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## NO DISCOUNT FOR JOINT TENANCY OWNERSHIP?

— by Neil E. Harl\*

Before 1989, the courts were almost uniformly unwilling to allow a discount for unmarketability of a fractional interest in property<sup>1</sup> for federal estate or federal gift tax purposes.<sup>2</sup>

But commencing with a 1989 Tax Court case<sup>3</sup> which allowed a 12 percent discount for tenancy in common ownership in land, about a dozen decisions have allowed discounts ranging up to 20 percent for undivided interests in property, mostly involving tenancy in common ownership interests in real estate.<sup>4</sup> Two 1998 Tax Court decisions, however, have disallowed a fractional interest discount or a lack of marketability discount for an interest held in joint tenancy.<sup>5</sup>

### Justification for discount

The taxpayer in *Estate of Youle*<sup>6</sup> argued persuasively that co-ownership reduced the value of property in part because of the necessity to bring an action for partition and sale under state law before full value could be realized from the undivided ownership interest. Undivided interests otherwise generally sell at a discount. Notwithstanding widespread judicial acceptance of a discount for co-ownership interests in recent years, the Internal Revenue Service position has continued to be that the discount should be limited to the cost of partitioning the property.<sup>7</sup> The decisions, however, have allowed discounts greatly in excess of the cost of partitioning the property.<sup>8</sup> In a 1998 Tax Court case,<sup>9</sup> a discount was allowed for a gift of an undivided interest in Florida timberland of 20 percent for lack of marketability and 30 percent for lack of control and the need to partition the property, for a total discount of 44 percent.<sup>10</sup>

In one of the two cases to reach the Court of Appeal level, *Estate of Cervin*,<sup>11</sup> the Tax Court allowed a 20 percent discount for a 50 percent interest in a farm and homestead.<sup>12</sup> On appeal, the government dropped the resistance to the discount and limited its arguments to other issues in the case.<sup>13</sup> In the other case, decided by the same Court of Appeal,<sup>14</sup> a discount was allowed for an undivided interest in ranchland and an undivided interest in other property held in a QTIP trust under the predeceased spouse's will.<sup>15</sup> A discount was permitted for property interests held by the marital share even though the non-marital share ownership was held by family members.<sup>16</sup> The Internal Revenue Service had argued, unsuccessfully, that the property ownership merged at the time of the surviving spouse's death, extinguishing

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the fractional undivided interest and resulting in 100 percent fee simple ownership of assets by the estate.<sup>17</sup>

### But no discount for joint tenancy ownership

In the first 1998 decision of the Tax Court, *Estate of Young v. Commissioner*,<sup>18</sup> a decedent who was a U.S. resident but not a U.S. citizen died owning five tracts of land owned in joint tenancy with his wife. The decedent excluded one-half under state community property law and claimed a 15 percent discount as to valuation of the other 50 percent.<sup>19</sup> The Tax Court first determined that the property was includible in the decedent's gross estate as joint tenancy property, not as community property, and then proceeded to disallow the claimed 15 percent discount.<sup>20</sup> The Tax Court took the position that, unlike I.R.C. § 2033, the joint tenancy provision (I.R.C. § 2040) is not concerned with quantifying the value of the fractional interest.<sup>21</sup> Rather, I.R.C. § 2040 includes in the gross estate the entire value of the property less any contribution by the surviving joint tenant.<sup>22</sup> The opinion notes that I.R.C. § 2040(a) (the "consideration furnished" rule<sup>23</sup>) was the applicable provision, not I.R.C. § 2040(b) (the "fractional share" rule<sup>24</sup>) because the surviving spouse was not a citizen of the United States.<sup>25</sup> The estate argued that the IRS position was premised on the "unity of ownership" theory, that is the theory that because the surviving joint tenant succeeds to the interest of the deceased joint tenant, there is nothing against which to apply the fractional share discount.<sup>26</sup> The Court acknowledged that the "unity of ownership" theory has been rejected by the courts, including the Ninth Circuit Court of Appeal, to which *Estate of Young* is appealable.<sup>27</sup> The court asserted that it was not basing its conclusion on the unity of ownership theory but upon interpretation of the governing statutes.<sup>28</sup>

The question is whether the Tax Court's interpretation of the relevant statutes and its reading of *Propstra v. United States*<sup>29</sup> are defensible. Certainly, the statute controlling the tax treatment of the joint tenancy interests involved in this case<sup>30</sup> does not unambiguously reject a fractional share discount. In light of the Ninth Circuit decision in *Propstra v. United States*<sup>31</sup> and the decision by the Fifth Circuit Court of Appeals in *Bonner v. United States*<sup>32</sup> (the *Bonner* decision followed *Estate of Bright v. United States*,<sup>33</sup> which in turn was followed a year later by the Ninth Circuit Court of Appeals in *Propstra v. United States*,<sup>34</sup>) the Tax Court decision in *Estate of Young v. Commissioner*<sup>35</sup> may have a short life. The Internal Revenue Service is apparently convinced that fractional interest discounts have gotten out of hand<sup>36</sup> and should be curbed. With the degree of success achieved by taxpayers at the appellate court level, it would appear that any effort to limit fractional share discounts will have to come from Congress. The Tax Court's analysis of the problem is unconvincing.

### FOOTNOTES

<sup>1</sup> See *Estate of Pudim v. Comm'r*, T.C. Memo. 1982-606; *Estate of Clapp v. Comm'r*, T.C. Memo. 1983-721; *Estate of McMullen v. Comm'r*, T.C. Memo. 1988-500 (value of decedent's undivided one-half interest in trust property not discounted as fractional share when trust property to be sold as entire fee simple interest).

<sup>2</sup> See generally 5 Harl, *Agricultural Law* § 43.02[1][a] (1998); Harl, *Agricultural Law Manual* § 5.02[1] (1998).

<sup>3</sup> *Estate of Youle v. Comm'r*, T.C. Memo. 1989-138.

<sup>4</sup> E.g., *Estate of Cervin v. Comm'r*, T.C. Memo. 1994-550, *rev'd on another issue*, 111 F.3d 1252 (5th Cir. 1997).

<sup>5</sup> *Estate of Young v. Comm'r*, 110 T.C. No. 24 (1998); *Estate of Fratini v. Comm'r*, T.C. Memo. 1998-308.

<sup>6</sup> T.C. Memo. 1989-138.

<sup>7</sup> Ltr. Rul. 9336002, May 28, 1993.

<sup>8</sup> See, e.g., *Estate of Williams v. Comm'r*, T.C. Memo. 1998-59.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> T.C. Memo. 1994-550, *rev'd on another issue*, 111 F.3d 1252 (5th Cir. 1997).

<sup>12</sup> *Estate of Cervin v. Comm'r*, T.C. Memo. 1994-550.

<sup>13</sup> See 111 F.3d 1252 (5th Cir. 1997).

<sup>14</sup> *Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996).

<sup>15</sup> *Id.* See Harl, "Funding Marital and Non-Marital Deduction Portions: The Possibility of a Discount," 7 *Agric. L. Dig.* 125 (1996).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> 110 T.C. No. 24 (1998).

<sup>19</sup> See *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982).

<sup>20</sup> *Estate of Young v. Comm'r*, 110 T.C. No. 24 (1998).

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> See 5 Harl, *supra* n. 2, § 43.02[2][a]; Harl, *supra* n. 2, § 5.02[2].

<sup>24</sup> See 5 Harl, *supra* n. 2, § 43.02[2][b]; Harl, *supra* n. 2, § 5.02[2].

<sup>25</sup> See I.R.C. § 2056(d)(1)(B) ("fractional share" rule of I.R.C. § 2040(b) is not available if the spouse is not a U.S. citizen).

<sup>26</sup> *Estate of Young v. Comm'r*, 110 T.C. No. 24 (1998).

<sup>27</sup> *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982).

<sup>28</sup> *Estate of Young v. Comm'r*, 110 T.C. No. 24 (1998).

<sup>29</sup> 680 F.2d 1248 (9th Cir. 1982).

<sup>30</sup> I.R.C. § 2040(a).

<sup>31</sup> 680 F.2d 1248 (9th Cir. 1982).

<sup>32</sup> 84 F.3d 196 (5th Cir. 1996).

<sup>33</sup> 658 F.2d 999 (5th Cir. 1981).

<sup>34</sup> 680 F.2d 1248 (9th Cir. 1982).

<sup>35</sup> 110 T.C. No. 24 (1998).

<sup>36</sup> See Ltr. Rul. 9336002, May 28, 1993.