Introduction

Throughout history, man has used the power of the wind to accomplish numerous purposes, such as powering ships, pumping water and more important today, to produce electricity.[1] Generally, production of electricity comes in the form of wind turbines, ranging in size from a small unit on top of one's home to large wind turbines standing eighty meters (262 feet) high with blades around forty meters (131 feet) long.[2] Leasing one's real property to a wind energy company to erect wind turbines is a large endeavor, which has many potential estate tax implications, including an unknowing step into estate tax liability, the inability to specially value farmland or ranchland and recapture of tax savings gained using special valuation.[3]

The recent popularity of harnessing the energy of the wind has come about for many reasons. First, many environmental groups have supported wind energy as an alternative source of energy, as it is renewable and does not release carbon into the air.[4] Second, powerful lobbying by these environmental groups has led to legislation that gives tax credits to companies that put up energy-producing wind turbines and permits the United States Department of Energy to make grants, subsidies and low-interest loans to companies investing in re-

1. Roger A. McEowen, *Wind Energy Production: Legal Issues and Related Liability Concerns for Landowners*, Iowa St. Univ. Ctr. for Agric. Law & Tax'n 1 (June 20, 2011), http://www.calt.iastate.edu/briefs/CALT%20Legal%20Brief%20-%20Wind%20Energy%20Production.pdf.

2. *How Big are Wind Turbines?*, Windustry, http://www.windustry.org/how-big-are-wind-turbines (last visited June 16, 2012); *FAQ-Size*, Nat'l Wind Watch, http://www.wind-watch.org/faq-size.php (last visited June 16, 2012).

3. While erecting small turbines on one's own property may have few legal implications, large turbines and commercial leases are highly complex and may involve many legal issues. As such, this paper will focus on landowners leasing their land to commercial energy companies.

4. Those that have not supported wind energy usually reason that its high cost of production, along with some adverse effects on wildlife, cancel out its benefits.

newable energy development.[5] Naturally, these benefits have caused energy companies to begin exploring options for constructing wind turbines. The main part of this exploration entails finding the large amount of real estate required to place these turbines, and energy companies have two options: (1) purchase land from landowners; or (2) execute leases with landowners to construct wind turbines on the landowner's land.[6] Each has benefits and drawbacks, but since the typical scenario involves leasing land, this Comment will focus exclusively on leases entered into with landowners.

Wind leases, which will be examined in further detail below, are typically lengthy and are offered to the landowners whose land is most suitable for collecting the wind. Developers examine many criteria, including the amount of land available, whether development is prohibited, the ease of connecting to the electricity grid, whether land is subject to conservation easements, and most importantly whether the land is "open."[7] After a thorough examination of these and other characteristics, the energy companies often choose the land of farmers and ranchers as it is often open, unrestricted and unencumbered.[8]

For farmers and ranchers, particularly those with inconsistent production from crops or livestock, receiving a consistent check from an energy company while still being able to utilize a majority of their land is a Godsend. As farmers and ranchers can attest, the selling prices of crops and livestock does not always exceed the costs of production, machinery and operations. Additionally, because of their lack of liquidity, farmers and ranchers may not become conscious of the possibility of estate tax implications that could arise if they already have (or subsequently gain) significant farm assets and execute a lease with a wind energy company. Specifically, the landowner may not realize that executing the lease could bring forth federal estate tax liability because of the increased value of his or her real property due to the value of the right to receive future lease payments.[9] Additionally, while a decision has not yet been rendered, a court is likely to hold that an execution of a wind lease is not a "qualified use" of the property, which is required for special valuation under section 2032A of

5. *Wind Program: Related Financial Opportunities*, U.S. DEP'T OF ENERGY, http://www.eere.energy.gov/wind/related_opportunities.html (last updated Mar. 20, 2012).

6. Charles Owens, *Official Statement: Companies Buy Land for Wind Project*, BLUEFIELD DAILY TEL. (Jan. 23, 2009), http://bdtonline.com/local/x241150099/Official-statement-Companies-buy-land-for-wind-project.

7. Charles Komanoff, *Whither Wind: A Journey Through the Heated Debate over Wind Power*, ORION MAG., (Sept.–Oct. 2006), http://www.orionmagazine.org/index.php/articles/article/178/; Tex. State Energy Conservation Office, Answer to First Question of Frequently Asked Questions, www.INFINITEPOWER.ORG, http://www.infinitepower.org/faq.htm#1 (last visited June 16, 2012).

8. Komanoff, *supra* note 7.

9. *See* McEowen, *supra* note 1, at 12–13; Judon Fambrough, *Against the Wind*, REAL ESTATE CTR. TEX. A&M UNIV., (Oct. 2008), http://recenter.tamu.edu/pdf/1878.pdf.

the Internal Revenue Code ("section 2032A"), since it is not a traditional farming activity. Finally, while this matter has also not been decided, a court would likely hold that if a decedent's executor properly elects section 2032A, but an heir subsequently executes a wind lease on a portion of the property, the IRS would be able to recapture the tax savings gained using the special valuation on the leased property. As such, a wind lease may actually reverse the effects of the special valuation, as not only is the value of lease ineligible for special valuation, but the lease may also increase the value of land and render the land ineligible to receive special valuation.

This Comment will begin by discussing wind leases, to provide a foundation for the length, rental value, and various other aspects that have bearing on estate valuation. Next, it will provide some basic information on the federal estate tax, and most importantly, section 2032A. It will then discuss the estate tax implications of landowners executing wind leases prior to death, including both the possibility of estate tax liability and limitation on ability to make a section 2032A election, as well as the potential for estate tax recapture if the beneficiary of an estate whose executor has made a section 2032A election decides to execute a wind energy lease. Finally, it will discuss why these results are not only inequitable, but also contrary to legislative history, and will make suggestions on how the IRC could be changed.

## II. Wind Energy Leases and Effects on Property Value[10]

Wind energy leases vary greatly in length, monetary value and burdens to landowners. There are typically two components of wind leases: the initial lease and the actual, or production, lease.[11] The initial part of most leases is a short-term, low-cost (around \$2–\$10 per acre) lease that merely secures the company's right to develop, should it desire to do so, and prohibits other companies from developing the landowner's land.[12] More importantly, it allows the energy company to test the landowner's land for suitability for wind turbines.[13] The second lease, which is called the actual or production lease, has much more legal significance than the initial lease.[14] It only arises if the company exercises its rights under the initial lease to develop the land,

10. This is a very cursory discussion of wind leases and includes only portions relevant to the topic of this paper. Leases vary from company to company, and entail many other details, including but not limited to responsibility for removal of the turbines at the expiration of the lease, liability for damage caused by the turbines, renewal clauses, and unilateral ability of the energy company to use more land for required improvements related to the turbines.

11. Dwight Aakre & Ron Haugen, N.D. State Univ. Extension Serv., Wind Turbine Lease Considerations for Landowners 2 (2009), *available at* http://www.ag.ndsu.edu/pubs/agecon/market/ec1394.pdf.

12. *Id.*; *see* Fambrough, *supra* note 9.

13. *See* Fambrough, *supra* note 9.

14. *See* Aakre & Haugen, *supra* note 11, at 2.

and should have provisions that govern the period of time, construction, maintenance, rent costs, royalties paid, and other aspects of having the wind turbine and related improvements on the landowner's land.[15] In this Comment, "lease" refers to the actual or production lease.

When attempting to place a value on a wind lease, one of the most important aspects of the lease contract is its term, as it governs the amount of time the landowner will be entitled to receive lease payments. Because of the large costs associated with erecting a wind turbine, the energy companies need to ensure that lease periods last for as long as possible.[16] As such, the average wind lease is for a term of approximately thirty-five years, but can range from twenty to one hundred and fifty years and may include an option for the energy company to renew or renegotiate the lease upon its expiration.[17] To put a damper on excessively long lease terms, however, at least one state has statutorily placed a limit on the duration of such leases.[18]

An equally important aspect of wind leases is the compensation scheme, which is usually in the form of royalty payments, fixed rental payments, or other types of payments. While compensation terms can vary greatly, the most common scheme involves the energy company making royalty payments to the landowner based on performance of the turbines and fluctuations in the market.[19] A guaranteed minimum payment to the landowner is sometimes included in this structure to ensure that the landowner will receive at least some compensation for the encumbrance on his or her property.[20] A second scheme is a flat-fee or fixed-fee agreement, whereby the energy company, regardless of performance, prices or revenue, pays the landowner a set amount per turbine, per unit of power that the turbines have the capacity to produce (often measured in megawatts) or per unit of land with wind turbines installed (often measured in acres).[21] A third scheme pro-

15. *Id.* at 2–3.

16. *See id.* at 2; RODERICK E. WETSEL ET AL., 2007 WIND ENERGY INST., UNIV. OF TEX. SCH. OF LAW, CURRENT ISSUES IN TEXAS WIND ENERGY LAW 2007: LEASES, OWNERSHIP OF WIND RIGHTS AND LITIGATION 2 (2007), *available at* http://www.utcle.org/eLibrary/preview.php?asset_file_id=10312.

17. WETSEL ET AL., *supra* note 16, at 15–16; s*ee also* Aakre & Haugen, *supra* note 11, at 2; *Leasing to a Developer*, WINDUSTRY, http://www.windustry.org/leases (last visited June 16, 2012).

18. *See, e.g.*, S.D. Codified Laws § 43-13-19 (2004) (limiting to fifty years the maximum number of years that wind energy rights may be leased).

19. K. PARADY ET AL., WILLIAM D. RUCKELSHAUS INST. OF ENV'T & NATURAL RES., UNIV. OF WYO., COMMERCIAL WIND ENERGY DEVELOPMENT IN WYOMING: A GUIDE FOR LANDOWNERS 8 (2009), *available at* http://www.conservationtaxcenter.org/plnlo/windenergydevelopmentinwyoming.pdf.

20. *Id.* at 7–8; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-04-756, *Renewable Energy: Wind Power's Contribution to Electric Power Generation and Impact on Farms and Rural Communities 35–36 (2004)* [hereinafter RENEWABLE ENERGY REPORT], *available at* http://www.gao.gov/new.items/d04756.pdf.

21. PARADY ET AL., *supra* note 19, at 7–8.

vides the landowner both a royalty payment and a fixed fee, combining both of the previously mentioned concepts.[22] A fourth scheme, which is relatively uncommon, is a lump-sum payment method in which the energy company makes a one-time payment to the landowner in exchange for his agreement to the lease, but does not make any subsequent payments to the landowner.[23]

Like other aspects of wind leases, the amount paid to the landowner varies greatly and depends on the amount of wind turbines, capacity of wind turbines, land and prices of electricity. The United States Government Accountability Office has found that, generally, a "farmer who leases land for a wind project can expect to receive $2,000 to $6,000 per turbine per year in lease payments."[24] Many sources, however, report that royalty payments to landowners average about 4% (typically between 2% and 6%) of the energy company's gross revenues from the turbines on the landowner's property.[25] While prices vary greatly, at the time of this writing, a consumer in Fort Worth, Texas could purchase electricity produced entirely by wind turbines for between $88.00 and $110.00 per megawatt.[26] If a turbine with a one-megawatt capacity ran continuously for one year, it would produce 8,760 megawatts of electricity. Assuming a landowner was entitled to 4% of gross income royalties at a price of $100.00 per megawatt, that landowner would receive approximately $35,040 per year in royalty payments. Usually, however, turbines run at only 20% to 45% of their stated capacity, with an average of just under 27%.[27] Using that average, a one-megawatt turbine would produce 6.456 megawatts per day or 2,356.44 megawatts per year. Assuming that the energy company sells each megawatt for $100.00 and that no changes in price occur, the turbine would produce gross revenues of approximately $235,600. Assuming gross revenues of $235,600, a landowner entitled to 4% in royalties would earn approximately $9,425.76 in yearly lease payments for that turbine.

The burden placed on the landowner's property is another important factor when evaluating the change of the property's value. While a turbine itself may only require around 100 square feet, wind leases will almost certainly include provisions for substations, power lines,

22. *See id.*; RENEWABLE ENERGY REPORT, supra *note 20, at 40.*

23. PARADY ET AL., *supra* note 19, at 7–8.

24. See RENEWABLE ENERGY REPORT, supra *note 20, at 6.*

25. WETSEL ET AL., *supra* note 16, at 7–8; *see also* Aakre & Haugen, *supra* note 11, at 3.

26. *Available Offers*, TEX. ELECTRIC CHOICE, http://powertochoose.org/_content/_compare/compare.aspx (enter the numbers 76102 in the box for "Search By Zip Code" and click submit; then click on the down arrow next to "Renewable Content" to open the drag down menu; then click "Only 100%"; then click "Submit") (last visited June 16, 2012).

27. *See* NAT'L WIND WATCH, *supra* note 2; AM. WIND ENERGY ASS'N, WIND HANDBOOK FOR ELECTRIC COOPERATIVES 21 (2009), *available at* http://www.awea.org/learnabout/utility/upload/windhandbook_edit3.pdf.

roads and other pieces of equipment, as required.[28] While each lease and situation will require different amounts of land to be burdened by these things, sources estimate each turbine can burden up to one-half acre of land.[29] While the amount of burdened land is relatively small, each turbine takes a significantly larger amount of land and space to effectively "capture" the wind. An extensive study by the United States Government in 2009 found that because of the interference in the patterns of the wind and the spacing required, it takes an average of around eighty-five acres of land to produce one megawatt of electricity.[30] Since there are 640 acres per square mile, this equates to only seven one-megawatt turbines per square mile. Although the amount of land required is significant, studies have shown that the yearly increase in income of land subject to a wind lease averages $70 per acre.[31] However, examining the example described in the previous paragraph (which calculated approximately $9,425.76 in yearly royalties) and assuming eighty-seven acres per one-megawatt turbine, the increase in yearly income would be approximately $108.34 per acre.

In addition to the physical burdens, there are intangible burdens that accompany placing wind turbines on one's property. Not only are the turbines large and imposing, the blades and generator produce a constant noise, electromagnetic fields can potentially cause electric shock and disrupt wireless service and spinning blades have been known to kill bats and birds.[32] The turbines can also cause damage to property below the turbine, as equipment malfunctions may cause

28. *Frequently Asked Questions*, WIND ENERGY AM., http://www.windenergy america.com/faqs.html; *see also* TEX. COMPTROLLER OF PUB. ACCOUNTS, THE ENERGY REPORT 164 (2008), *available at* http://www.window.state.tx.us/specialrpt/energy/pdf/96-1266EnergyReport.pdf.

29. *How Will Wind Turbines Affect My Farm? How Much Space Will They Take Up?*, WINDUSTRY, http://www.windustry.org/how-will-wind-turbines-affect-my-farm-how-much-space-will-they-take-up (last visited June 16, 2012); *Farming the Wind: Wind Power and Agriculture*, UNION CONCERNED SCIENTISTS, http://www.ucsusa.org/clean_energy/technology_and_impacts/impacts/farming-the-wind-wind-power.html (last visited June 16, 2012).

30. *Areas of Industrial Wind Facilities*, AWEO.ORG, http://www.aweo.org/windarea.html (last visited June 16, 2011); *see also* PAUL DENHOLM ET AL., NAT'L RENEWABLE ENERGY LAB., NREL/TP-6A2-45834, LAND-USE REQUIREMENTS OF MODERN WIND POWER PLANTS IN THE UNITED STATES 26–39 (2009), *available at* http://www.nrel.gov/docs/fy09osti/45834.pdf (determining that, based on an area's geographical terrain, producing one megawatt of power could require as little as fourteen acres or as many as 307 acres); *Wind 101: Frequently Asked Questions About Wind*, UTAH CLEAN ENERGY, http://utahcleanenergy.org/clean_energy_101/wind_101 (last visited June 16, 2012) (finding that, in Utah, between ten and twenty megawatts could be produced per square mile, equal to sixty-four acres for each one to two megawatts produced).

31. U.S. Dep't of Energy, *Electricity from the Wind: What Landowners Should Know*, WIND POWERING AM., http://www.windpoweringamerica.gov/docs/what_landowners_should_know.doc (last updated May 23, 2012).

32. *See* Aakre & Haugen, *supra* note 11, at 5; McEowen, *supra* note 1, at 9.

blades to break off of the turbine and in cold climates, ice can build on the blades causing the blade, ice, or both to fall to the ground.[33]

These burdens are particularly relevant in determining the actual extent of the change in land value after a wind turbine is placed on the property. Unsurprisingly, there will be a diminution in the value of the leased property due to the transfer of the right to occupy a portion of the property and due to the aesthetic damage.[34] A widely-cited appraisal completed in 2007 by the Gardner Appraisal Group found that property burdened by wind turbines pursuant to a lease is subject to a decrease in value of 29% to 45%, with an average of 37%.[35] Another commentator further observed that "many of the agreements are quite restrictive . . . [A] willing buyer would take all of those factors into consideration when determining what price to pay for the property."[36] Indeed, in Illinois, tax assessed value on farmland near wind turbines has decreased from 22% to 30%.[37]

Any diminution in value, however, may be outweighed by the long-term right to the payments that come with executing a wind lease. Similar to a landowner's ability to sever his or her mineral rights, a landowner is permitted to grant or retain the rights to lease payments upon the subsequent sale of the leased property, absent a contrary provision in the lease.[38] As one may expect (and at least one commentator has pointed out), if the right to receive royalty payments is granted to the purchaser in such sales, the value of the real estate may be enhanced.[39]

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33. Aakre & Haugen, *supra* note 11, at 5. Liability for damage caused by wind turbines is typically addressed in the lease and usually falls on the energy company. *See also* McEowen, *supra* note 1, at 8–9. Regardless of where the liability falls, however, a landowner should consider the fact that the turbines may cause damage and that he or she could end up in litigation to determine liability. *See id.*

34. *See* McEowen, *supra* note 1, at 12; PowerPoint: Derry T. Gardner, Presentation, *Impact of Wind Turbines on Market Value of Texas Rural Land* at the S. Plains Agric. Wind & Wildlife Conf. (Feb. 13, 2009), *available at* http://docs.wind-watch.org/gardner_wind-property-values_2_13_09.pdf.

35. *See* Gardner, *supra* note 34.

36. *See* McEowen, *supra* note 1, at 12.

37. *Id.*

38. See *Examples of Wind Easements and Land Leases*, INDUS. WIND ACTION GRP. (April 8, 2006), http://www.windaction.org/documents/2435, for a list of sample wind leases.

39. *See* Jay Haley, *Landowners' Frequently Asked Questions About Wind Development*, WIND POWERING AM., http://www.windpoweringamerica.gov/pdfs/wpa/34600_landowners_faq.pdf (last visited June 16, 2012); *see also* John S. Baen, Rural/Urban Energy Farms: Onsite Alternative Energy Production from Wind Rights, and Geothermal and Mineral Rights as Value Added or Potential Cash Flow Sources 4, 10–13 (Apr. 14, 2007) (unpublished manuscript) (on file with author), *available at* http://www.cob.unt.edu/firel/baen/Wind,%20Geothermal,%20Mineral%20Rights%20Paper%20with%20Exhibits.pdf.


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## III. The Federal Estate Tax

The federal estate tax was initially created as part of the Revenue Act of 1916, and imposes a tax on certain "transfer[s] of wealth from an estate to its beneficiaries."[40] The estate tax was established, in part, to replace the revenue lost when the inheritance tax was repealed.[41] A secondary purpose of this tax, however, was to attempt to break up the wealth and power that may accumulate around wealthy family dynasties.[42]

During its ninety-five years of existence, the estate tax has undergone various changes in its rate scheme, exemption amount, exclusion amount and unified credit amount.[43] Its most recent variation was enacted as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.[44] This Act temporarily lowered the maximum rate to 35% and increased the unified credit exemption to $5,000,000.[45] This taxpayer-friendly structure is set to expire on December 31, 2012, and if no legislation is passed to re-delineate the estate tax, rates will revert to the structure as it existed prior to the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001: a $1,000,000 unified credit exemption equivalent and a graduated rate structure with a maximum tax rate of 55%.[46]

Determining which property is to be included in a decedent's gross estate can be a complex process, so this Comment will describe only the basics of the gross estate. The estate tax is imposed on the taxable

40. Darien B. Jacobson et al., *The Estate Tax: Ninety Years and Counting*, 27 STATS. INCOME BULL., no. 1, 2007, at 118, 120; *see also* Revenue Act of 1916, ch. 463, §§ 200–212, 39 Stat. 756, 777–80 ("A tax . . . hereby imposed upon the transfer of the net estate of every decedent dying after the passage of this Act.").

41. Jacobson et al., *supra* note 40, at 120. The estate tax levies the tax against the decedent's estate, rather than the beneficiaries of the estate, as the inheritance tax had done. *Id.*

42. *See id.*

43. *Id.* at 120–24.

44. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (codified as amended in scattered sections of 26 U.S.C.).

45. *Id.* § 302(a)(1), 124 Stat. at 3301. The $5,000,000 exclusion amount applies to lifetime gifts that exceed a statutorily set exclusion amount found in I.R.C. § 2010 (Supp. V 2011), as well as to the value of the decedent's estate at his or her death. Practically, this means that a single taxpayer dying in 2011 or 2012 will only be liable for estate tax to the extent that his or her gross estate *and* total lifetime gifts—over the annual statutorily set exclusion amount—exceed $5,000,000. *See id.* This $5,000,000 unified exclusion amount is adjusted according to inflation for years after 2011. *Id.* § 2010(c)(3)(B). For estates of decedents who pass away in 2012, the unified credit exclusion amount is $5,120,000. Rev. Proc. 2011-52, 2011-45 I.R.B. 701 (2011). However, for purposes of simplicity, an exclusion amount of $5,000,000 will be presumed for all examples and hypotheticals discussed in this Comment.

46. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (amended 2010); *see also* Susan A. Berson, *Implementing the Estate and Gift Tax Changes Before 2013's Sunset*, 80 J. KAN. B. ASS'N 24, 27 (2011).

estate of a decedent, which is defined as the gross estate minus deductions.[47] The gross estate of the decedent includes "the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."[48] While an examination of the permissible deductions is beyond the scope of this Comment, the typical deductions from the gross estate include the marital deduction for amounts passing to the decedent's spouse, the charitable deduction for amounts passing to charitable organizations, and the deductions for estate administration expenses and debts of the decedent.

Of course, the value of a decedent's gross estate is heavily dependent on the method of valuation—both the time at which the assets are valued and the means by which a value is given to those assets. While a later valuation date is available under certain circumstances, the point at which the assets are typically valued for estate tax purposes is the date of the decedent's death.[49] Determining the numerical value of an asset depends on its classification, but fair market value is the default standard of valuation and is the standard for valuations of real property.[50] Treasury Regulations define fair market value 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 to sell and both having reasonable knowledge of relevant facts."[51]

When determining the value of real property for estate tax purposes, case law has indicated that leased-fee interests must be taken into account.[52] A leased-fee interest exists where the "owner of commercial or income-producing property has the right to receive the actual contract rent that the property is generating over the remaining terms of the outstanding leases on the property. . ."[53] In *Estate of*

47. I.R.C. § 2051 (2006).

48. I.R.C. § 2031(a) (2006).

49. *Compare* I.R.C. § 2023 (Supp. V 2011) (explaining that an executor can, if certain requirements are met, elect an alternate valuation date), *with* I.R.C. § 2031(a) (Supp. V 2011) (explaining that the valuation date of the gross estate is "at the time of [decedent's] death . . . .").

50. 26 C.F.R. § 20.2031-1(b) (2011); *see also* Rushton v. Comm'r, 498 F.2d 88, 89 (5th Cir. 1974) ("When any property is assessed for the purpose of imposing a federal tax—whether income, gift, or estate—the dollar amount assigned to it rests, at least theoretically, on the notion of fair market value." (citing Champion v. Comm'r, 303 F.2d 887 (5th Cir. 1962))).

51. § 20.2031-1(b); *see also* H.R. REP. NO. 94-1380, at 20–22 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3356, 3375 (noting that one of the most important factors in determining fair market value is "the highest and best use to which the property can be put"). *Cf.* Martin D. Begleiter, *Material Participation Under Section 2032A: It Didn't Save the Family Farm but It Sure Got Me Tenure*, 94 DICK. L. REV. 561, 564 (1989) (stating that if certain requirements are met, "real property used in a farm for farming purposes is valued for estate tax purposes at its value as a farm or business.").

52. *See, e.g.*, Estate of Mitchell v. Comm'r, 101 T.C.M. (CCH) 1435, 1438–39 (2011).

53. Marks v. Comm'r, 49 T.C.M. (CCH) 1222, 1224 (1985).

*Mitchell v. Comm'r*, the decedent owned residential rental property, among other things, but passed away before one of the leases had ended.[54] The lease gave the tenant the ability to renew the lease for approximately twenty years after the date of the decedent's death.[55] In determining the value of the property subject to the lease, the tax court valued the real property by adding the value of the landlord's reversionary interest in the property (taking into account the length of the lease and other factors affecting value) to the adjusted value of the lease payments he was owed.[56] While neither the IRS nor case law has provided any guidance on whether the value of real property leased to a wind energy company should be increased because of projected leased-fee income or decreased for the burdens such lease imposes on the property, the IRS could quite easily argue that the right to receive wind lease payments for years into the future is an enhancement to value.[57] Indeed, a future stream of revenue from a wind lease is arguably much more quantifiable than is the aesthetic burden accompanying the presence of wind turbines.

Taking the estate tax as currently in effect (and assuming no estate planning has occurred), a farmer who died owning 2,000 acres of farm land, a house, various improvements associated with the farm, livestock and machinery used for farming purposes would be required to include the fair market value of all of such assets in his or her gross estate. Unsuspecting farmers and ranchers, who often have appreciated real property in their estates, could easily have the misfortune of incurring unanticipated estate tax liability, particularly during spikes in the real estate market. Further, since the court in *Estate of Mitchell* treated a leased-fee interest in real property as having an enhanced value, a farmer or rancher who has executed a long-term wind lease should be aware that his or her executor may have to pay estate tax out of the assets of the estate.[58]

## IV. IRC Section 2032A

### A. *Introduction to Section 2032A*

In response to outcries from farmers and ranchers who were forced to liquidate portions of their farms and ranches to pay federal estate tax, Congress passed the Tax Reform Act of 1976, part of which was codified as IRC section 2032A.[59] Section 2032A is a powerful statute that allows executors of decedent's estates to elect to take a "special use valuation" of the decedent's real property, if certain conditions

54. *Estate of Mitchell*, 101 T.C.M. (CCH) at 1436–37.
55. *Id.* at 1437.
56. *Id.* at 1439–40.
57. *See* McEowen, *supra* note 1, at 12.
58. *Estate of Mitchell*, 101 T.C.M. (CCH) at 1439.
59. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003, 90 Stat. 1520, 1856–62 (codified as amended at I.R.C. § 2032A (2006)).

are met.[60] This special use valuation allows the executor to value land at a reduced amount, rather than valuing the land at its fair market value,[61] for purposes of reducing estate tax liability.

The requirements of section 2032A, some of which are described at length below, are quite extensive. First, the decedent must have been a citizen or resident of the United States[62] and the property for which the special valuation is sought to be applied to must be located in the United States.[63] Second, the property must be passed to one or more "qualified heirs" of the decedent.[64] Third, all heirs having any interest in the property must agree in writing[65] to the executor's decision to make a section 2032A election.[66] Fourth, at least one-half of the value of the decedent's gross estate must consist of real or personal property used for a "qualified use" by the decedent or his family and be passed from the decedent to a qualified heir.[67] Fifth, at least one-fourth of the decedent's gross estate must consist of real property that is granted to a qualified heir by the decedent, and for at least five out of eight years ending on the date of the decedent's death, such property must be owned by, put to a qualified use by, and materially participated in by the decedent or a member of the decedent's family.[68] Sixth, only real property that is put to a "qualified use" and materially participated in by the decedent or a member of the decedent's family for at least five out of eight years ending on the date of the decedent's death is entitled to special use valuation.[69] Finally, once the qualified heir or heirs receive the qualified property, they must continue to own the property and use it for a qualified manner for a period of ten years starting at the date of the decedent's death.[70]

### B. *"Qualified Use"*

The policy underlying IRC section 2032A is to save farms, ranches and other small businesses from having to liquidate assets to pay estate tax.[71] To ensure that the valuation was not given to undeserving

60. *See* I.R.C. § 2032A (2006).
61. LeFever v. Comm'r, 100 F.3d 778, 782 (10th Cir. 1996) (holding that, for purposes of real estate, fair market value is to be used to determine the property's highest and best use (citing Whalen v. United States, 826 F.2d 668, 669 (7th Cir. 1987))).
62. *Id.* § 2032A(a)(1)(A).
63. *Id.* § 2032A(b)(1).
64. *Id.* § 2032A(b)(1)(A)(ii); *see generally id.* § 2032A(e)(1)–(2) (defining the term "qualified heir" as a "member of the family" which includes such individuals as ancestors, parents, and the surviving spouse, as well as lineal descendants of the decedent, spouse, or parent and their spouses).
65. *Id.* § 2032A(a)(1)(B).
66. *Id.* § 2032A(d)(2).
67. *Id.* § 2032A(b)(1)(A).
68. *Id.* § 2032A(b)(1)(B)-(C).
69. *Id.* § 2032A(b)(1)(C).
70. *Id.* § 2032A(c)(1)(A)–(B).
71. *See supra* note 56 and accompanying text.

taxpayers, requirements were set in place to ensure that landowners and the beneficiaries of their estates use the land in a manner consistent with Congress's intent.[72] Collectively, these requirements are known as "qualified use."[73]

Qualified use is broadly defined as devoting the property to "use as a farm for farming purposes"[74] or using the property "in a trade or business other than the trade or business of farming."[75] "Farm" includes stock, ranches, dairy, and "other structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands."[76] "Farming purposes" centers around using the farm as an ordinary farmer would, including "cultivating the soil or raising or harvesting any agricultural or horticultural commodity . . . and handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity . . . but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity."[77]

Although the determination of whether a use is qualified might not appear to be difficult, it is not always such a bright-line determination. Specifically problematic are situations where a decedent's qualified heirs lease the specially-valued real property to an unrelated third party.[78] When deciding if the use is qualified (and ultimately determining if leased property is to retain its qualified status), courts examine the lessee's identity and the terms of the lease.[79] Particularly, courts look to and apply the legislative intent of section 2032A, which states that, "during any period when the decedent leases the real property to a *nonfamily member* for use in a qualified use pursuant to a lease *under which the rental is not substantially dependent upon production*, the qualified use requirement is not satisfied."[80] As such, the qualified use requirement is not met if the real property is passively

72. Estate of McAlpine v. Comm'r, 96 T.C. 134, 139–40 (1991), *aff'd*, 968 F.2d 459 (5th Cir. 1992).

73. *See generally* § 2032A(b)(1)(C)(i) (requiring the subject real property to have been "owned by the decedent or a member of the decedent's family and used for a qualified use . . ."); *id.* § 2032A(b)(2) (defining the term "qualified use").

74. *Id.* § 2032A(b)(2)(A).

75. *Id.* § 2032A(b)(2)(B).

76. *Id.* § 2032A(e)(4).

77. *Id.* § 2032A(e)(5)(A)–(B).

78. *See* H.R. Rep. No. 94-1380, at 23 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3356, 3377 (stating that it was the intent of the drafters that qualifying real property be used for trade or business and that "mere passive rental of property" does not qualify as either).

79. *See, e.g.*, Schuneman v. United States, 783 F.2d 694 (7th Cir. 1986).

80. S. Rep. No. 97-144, at 133 (1981), *reprinted in* 1981 U.S.C.C.A.N. 105, 234 (emphasis added). *See* Schuneman, 783 F.2d at 698 (7th Cir. 1986); *see also* Estate of Gavin v. United States, 113 F.3d 802, 806–07 (8th Cir. 1997).

rented to a nonfamily member, unless the rental payments are substantially dependent upon production.[81]

A related determination for qualified use is whether the decedent or his qualified heirs were actively involved in the management of the property.[82] In *Martin v. Comm'r*, the landowner, whose land was primarily used for growing crops, entered into a sharecropping agreement with a qualified heir prior to his death.[83] After the landowner died, however, his personal representative terminated the agreement and executed a flat-rate lease with a commercial farming company.[84] The court held that even though the farm was used for farming purposes both before and after the decedent's death, the qualified use must be continued by the qualified heir, or the qualified heir must at least have a financial stake in the outcome of the production of the land.[85] Accordingly, because the heir executed the flat-rate lease (also known as a cash lease) of the property, he was merely a passive investor and was not a qualified user.[86]

To ensure that there is continuity with the qualified use, subsection 2032A(b)(1)(c) also requires that "during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more" that the decedent or a member of the decedent's family put the land to a qualified use.[87] In addition, if "during any period of eight years ending after the date of the decedent's death and before the date of the death of the qualified heir, there had been periods aggregating more than 3 years during which" the decedent or a member of his family (before the decedent's death) or the qualified heir or a member of his family (after the decedent's death) failed to materially participate in the operation of the farm or other business, the requirements for continuation of a qualified use have not been met.[88] In other words, the decedent or a member of his family must not only use the land in a qualified manner for five out of last eight years of the decedent's life, but also the qualified heir must use the property in a qualified manner for five out of eight years after the

81. *See* H.R. REP. NO. 94-1380, at 23 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3356, 3377.

82. *See, e.g.*, LeFever v. Comm'r, 100 F.3d 778, 782 (10th Cir. 1996) (holding that the decedent or member of the decedent's family must have "materially participate[d] in putting the property to a qualifying use" (citing Estate of Sherrod v. Comm'r, 774 F.2d 1057, 1062–64 (11th Cir. 1985))).

83. 783 F.2d 81, 82 (7th Cir. 1986). Under this sharecropping agreement, both the landlord and the tenant took a portion of the profits, which depended on the production of the land. *See id.*

84. *Id.*

85. *Id.* at 84.

86. *Id.* at 83–84. *See generally* Burton Pflueger, *Crop Cash Lease Agreements*, EXTENSION EXTRA (S.D. St. Univ. Sch. Agric. & Biol. Scis., Brookings, S.D.), no. 5063, 2007, at 1, *available at* http://pubstorage.sdstate.edu/AgBio_Publications/articles/ExEx5063.pdf, for a discussion on cash leases.

87. I.R.C. § 2032A(b)(1)(C) (2006).

88. *Id.* § 2032A(c)(6)(B); *see also* Begleiter, *supra* note 51, at 564–65.

decedent's death. Finally, if a qualified heir disposes of any interest in the qualified real property or "ceases to use for the qualified use the qualified real property which was acquired (or passed) from the decedent," within ten years from the date of the decedent's death, there has been a failure to use the land for a qualified use.[89]

While the IRC, Treasury Regulations and case law do not expressly state that executing a wind lease that burdens otherwise qualified real property is not a qualified use, legislative history, and administrative guidance discuss leases of mineral interests, a similar arrangement.[90] When a mineral lease exists between an energy company and the decedent at the time of his death, not only is the remaining value of the mineral lease to be included in a decedent's gross estate, but also such a lease is not entitled to receive special valuation, since it is not functionally related to the qualified use.[91]

Based on the estate tax treatment of mineral leases, it is unlikely that the IRS will take the position that a cash lease of property to a wind energy company is a qualified use of the property, due to the farming purposes requirement. As such, the property that is burdened by the lease and the present value of future payments under the lease have no real legal basis under which to be specially valued.[92] However, even in the unlikely event that the IRS viewed wind leases as falling within the "farming purposes" requirement and therefore allowed them to be considered for special valuation, some individual leases may create their own problems.[93] As previously noted, where farm land that has been leased to an unrelated third party and the lease payments are not substantially dependant on production, the IRS has expressly denied qualified status.[94] Under that same reasoning, a flat fee lease would likely not fall within the requirements of qualified use. While still unlikely falling outside the realm of farming

89. I.R.C. § 2032A(c)(1).

90. *See* H.R. Rep. No. 94-1380, at 24 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3356, 3378; *see also* Rev. Rul. 88-78, 1988-2 C.B. 330.

91. H.R. Rep. No. 94-1380, at 24. The Committee on Ways and Means stated in this house report that "elements of value which are not related to the farm or business use (*such as mineral rights*) are not to be eligible for special use valuation." *Id.* (emphasis added). Case law illustrates that the remaining value of mineral leases must be included when valuing a decedent's gross estate. *See, e.g.*, Estate of Livermore v. Comm'r, 56 T.C.M. (CCH) 525 (1988); Estate of Wolfe v. Comm'r, 13 T.C.M. (CCH) 22 (1954).

92. *See supra* Part II (discussing how wind leases may be construed as cash leases, which are not substantially dependent upon production of the turbines).

93. This Comment is not advancing the prospect that the IRS may consider a wind lease with a commercial energy company as a farming purpose. While a small-scale, individually owned and maintained wind turbine, used to provide electricity to a farm or ranch, could be considered "related to the farm or business," it is highly unlikely that the IRS or any court will find such a relationship when examining a commercial lease.

94. *See, e.g.*, Schuneman v. United States, 783 F.2d 694, 698 (7th Cir. 1986); Estate of Gavin v. United States, 113 F.3d 802, 806–07 (8th Cir. 1997).

purposes, leases that pay royalties based on wind production or revenues, on the other hand, have a stronger argument against the landowner being merely a "passive investor," since the payments depend upon the production of the wind turbine.

### C. *"Qualified Real Property"*

Another one of the requirements for the property to receive special use valuation is that at least 50% of the decedent's property be "qualified real property."[95] Labeling a piece of property as "qualified" is important primarily for two reasons. First, if property is qualified, the value of such property may be put toward the 50% requirement of section 2032A.[96] Second, only property labeled as qualified real property is entitled to special use valuation.[97] While the basic requirements of qualified real property are defined in section 2032A, they are expanded upon in its subsections, Treasury Regulations, legislative history of the statute, and case law.

The key to determining whether an asset may be counted toward the 50% requirement and receive special valuation is whether it is functionally related to the qualified use (for purposes of this Comment, the farm or ranch). While subsection 2032A(b)(1) includes only real property when defining qualified real property,[98] subsection 2032A(e)(3) states that residential buildings occupied on a regular basis by the landowner or lessee "for the purpose of operating or maintaining such real property, and roads, buildings, and other structures and improvements *functionally related* to the qualified use shall be treated as real property devoted to the qualified use," may be considered qualified real property.[99] The legislative history of section 2032A draws a line at what does not constitute qualified real property by noting that "elements of value which are not related to the farm or business use. . .are not to be eligible for special use valuation."[100] The legislative history also provides a helpful example of elements of value which are unrelated to the qualified use, as well as how to account for them for estate tax purposes:

> "[I]f there is an oil lease on a farm, the full value of the mineral rights is to be taken into account for estate tax purposes. Similarly, if there are buildings or other improvements on (or contiguous with) the farm that are not *functionally related* to the farm and do not qualify as a farmhouse and related improvements, these build-

95. I.R.C. § 2032A(b)(1) (2006).
96. *Id.* § 2032A(b)(1)(A).
97. *Id.* § 2032A(a)(1); Bradley Holtorf, Comment, *An Analysis of the "Actual Use" Valuation Procedure of Section 2032A*, 56 NEB. L. REV. 860, 865 (1977).
98. I.R.C. § 2032A(b)(1).
99. *Id.* § 2032A(e)(3) (emphasis added).
100. H.R. REP. NO. 94-1380, at 24 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3356, 3378.

ings and other improvements are not treated as qualified farm real property."[101]

The functional relationship requirement was at issue in *Estate of Sherrod v. Comm'r*, where a decedent had an ownership interest in three separate tracts of land that were used for farming, grazing and growing timber.[102] The majority of one tract was used for growing timber, but a small portion was not put to any use and was not used to help the landowner grow timber on the larger portion.[103] The court held that even though there was no division in the tract, the unused portion did not qualify for special use valuation since there was no functional relationship between leaving the smaller portion barren and growing timber on the larger.[104]

The functional relationship test is particularly relevant in estates where the deceased landowner had entered into a wind lease prior to his or her death, since the lease has likely granted away the rights to use portions of his land. As such, the executor of the decedent's estate must be aware that portions of the estate's real property (the property subject to the lease) will almost certainly not be permitted to count toward the 50% requirement of section 2032A and that even if all of the other requirements under section 2032A are met, the leased portions of the decedent's real property will not be permitted to receive special valuation. Additionally, since the right to future payments under the lease is an "element of value" that is also unlikely to be found to be functionally related to the qualified use, it will not likely be eligible to receive special valuation.

### D. *"Material Participation"*

If the land meets the requirements of qualified real property and is being used in a qualified manner, the decedent or his family must also "materially participate" in the qualified use for five out of the eight years prior to the decedent's death to achieve special valuation.[105] Not to be confused with putting the land to a qualified use, material participation centers on both the decedent and the qualified heirs being actively involved in the management of the property.[106] In order for a decedent's personal representative to a make a section 2032A election, the decedent must have materially participated in the qualified use,[107] and in addition, if special valuation is permitted but the

101. *Id.* (emphasis added).
102. 774 F.2d 1057, 1058–59 (11th Cir. 1985).
103. *Id.* at 1060.
104. *Id.* at 1066–67.
105. I.R.C. § 2032A(b)(1)(C)(ii) (2006).
106. 26 C.F.R. § 20.2032A-3(e)(1) to -3(e)(2) (2011).
107. I.R.C. § 2032A(b)(1)(C) (2006).

decedent's qualified heirs fail to materially participate in the qualified use, the IRS can recapture the tax savings.[108]

Under subsection 2032A(e)(6), material participation is to be determined in a manner similar to that of section 1402(a),[109] which deals with determining taxable income from self-employment.[110] Section 1402(a) provides that rental income of the owner/landlord of real property is excluded from self-employment income unless there is an agreement with the tenant that the landlord is to materially participate in the "production" or "management of the production" of income from the property and the parties subsequently perform upon such agreement.[111]

The regulations interpreting section 1402(a) expand on what is required to materially participate in the production or management of the production.[112] Production is composed of two major elements: physical work and the furnishing of resources required for production.[113] Physical work, which includes the actual work of planting, cultivating and harvesting crops, creates a strong showing of material participation.[114] Furnishing of resources, while not itself enough to constitute material participation, may become an important factor when the physical work performed does not rise to the requisite level."[115] Management of production "refer[s] to the responsibility for and the actual making of decisions, and other activities affecting the production of a commodity."[116] Particularly important is making regular inspections of the production activities, advising and consulting with the tenant, which together create a "strong inference" of material participation.[117] Treasury Regulations and case law describe finding material participation as a:

> "[F]actual 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."[118]

108. *Id.* § 2032A (c)(1).
109. *Id.* § 2032A (e)(6).
110. *See* I.R.C. § 1402(a) (2006).
111. *Id.* § 1402(a)(1); *see also* Begleiter, *supra* note 51, at 566.
112. *See, e.g.*, 26 C.F.R. § 1.1402(a)-4(b) (2011).
113. Begleiter, *supra* note 51, at 567. *See also* § 1.1402(a)-4(b)(3)(ii); Heffley v. Comm'r, 884 F.2d 279, 285–86 (7th Cir. 1989).
114. § 1.1402(a)-4(b)(3)(ii).
115. Begleiter, *supra* note 51, at 567. *See also* § 1.1402(a)-4(b)(3)(ii).
116. Begleiter, *supra* note 51, at 567. *See also* § 1.1402(a)-4(b)(3)(iii).
117. § 1.1402(a)-4(b)(3)(iii).
118. 26 C.F.R. § 20.2032A-3(a) (2011). *See also Heffley*, 884 F.2d at 285–86.

Material participation requires actual employment to the extent necessary to fully manage the farm or business, but may exist as long as all necessary functions are performed even though little or no actual activity occurs during nonproducing seasons.[119]

Thus, even if the IRS conceded that wind leases fit under the umbrella of farming purposes and labeled a wind lease a qualified use, it would not likely find that a farmer or rancher has materially participated in the qualified use. Wind leases—even those that pay royalties based on production—do not delegate any management ability or responsibility to the landowner or the qualified heirs.[120] Not only are the landowner or qualified heirs typically unaware of how the company is managed, but unless they own shares of stock in the energy company, they will be unable to even vote on any company decisions. Rather, because the landowner or qualified heirs only receive passive income but make no management decisions, the IRS will likely find that no material participation in the production or management of real property that has been leased to a wind energy company.

### E. *Calculating Special Use Valuation*

If all of the requirements of section 2032A are met at the date of the decedent's death, the executor is entitled to value the qualified real property of the decedent's estate using the special use valuation formula.[121] This formula, provided in subsection 2032A(e)(7)(A), is "the excess of the average annual gross cash rental for comparable land used for farming purposes and located in the locality of such farm over the average annual state and local real estate taxes for such comparable land" divided by "the average annual effective interest rate for all new Federal Land Bank loans."[122] Practically, this formula requires examining the decedent's real property to find comparable property, taking the fair cash rental value of such comparable real property and subtracting average state and local taxes imposed on such comparable property. It then takes this result and divides it by the current rate for loans issued by Federal Land Banks.[123]

The value of land, for purposes of evaluating both fair market value and rental value, tends to vary a great deal depending on terrain, fertility, climate and surrounding lands. Broadly, and only for purposes

119. § 20.2032A-3(e)(1); Estate of Donahoe v. Comm'r, 56 T.C.M (CCH) 271, 275 (1988), *rev'd sub nom.* Brockman v. Comm'r, 903 F.2d 518 (1990) (quoting § 20.2032A-3(e)(1)).

120. Management decisions could include determining when to sell the electricity, the price, or any other business decisions on behalf of the company.

121. I.R.C. § 2032A(a)(1) (2006).

122. *Id.* § 2032A(e)(7)(A). Under 26 C.F.R. § 20.2032A-4(a) (2011), the average annual gross cash rental rate and average tax rate is to be determined using data from the "[five] most recent calendar years ending before the date of the decedent's death."

123. 26 C.F.R. § 20.2032A-4(a).

of providing a foundation, the United States Department of Agriculture reports that the fair market value of land used to grow crops ranges from approximately $800 to $12,800 per acre with a nationwide average of $3,030.[124] Additionally, the report notes that the fair market value of pasture land is much more variable, ranging from approximately $300 to $13,900 per acre, but is typically much less valuable, having a nationwide average of only $1,100.[125] Studies have shown that rental values can range from just over 1% to 7% of the land's fair market value per year, and as expected, depend on the quality and fertility of the land and its available uses.[126]

As a simple illustration of the special use formula and the special use valuation, consider the following example: If the fair market value of a parcel of real property was $2,000 per acre and was leased at a rental rate of 5% of its value, the landowner would receive $100 per acre per year. If, for purposes of special use valuation, this property had comparables leasing for the same amount ($100 per acre per year), with such landowners owing $10 per acre that year in state and local taxes, and the Federal Land Bank rate of interest was 6.25%, the formula would be ($100 - $10)/.0625. As such, the special valuation would be $1,440.00 per acre, a decrease in valuation of $560 (or 28%) per eligible acre. If, at the time of his or her death, the landowner owned 3,000 acres of qualified real property and met the other requirements of section 2032A, each of the 3,000 acres would be valued at $1,440 rather than $2,000. This special valuation produces a net discount of $1,680,000, lowers the value of the decedent's gross estate

124. NAT'L AGRIC. STATS. SERV., U.S. DEP'T OF AGRIC., LAND VALUES: 2011 SUMMARY 10–11 (2011), *available at* http://www.nass.usda.gov/Publications/Todays_Reports/reports/land0811.pdf.

125. *Id.* at 14–15.

126. *See* KEVIN SEDIVEC, DETERMINING PASTURE RENTAL VALUE RENTAL RATES, N.D. ST. UNIV. EXTENSION SERV. 2 (photo. reprint 1999) (1995), *available at* http://www.ag.ndsu.edu/pubs/agecon/market/r1092.pdf (reporting that average pasture land rates in North Dakota are 6% to 7% of the fair market value of the land); JEFF FISHER & DAVID MANGIONE, OHIO ST. UNIV. EXTENSION, PUB. NO. FR-8-06, ESTABLISHING A FAIR PASTURE RENTAL RATE 3 (2006), *available at* http://ohioline.osu.edu/fr-fact/pdf/0008.pdf (recommending that landowners rent their land at 3.5% to 6% of its current market value); WILLIAM EDWARDS, IOWA ST. UNIV. EXTENSION & OUTREACH, PUB. NO. C2-20, COMPUTING A CROPLAND CASH RENTAL RATE 2 (2011), *available at* http://www.extension.iastate.edu/publications/fm1801.pdf (reporting that rental rates for good cropland in Iowa have averaged 3% to 4% of their fair market value); KEVIN C. DHUYVETTER & MYKEL TAYLOR, KAN. ST. UNIV. RES. & EXTENSION, PUB. NO. MF-1100, KANSAS LAND PRICES AND CASH RENTAL RATES 7 tbl.9 (2011), *available at* http://www.ksre.ksu.edu/library/agec2/mf1100.pdf (reporting that in 2011, irrigated cropland was rented at 5.8% of fair market value, non-irrigated cropland at 3.5%, and pasture land at 1.8%); CRAIG L. DOBBINS & KIM COOK, PURDUE AGRIC., INDIANA FARMLAND VALUES & CASH RENTS: RENEWED STRENGTH IN A WEAK ECONOMY 1–3 (2010), *available at* http://www.agecon.purdue.edu/extension/pubs/paer/2010/august/paer0810.pdf (finding that farm land rents averaged between 1.4% to 3.8% in 2010).

from $6,000,000 to $4,960,000, and most importantly, puts the gross estate within the current federal estate tax exclusion amount.[127]

The formula used to calculate special valuation is unconventional and requires a valuation of the average rental and tax rates of surrounding lands, as well as determining the current interest rate on loans issued by Federal Land Banks. However, if special valuation is permitted on the real property, the benefits may well be worth the effort.

### F. *Limitations on Special Use Valuation*

While section 2032A is a great benefit to families of farmers and ranchers, the statute may not allow the executor to take advantage of special use valuation for all of the decedent's property. As previously noted, special use valuation can only apply to property and improvements that meet the requirements of qualified real property.[128] Additionally, subsection 2032A(a) limits the total decrease in the qualified real property's value that may be taken.[129]

Specifically, subsection 2032A(a)(2) limits the aggregate decrease in the value of qualified real property to $750,000.[130] This base amount, however, is modified by subsection 2032A(a)(3), which allows the $750,000 base amount to be multiplied by a slightly altered version of the cost of living adjustment.[131] To determine the multiplier, this formula takes the Consumer Price Index of August of the year prior to the year of the decedent's death and divides it by the Consumer Price Index of August 1997.[132] The resulting number is then multiplied by $750,000, to reach the aggregate limit on the reduction of the value of the qualified real property.[133]

Likely realizing that leaving these calculations up to personal representatives of estates and their attorneys would lead to many miscalculations, the IRS issues Revenue Procedures each year that provide the limit on the aggregate decrease in property value. For decedents who passed away in 2011, the aggregate limit of decrease in property value is $1,020,000, and for decedents dying in 2012, such limit is $1,040,000.[134]

127. This example assumes the decedent died in 2012. While this discount would actually lower the value of the decedent's gross estate to $4,320,000, special valuation in 2012 is limited to $1,040,000, as will be explained in the next section. *See infra* Part IV.F.

128. *See supra* Part IV.B.

129. I.R.C. § 2032A(a)(2) (2006).

130. *Id.*

131. *Id.* § 2032A(a)(3)(A)–(B). See I.R.C. § 1(f)(3) (2006), for the cost of living adjustment.

132. *See* I.R.C. § 2032A(a)(3)(B) (2006); *see also* I.R.C. § 1(f)(3) (2006).

133. I.R.C. § 2032A(a)(3) (2006). This section includes further instructions to round the resulting number to the next lowest multiple of $10,000.00. *Id.*

134. Rev. Proc. 2011-52, 2011-45 I.R.B. 3.30; Rev. Proc. 2010-40, 2010-46 I.R.B. 3.20.

### G. *Cessations of Qualified Use and Dispositions of Qualified Real Property*

Even if the decedent and qualified heir have met the stringent requirements of IRC section 2032A, if a qualified heir either disposes of the property or stops using it in a qualified manner, the IRS may be able to recapture at least a portion of the taxes saved by electing to receive special use valuation.[135] This recapture provision was enacted to avoid giving windfalls to devisees of specially valued property that later stop using the property in a qualified manner or sell the property at its fair market value, rather than at the special value it was allowed to use.[136] If such tax is demanded by the IRS, it is due within six months of the disposition of the qualified use[137] and the qualified heir who received the qualified real property is personally liable for remitting payment.[138]

Subsection 2032A(c)(1) imposes additional estate tax (the tax savings using special valuation) if the qualified heir, within ten years of the decedent's death: (1) ceases, at any time, to use the qualified real property in a qualified manner; or (2) disposes of *any* interest in the qualified real property (other than to a family member).[139] For the first condition, it is sufficient to note that if the qualified use, which was discussed extensively *supra*, is not met as to any or all of the specially valued property for ten years after the date of the decedent's death, section 2032A allows the IRS to recapture all of the taxes saved using the special valuation.[140]

The second condition of subsection 2032A(c)(1), which disallows disposition of any interest in the qualified real property by the qualified heir, is strictly applied.[141] In *Estate of Gibbs v. U.S.*, the personal representative of the decedent's estate property elected section 2032A and was allowed to specially value the decedent's interest in his dairy farm.[142] The qualified heir took over the dairy farm and proceeded to use it in a qualified manner and materially participated in its operations.[143] Eight years after the date of the decedent's death, however, the qualified heir voluntarily granted a development easement to the state of New Jersey as part of a program to limit development on the

135. *See* I.R.C. § 2032A(c)(1).
136. H.R. Rep. No. 94-1380, at 22 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3356, 3376.
137. I.R.C. § 2032A(c)(4).
138. *Id.* § 2032A(c)(5).
139. *Id.* § 2032A(c)(1)(A)–(B).
140. *Id.* § 2032A(c)(1)(B).
141. *See, e.g.*, Estate of Gibbs v. U.S., 161 F.3d 242 (3d Cir. 1998); Estate of Williamson v. Comm'r, 974 F.2d 1525 (9th Cir. 1992); Smoot v. U.S., 892 F.2d 597 (7th Cir. 1989).
142. *Estate of Gibbs*, 161 F.3d at 243.
143. *Id.*

land.[144] Applying New Jersey law, the court first held that this type of easement was a transfer of rights (as opposed to a land-use restriction).[145] It then had to determine if granting the easement was a disposition of "any interest in the qualified real property."[146] To do this, it used the time-worn but quintessential property metaphor of a "bundle of rights" and found that when the property was passed from the decedent to the qualified heir, the property had "two portions: first, the 'bundle of rights' relating to the agricultural use of the land, and second, the additional value represented by the 'bundle of rights' relating to development uses of the land."[147] The court held that the estate had taken special valuation on both "bundles of rights," and by disposing of the right to develop, had disposed of an interest in the land.[148]

*Gibbs* also illustrated the concept of partial dispositions of interests in qualified real property, an important part of section 2032A and estate tax recapture.[149] Legislative history indicates that Congress intended that the recapture provision apply to both total and partial dispositions of interests in qualified real property.[150] This desire was codified as subsection 2032A(c)(2)(D) and permits the IRS to recapture the portion, pro rata, of the initial tax savings of the decedent's estate if any interest in specially-valued property is subsequently disposed of.[151]

If an interest in specially-valued property is disposed of, subsection 2032A(c)(2) provides a complex formula to compute amount of recapture tax that must be repaid.[152] Such amount is equal to the lesser of: (1) the adjusted tax difference attributable to such interest, or (2) the amount realized in the disposition less the special value initially given to the interest.[153]

It appears, however, that Congress was not satisfied that the recapture tax would be paid if the IRS simply sent a bill to the heirs, as it enacted IRC section 6324B.[154] This statute imposes a lien in favor of

144. *Id.* The easement in this matter was a type of conservation easement, which interestingly *prevented* future development or improvement on the land. *Id.*

145. *Id.* at 246–47.

146. *Id.* at 247.

147. *Id.*

148. *Id.* at 247–48.

149. *See id.* at 250.

150. H.R. REP. NO. 94-1380, at 26 (1976) (stating that "[d]isposition, or cessation of qualified use, of a portion or an interest may result in a full or partial recapture."), *reprinted in* 1976 U.S.C.C.A.N. 3356, 3380.

151. I.R.C. § 2032A(c)(2)(D) (2006); *see also* RUSTY W. RUMLEY, NAT'L AGRIC. L. CTR., AN OVERVIEW OF SPECIAL USE VALUATION UNDER 26 U.S.C.A. § 2032A, at 6 (2011), *available at* http://www.nationalaglawcenter.org/assets/articles/rrumley_2032A.pdf.

152. *See* I.R.C. § 2032A(c)(2).

153. *Id.* § 2032A(c)(2)(A).

154. *See* I.R.C. § 6324B (2006).

the United States on the property that received the special use valuation.[155] The amount of the lien is the difference between the tax on the fair market value and tax on the special use valuation, and lasts from the time of the section 2032A election until the later of ten years after the date of the decedent's death (the same amount of time as the land must be used in a qualified manner) or until the Secretary of the Treasury is satisfied that no further tax may arise under section 2032A.[156]

## V. Potential Estate Tax Issues that May Arise with Wind Leases

### A. *Landowners Executing Wind Leases before Death*

#### 1. Estates Pushed into Estate Tax Liability

One of many implications of a lease of one's real property to a wind energy company is the potential for increased value of real property.[157] If the IRS is able to successfully argue that the right to receive future lease payments or other royalty payments under wind leases is an enhancement to the value of real property, like the present value of future payments of a mineral lease, an estate could unknowingly be forced into or pushed further into federal estate tax liability.

As noted above, there are typically two stages to wind energy leases, and potential estate tax liability appears to depend on the stage of the lease at the time of the decedent's death.[158] If a landowner signs a lease that allows the wind energy company to both survey and to later erect (at the company's discretion) wind turbines on his property, but dies during the primary lease, the IRS would likely have difficulty convincing a court that the value is enhanced, as the possibility of placing wind turbines on the deceased landowner's real property is merely contingent on the energy company's decision.[159]

The argument for enhanced value becomes more convincing, however, after the energy company has exercised its right to develop the landowner's land, since there is now more than a mere contingent interest in the lease payments.[160] Rather, because neither party is likely able to legally back out of the lease, the landowner or his estate has become entitled to receive the payments (and has a reversionary interest in the leased property) and the energy company is entitled to keep the turbines on the leased property for the duration of the lease. For example, assume an unmarried landowner dies in 2012 (who has

155. *Id.* § 6324B(a).
156. *Id.* § 6324B(b)(1)–(2).
157. *See supra* Part II (discussing wind leases and their effects on the value of real property).
158. *See supra* Part II.
159. *See* McEowen, *supra* note 1, at 12.
160. *Id.*

done no estate planning) owning only a 2,000 acre ranch with a fair market value of $2,500 per acre. His or her estate would fit squarely into the $5,000,000 estate tax exclusion amount. However, if the decedent had executed a thirty-year wind lease three years before his death and the energy company subsequently erected twenty wind turbines (and assuming a 25% discount to the ranch's value due to the presence of the lease and the intangible burdens), the fair market value of the ranch could be reduced to $3,750,000. Assuming each of the twenty turbines paid a flat rate of $4,000 per year, however, the IRS would have a strong argument that even considering the $1,250,000 discount, the landowner's estate has the right to receive $2,160,000 in future lease payments, increasing the deceased landowner's total gross estate to $5,910,000, resulting in $910,000 being subject to estate tax.[161]

The IRS has a strong argument that the present value of future payments arising from wind leases is an enhancement to the property's fair market value. As such, landowners should be aware that executing a wind lease can either push their estates into estate tax liability, or if a landowner's estate is already going to be liable for estate tax, the lease could increase the value of his or her gross estate, causing greater estate tax liability.

### 2. Limitation on Ability to Elect Section 2032A

In addition to potential estate tax liability, execution of a wind lease by a landowner could limit the extent to which the executor of his or her estate may elect IRC section 2032A. Among other requirements, in order to make a section 2032A election, 25% of the value of decedent's gross estate must be comprised of real property that was used in a qualified manner and materially participated in by the decedent for five out of eight years ending on the date of his or her death.[162] Additionally, 50% of the value of the decedent's estate must be real or personal property used in a qualified manner and must be passed to a qualified heir.[163] These requirements may be difficult to fulfill when a landowner executes a wind lease prior to his or her death because his or her personal representative is unable to count the right to receive future payments of the lease and the property burdened by the

161. This scenario assumes that no, pre- or post-death, estate planning has occurred. It also does not take into account any discount in the present value of the future payments, which courts have allowed. *See, e.g.*, Shepherd v. Comm'r, 115 T.C. 376 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).

162. I.R.C. § 2032A(b)(1)(B)–(C) (2006).

163. *Id.* § 2032A(b)(1)(A). It is important to note that these limitations only appear to become relevant if the IRS can successfully argue that the deceased landowner had a leased-fee interest. If it is unable to do so, no value is placed on the expected royalty payments under the lease and the value of such payments will not count toward the decedent's gross estate (or against the requirements of § 2032A for purposes of determining qualified real property).

lease toward the qualified property requirements listed above. Additionally, the remaining value of such lease will make the ratio of qualified to unqualified real property lower, as it will increase the value of the decedent's gross estate without increasing the amount of qualified real property.[164]

While these limitations may not have as great of an impact on large farms and ranches, they could certainly affect estates in which the decedent owned a smaller farm or ranch with highly-valued real property, did not use the large portions of their real property for a qualified purpose, or held a significant amount of property that is not qualified real property. For example, suppose a widower farmer owned 2,000 acres of ranch land with a total fair market value of $4,000,000, a collection of antique automobiles valued at $1,000,000, a brokerage account valued at $2,000,000, and has the unrestricted rights to receive distributions of income and principal of an irrevocable trust set up by his deceased father, which had a value of $1,000,000 at the time of the landowner's death.[165] Assuming there has been no estate planning and without considering post-death discounts, the value of the decedent's gross estate is $8,000,000. If the decedent used the real property in a qualified manner and materially participated in the qualified use on the land for the requisite amount of time, the first requirement is met. Additionally, assuming the property is passing to a qualified heir (and since the value of the real property makes up the requisite 50% of the decedent's gross estate), the property meets the second requirement. Since both requirements are met (and assuming all other requirements are met), the IRS should permit the real property to be specially valued.

The situation could change, however, if the landowner had executed a wind energy lease prior to his death. Suppose that the decedent in the prior example executed a thirty-year wind lease ten years prior to his death and twenty wind turbines were placed on his land, each of which paid $4,000 per year in fixed royalties. The estate should discount the value of the real property for the encumbrance, and assuming a 25% discount is appropriate and uncontested, the value of the real property should be listed at $3,000,000 on the estate tax return. Before considering the right to receive $1,600,000 in future payments under the lease on the real property, a problem has been created for an executor looking to make a section 2032A election: the value placed on the real property (the only real or personal property of the estate that fits into the qualified use requirement) no longer makes up half of the decedent's gross estate. Because of this, the executor will

164. Adding the present value of the right to future payments of the lease to the gross estate, and subtracting the value of the land burdened by the wind equipment from the 25% and 50% requirements will inherently make it more difficult for smaller farms and ranches to meet such requirements.

165. Assuming that portability is not possible.


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be unable to make a section 2032A election and thus be unable to specially value the real property of the decedent's estate. Additionally, if the IRS requires the valuation of the real property to include both the discount and the value of the leased-fee interest, as it requires inclusion of the remaining value of existing mineral leases, an additional $600,000 will be added to the decedent's gross estate and exposed to estate tax.[166]

Wind leases have effects on the value of land that can interfere with a planned 2032A election. A landowner planning to have his or her personal representative make an election should be aware that not only will the property burdened by the lease likely not be eligible for special valuation, but the value of the land and the lease will likely work against the estate being able to make a section 2032A election, as they count toward the total value of the estate but not toward qualified real property.

### B. *Execution of Wind Leases after Death by Qualified Heirs of Estate*

Generally, what the heirs or devisees of a decedent's estate do with the property they inherit is irrelevant for purposes of the valuation of the estate. However, if the personal representative of an estate has made a section 2032A election and a qualified heir executes a wind lease on the specially valued property, the IRS will likely be able to argue that the heir has made a disposition of an interest in real property or is no longer using the property in a qualified manner.[167] If it can successfully argue that one of these requirements has been violated, the IRS has the ability to assert its right to recapture the tax savings gained using special valuation on the leased land.[168]

Recently, a scenario involving a decedent's heirs executing a wind energy lease and the IRS demanding recapture tax occurred in Texas.[169] The personal representative of a decedent's estate properly elected section 2032A on the decedent's estate tax return and was permitted to specially value the qualified real property of the estate.[170] After receiving title to the land, the qualified heirs executed a lease (in which no participation by the qualified heirs was to occur) with a wind energy company to place turbines on the qualified real property.[171] The IRS discovered the lease when the heirs approached it about subordinating its statutory lien, as was required in the lease with

166. This takes into account the real property originally valued at $4,000,000, discounted by 25% ($1,000,000) and increased by the present value of future payments under the lease ($1,600,000).
167. *See, e.g.*, McEowen, *supra* note 1, at 12; Fambrough, *supra* note 9, at 3. *See generally* I.R.C. § 2032A(c)(1).
168. *See generally* § 2032A(c).
169. *See* McEowen, *supra* note 1, at 13; *see also* Fambrough, *supra* note 9, at 3.
170. McEowen, *supra* note 1, at 13.
171. *Id.*

the energy company.[172] Rather than subordinating its lien, however, the IRS asserted its right to recapture the tax savings on all of the property that had received special valuation, since the lease was a disqualified cash lease.[173] After some negotiations, the IRS agreed to only recapture the tax savings on the land that was no longer being used in a qualified manner.[174] The heirs subsequently paid the tax, but commentators expect the heirs to sue the IRS for a refund.[175]

## VI. Inequitable Results and Statutory Recommendations

Upon an examination of statutory law, case law, and administrative materials, the estate tax results of executing a wind lease appear to be fair. The land may have gone up in value, the estate has a right to receive future lease payments, the lease conveys away an interest in the property, and for purposes of section 2032A, the lease will almost certainly not allow the landowner (or qualified heirs) to materially participate in the business. The tax implications, however, appear to be inconsistent with national policy regarding agriculture and the legislative intent of section 2032A.

After examining the effects of the estate tax on farmers, the Ways and Means Committee of the House of Representatives issued a report supporting the enactment of section 2032A:

> When land is actually used for farming purposes . . . it is inappropriate to value the land on the basis of its potential "highest and best use" especially since it is desirable to encourage the continued use of property for farming. . . . Valuation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. [A] greater estate tax burden makes continuation of farming, or the closely held business activities, not feasible because the income potential from these activities is insufficient to service extended tax payments or loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes.[176]
>
> . . .
>
> The present [estate tax] provisions have proved inadequate to deal with the liquidity problems experienced by estates in which a substantial portion of the assets consist of a closely held business or other illiquid assets. In many cases, the executor is forced to sell a decedent's interest in a farm or other closely held business in order to pay the estate tax.[177]

172. *Id.*
173. *Id.*
174. *Id.*
175. *Id.*
176. H.R. Rep. No. 94-1380, at 21–22 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3356, 3375–76.
177. *Id.* at 30.

Three concerns are clearly identifiable in this excerpt: (1) it is consistent with national policy to encourage people to use their real property for farming; (2) because of such policy, it is not appropriate to value such property at its "highest and best use" but rather its "actual use," which will lower the estate tax burden for farmers and ranchers; and (3) that estates that consist primarily of a farm, ranch or closely-held business will likely have liquidity issues, which could in turn cause personal representatives to be forced to sell estate assets to pay a decedent's estate tax liability.[178] To help alleviate these concerns, section 2032A was enacted.[179]

While the legislature didn't want estate tax benefits to inure to undeserving estates—specifically those whose heirs did not intend to continue using the property in a qualified manner—qualified heirs that both execute a wind lease and continue farming could see these tax benefits shrivel quickly.[180] First, the portions of real property that are subject to a wind lease are no longer being used in a qualified manner, which allows the IRS to recapture at least a portion of the tax savings.[181] Second, and more importantly, the IRS will likely require the full remaining value of the lease to be included in the decedent's gross estate.[182]

Regardless of whether an executor has made a section 2032A election, requiring a decedent's estate to pay taxes on the present value of the right to the future payments under the lease contradicts the statute's legislative history.[183] Execution of a wind lease by a farmer or rancher does not necessarily change the liquidity of their estates, since leases are typically paid in relatively small installments over many years. Additionally, proceeds of such leases are often used to pay for farming and ranching expenses, to invest in assets for the farm or ranch, and quite frequently, to act as a supplement to farming activities.[184]

By treating lease payments in this manner, lawmakers should consider the policy being advanced: inclusion of the entire value of future lease payments in the gross estate discourages implementing green energy and using the land in its highest and best use. For example, an elderly farmer may be approached by a wind energy company seeking

178. *See id.* at 5.
179. *See id.* at 5–6.
180. *See* Estate of Sequieria v. Comm'r, 70 T.C.M. (CCH) 761 (1995), No. 16264-91, 1995 WL 558728, at *6 (U.S. Tax Ct. 1995) (noting that Congress intended to make 2032A available to *deserving* estates).
181. *See supra* Parts III, IV.
182. *See supra* Parts III, IV.
183. *See* H.R. Rep. No. 94-1380, at 20–22, 30.
184. *See* Glenn Puit, Great Lakes Bulletin News Serv., *Duke's Foes Call Wind Leases a 'Raw Deal'*, MICH. LAND USE INST. (June 23, 2011), http://mlui.org/landwater/fullarticle.asp?fileid=17493; *Turbines to Yield New Bumper Crop*, DET. FREE PRESS, July 10, 2011, at B1, *available at* 2011 WLNR 13641294.

to lease portions of his land for wind turbines. To the landowner, this is appealing, as he will receive a steady income stream and can begin to wind down his farming operations. However, if the landowner is wise enough to seek legal counsel concerning the implications of lease and receives a warning about the effects it could have on his estate (regardless of an intention to have his executor elect section 2032A), the landowner may not only be required to keep working, but also will not likely sign the lease to allow wind turbines on his property.

Pointing out this contradiction may be simple, but coming up with plausible solutions is more difficult. One option may be to enact a multi-faceted piece of legislation that offers a reduction in value for property that (1) has been leased to produce "green energy," (2) is unable to qualify for special use valuation under section 2032A because of such lease, and (3) where at least 50% of the remaining portions of the real property estate meet the qualified use and material participation requirements of section 2032A.[185] Additionally, such legislation should allow a special valuation on the present value of future payments from leases that have arisen for the production of green energy. On top of this, section 2032A should be amended to eliminate the IRS's ability to recapture taxes on property that received special valuation but is subsequently leased for the production of green energy.

With regards to farmers who do not intend to elect section 2032A, these amendments would allow the leased portion of the property and the present value of future payments under the lease to be valued at a reduced rate, which would ultimately lower or avoid estate tax liability. For a farmer whose estate plan involves having his executor elect section 2032A, the farmer would still have to ensure that the requirements of section 2032A are met on the remaining portions of his real property, but if he executed a wind lease before his death, his estate would be entitled to elect section 2032A on the unencumbered estate and also receive a separate special valuation on both the leased property and the right to the future payments under the wind lease. With regards to a qualified heir executing a wind lease after the executor of an estate has elected section 2032A, the special valuation of the entire estate would stand, as the lease would not trigger a recapture of the tax savings on the special valuation of the leased property.

An additional concern noted in the legislative history of section 2032A is to only allow deserving estates—those who use their property for qualified purposes—to receive the benefits of special valua-

185. Almost certainly, litigation would arise about what constitutes "production" and "green energy." The statutory changes being advocated for in this paragraph would undoubtedly need to be drafted more carefully and fully, and be further explained in regulations to the Internal Revenue Code.

tion.[186] The proposal above would also accomplish that, by requiring that at least 50% of the remainder of the real property comply with the qualified use and material participation requirements of section 2032A. This would prevent wealthy persons from simply investing in real property and executing leases with wind energy companies for estate planning purposes, since it would require the individual to use the land for "farming purposes" and participate in the production on the property. This would likely be more work than the value it would provide to these individuals.

While historically nonexistent within the realm of estate tax, income tax benefits relating to green energy and energy efficiency have long been available.[187] Presently, both companies and individuals are eligible to receive tax benefits for installing equipment that uses solar energy to heat or cool a structure and for implementing wind energy production systems.[188] Prior to the enactment of the Energy Policy Act of 1992, which created the initial version of the production tax credit, the Ways and Means Committee of the House of Representatives noted that "the development and utilization of certain renewable energy sources should be encouraged through the tax laws. . . . [The credit is intended] to promote competition between renewable energy sources and conventional energy sources."[189] Allowing a special valuation for the present value of payments for wind leases for estate tax is consistent with the policy of using the tax code to promote the devel-

186. *See* Estate of Sequieria v. Comm'r, 70 T.C.M. (CCH) 761 (1995), No. 16264-91, 1995 WL 558728, at *6 (U.S. Tax Ct. 1995).

187. *See generally* U.S. DEP'T OF ENERGY, *supra* note 5 (providing information regarding grants and tax incentives for those who purchase and install qualifying small wind electric systems). Wind tax credits have been available for a number of years in a variety of forms, starting with investment tax credits. *Id.* However, the Energy Policy Act of 1992 allowed a tax credit based on the production ("production tax credit") of wind turbines. *See* Energy Policy Act of 1992, Pub. L. No. 102-486, 106 Stat. 2866 (codified as amended in scattered sections of 42 U.S.C.).

188. I.R.C. § 48(a)(3) (2006). The tax credit under section 48 for small wind and solar systems installed prior to December 31, 2016, is 30% of the cost of the equipment of such systems. *Id.* § 48(a)(2). Commercial wind energy companies have the option to take a credit equal to 30% of investment cost under section 48, *id.*, or receive a 2.2 cent tax credit for each kilowatt produced in the first ten years of each turbine's operations, as permitted by I.R.C. § 45 (2006). The production credit found in section 45 is set to expire on January 1, 2013. *See id.* Michigan Senator Debbie Stabenow's recently proposed amendment to Moving Ahead for Progress in the 21st Century (MAP-21) Act, S. 1813, 112th Cong. (as passed by Senate, Mar. 14, 2012), that would have extended the availability of the tax credits in sections 45 and 48 through 2013 for onshore wind facilities, failed to garner the required sixty votes for approval. David S. Miller et al., *United States: Senator Stabenow's Alternative Energy Tax Incentive Measure Fails to Pass Senate*, MONDAQ (Mar. 23, 2012), http://www.mondaq.com/unitedstates/x/169980/Renewables/Senator+Stabenows+Alternative+Energy+Tax+Incentive+Measure+Fails+To+Pass+Senate.

189. H.R. REP. No. 102-474, pt. 6, at 42 (1992), *reprinted in* 1992 U.S.C.C.A.N. 1954, 2253.

opment and utilization of renewable energy sources, making them more competitive with conventional energy sources.[190]

Congress should certainly consider making these changes to the Internal Revenue Code, but considering the general instability of estate tax law and the tension between Democrats and Republicans on the issue, it seems unlikely that such changes will happen in the near future. It has long been the policy of this country to promote agriculture and renewable energy, and as explained, wind energy leases are a renewable energy source that can be good for those involved in agriculture. Requiring the remaining value of the lease payments to be included in a decedent's gross estate, however, places an undue hardship on family farms and ranches and will likely force personal representatives of the estates of farmers and ranchers to liquidate assets to pay estate tax. Additionally, it may put a damper on the plans of those who may otherwise desire to execute a wind energy lease. The proposed solution will ease the estate tax liability for farmers that have executed wind leases, will take wind leases out of consideration for landowners who plan to have their personal representatives make a section 2032A election, and will allow qualified heirs of estates that received specially valued real property to execute wind leases without having to be concerned about being liable for recapture tax.

## VII. Conclusion

This examination of wind energy leases, subsequent alterations in land values, and the Internal Revenue Code shows that executing a wind lease can potentially involve estate tax implications. While existing law does not provide direct guidance on the right to receive future wind lease payments, other situations where the decedent had a right to receive future lease payments should apply by analogy. This analogous guidance has indicated that, in cases where the decedent has a reversionary interest in the leased real property and the right to receive lease payments, the present value of the remaining lease payments is to be added to the value of reversionary interest when computing the value of the property for the estate tax.[191] While the burden placed on the land by the lease may entitle the personal representative to discount the value of the land, the value of the remaining

190. There are many other sections within the Internal Revenue Code which provide incentives and benefits to people that undertake certain activities. Indeed, on March 7, 2012, President Obama announced a plan that would increase the tax credit on electric cars from $7,500 to $10,000. President Barack Obama, Speech at the Daimler Trucks Manufacturing Plant (Mar. 7, 2012), *available at* http://www.whitehouse.gov/the-press-office/2012/03/07/remarks-president-energy-mount-holly-nc; *see also* Jason Udy, *Obama Asks Congress to Raise Tax Credit on Cleaner Cars; Include Commercial Trucks*, Motor Trend (Mar. 7, 2012, 3:30 PM), http://wot.motortrend.com/obama-asks-congress-to-raise-tax-credit-on-cleaner-cars-include-commercial-trucks-177641.html.

191. *See, e.g.*, Estate of Mitchell v. Comm'r, 101 T.C.M. (CCH) 1435 (2011).

lease payments should be included in the decedent's estate tax return, if filing an estate tax return is necessary.

When accepting the value added by a wind lease, a lessor may not consider how that same lease could interfere with his or her estate plan. If a decedent had been conducting farming or ranching operations under an assumption that she would be able to receive section 2032A special valuation on her real property but signs a wind lease prior to her death, the executor of her estate may be unpleasantly surprised if the IRS disallows the special valuation. While a wind lease may not burden a large amount of the decedent's real estate, the burdened portion cannot be put toward satisfying the requirements of subsection 2032A(b); indeed, the value of the lease will count against these requirements. Additionally, even if a deceased landowner had followed all the required steps to make a section 2032A election but an heir of the decedent executes a wind lease, there is substantial reason to believe that the IRS will view the lease as a discontinuation of the qualified use and demand a recapture tax on the savings achieved using the special valuation on the leased property.[192]

These results, while arguably equitable, contravene the intent of Congress as revealed in the legislative history of section 2032A. The United States has historically been grounded in agriculture, and American national policy has resulted in many laws that are favorable to agriculture. The legislative history of section 2032A indicates that the law was passed to prevent executors of the estates of farmers and ranchers from having to sell the estate's illiquid assets to pay estate tax. If a farmer or rancher executes a wind lease, requiring the present value of the future lease payments to be included in his or her gross estate and disallowing special valuation on both the value of and land encumbered by such leases goes against such policy. Additionally, the last twenty years have shown a large push toward using and producing renewable energy. However, if farmers and ranchers realize that they may be pushed into estate tax for executing a wind energy lease, it is likely that they will not do so. To avoid these results, Congress should amend the IRC to, under limited circumstances, allow leases and the underlying real property to be specially valued and prohibit the IRS from recapturing the tax savings if a wind lease is executed and burdens land that has been specially valued under section 2032A.

192. *See supra* Part V.B.