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## TRANSFER OF RESIDENCE WITH CONTINUED OCCUPANCY

— by Neil E. Harl\*

The rule has been well established that a transfer of a residence to a spouse with occupancy by the transferring spouse until death, would not result in inclusion of the value of the residence in the transferor's gross estate under a theory of a retained life estate.<sup>1</sup> The courts have consistently required proof of at least an implied agreement between the husband and wife (assuming the transferring spouse continued occupancy) before that spouse is held to have retained possession or enjoyment so as to require inclusion of the residence in the gross estate.<sup>2</sup> If the transferor is to prevail, it is generally also necessary to establish that the residence was not transferred in discharge of an obligation of support.

The Commissioner's acquiescence in *Estate of Gutchess*<sup>3</sup> indicated that the issue might not be pressed in the immediate future.<sup>4</sup> However, the Internal Revenue Service litigated and lost again in *Diehl v. United States*.<sup>5</sup> But the Internal Revenue Service won a round in *Estate of Linderme*<sup>6</sup> where the residence was quit claimed by the decedent to the decedent's three sons eight years prior to the decedent's death. An understanding apparently existed between the parties that the decedent could occupy the house. The decedent was considered to have retained the right to possession and enjoyment of the property until his death since (a) the sons made no attempt to rent or sell the residence, which remained vacant after the decedent entered a nursing home 20 months before he died; (b) the proceeds of sale were used partially to pay obligations of the decedent's estate; and (c) the decedent resided in the house and paid all expenses up to the date of his death.<sup>7</sup> No gift tax return was filed.

IRS prevailed in *Estate of Honigman*<sup>8</sup> by showing an implied understanding to occupy the residence and prevailed for similar reasons in *Estate of Callahan*.<sup>9</sup> In *Estate of Bianchi*,<sup>10</sup> a dairy farm with a residence was conveyed under a private annuity arrangement to a child but the mother continued to live in the residence. The value of the residence was included in the gross estate.<sup>11</sup>

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But the taxpayers have prevailed in parent-child transfers during life where there was no express or implied agreement that the transferor-decedent had the right to live in the residence.<sup>12</sup> By the Commissioner's view, an implied understanding that the parent can enjoy the residence for life makes the residence includible in the gross estate.<sup>13</sup> It has generally been thought that, except for husband-wife arrangements, transfers wherein the donor continued in exclusive possession or enjoyment were likely to be challenged.<sup>14</sup>

The enactment of the 100 percent federal estate tax marital deduction effective for deaths after 1981<sup>15</sup> undoubtedly had an effect on the pace of litigation in this area, at least for transfers involving spouses.

A 1992 Tax Court case, *Estate of Maxwell*,<sup>16</sup> has once again addressed the question of inclusion in the gross estate following transfer to a family member during life. In that case, the decedent at age 82 and in remission from cancer transferred her residence to her son and daughter-in-law. The decedent forgave part of the amount with a mortgage executed for the balance with nine percent interest payable monthly. At the time of the conveyance, the decedent entered into a lease with the son and daughter-in-law to continue to live in the residence. The amount of rent was approximately equal to the interest payments on the mortgage. The decedent's will, executed two days after the transfer, forgave and canceled the mortgage indebtedness at her death. In each of the following two years, the decedent forgave another \$20,000 on the note each year.

The Tax Court held that the fair market value of the property at the decedent's death was includible in her gross estate because she did not receive adequate and full consideration in money or money's worth for the property and she retained the possession and enjoyment of the residence until her death. The court said that substance must prevail over form and the transfer was in reality a transfer with retention of the right to possession for her life. The court cited several factors in support of that conclusion including the decedent's age and health concerns, the pattern of forgiveness of mortgage indebtedness during her life and at her death, the fact that the rent payments approximated

the interest payments on the note and the fact that the son was the decedent's only heir and the natural object of her bounty.

A 1991 private letter ruling involved a somewhat similar issue.<sup>17</sup> In that ruling, a revocable inter vivos trust sold an undivided five percent interest to the children. The sale was ineffective and the full fair market value of the residence was included in the decedent's gross estate.<sup>18</sup>

Clearly, parent-child transfers will be subjected to close scrutiny. To minimize the chance for a successful

challenge, a parent-child transfer should assure control and enjoyment to the child or children after the transfer. If the child does not move into the residence, paying real estate taxes and maintenance costs is helpful. A federal gift tax return should be filed if handled as a gift. If characterized as a sale, that characterization should not be weakened by forgiveness of principal. In the event the residence is sold by the new owners, the proceeds should not go to the decedent's estate. But even if handled at arm's length, an IRS challenge may still be successful.

## FOOTNOTES

<sup>1</sup> Union Planters Nat'l Bank v. U.S., 361 F.2d 662 (6th Cir. 1966); Stephenson v. U.S., 238 F. Supp. 660 (W.D. Va. 1965); Est. of Gutchess v. Comm'r, 46 T.C. 554 (1966), *acq.*, 1967-1 C.B. 2. See Binkley v. U.S., 358 F.2d 639 (3d Cir. 1966); Est. of Kitchin v. Comm'r, T.C. Memo. 1987-324 (no retained life estate where decedent received full and adequate compensation for farm land). Compare Nat'l Bank of Commerce v. Henslee, 179 F. Supp. 346 (M.D. Tenn. 1959). See generally 5 Harl,

**Agricultural Law** § 43.02[6][a] (1992).

I.R.C. § 2036.

*Supra* note 1.

See 46 T.C. 554 (1966), *acq.* 1967-1 C.B. 2.

68-1 U.S.T.C. ¶ 12,506 (W.D. Tenn. 1967).

52 T.C. 305 (1969).

*Id.*

66 T.C. 1080 (1976) (implied understanding that mother-donor would continue to reside in the house).

T.C. Memo. 1981-357 (implicit understanding that mother could occupy residence until death).

<sup>10</sup> T.C. Memo. 1982-380.

<sup>11</sup> *Id.*

<sup>12</sup> City Nat'l Bank of Connecticut v. U.S., 78-1 U.S.T.C. ¶ 13,219 (D. Conn. 1977); Est. of Roemer v. Comm'r, T.C. Memo. 1983-509.

<sup>13</sup> Rev. Rul. 78-409, 1978-2 C.B. 234.

<sup>14</sup> Rev. Rul. 70-155, 1970-1 C.B. 189. See Gynn v. U.S., 437 F.2d 1148 (4th Cir. 1971); Est. of Rapelje v. Comm'r, 73 T.C. 82 (1979).

<sup>15</sup> Pub. L. 97-34, Sec. 403, 95 Stat. 301 (1981), amending I.R.C. § 2056.

<sup>16</sup> 98 T.C. No. 39 (1992).

<sup>17</sup> Ltr. Rul. 9146002, July 31, 1991.

<sup>18</sup> *Id.*

# CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

## BANKRUPTCY

### GENERAL

**ESTATE PROPERTY.** When the debtor left an accounting firm, the debtor received monthly payments for the debtor's share of company stock. The payments were contingent upon the debtor's not independently performing any accounting services for the firm's clients. The debtor argued that the monthly payments were personal earnings not included in the bankruptcy estate. The court held that the payments were part of the compensation for the debtor's stock and were estate property. *In re McDaniel*, 141 B.R. 438 (Bankr. N.D. Fla. 1992).

### EXEMPTIONS.

**ANNUITY.** The debtor owned several annuities which were claimed as exempt under Iowa Code § 627.6(8)(e). The court held that because the debtor had the right to withdraw amounts from the annuities at any time, the annuities were not eligible for the exemption. *In re Huebner*, 141 B.R. 405 (N.D. Iowa 1992).

**PERSONAL INJURY AWARDS.** The debtor received a \$10,000 settlement from a hospital in satisfaction of a medical malpractice claim arising out of an injury to the

debtor's arm. The debtor claimed \$5,000 of the settlement as exempt under Ohio Rev. Code § 2329.66(A)(12), which did not allow an exemption for amounts received for pain and suffering or actual pecuniary loss. The settlement did not identify the portion of the amount which was for personal injury, pain and suffering or pecuniary loss. The trustee objected to the exemption, arguing that the debtor was required to allocate the settlement as to amounts received for personal injury and for the other purposes. The court held that the burden was on the trustee to prove that the debtor's exemption was not allowed as claimed. In addition, the court held that the Ohio exemption covered awards for personal injury and that at least \$5,000 of the settlement was reasonably allocated to the personal injury and was exempt. *In re Lester*, 141 B.R. 157 (S.D. Ohio 1992).

The debtor received a \$15,000 settlement from the debtor's insurance company on a suit against the insurance company for bad faith conduct in failing to pay the debtor's disability insurance claim arising out of an automobile accident. The debtor claimed the settlement proceeds as exempt under Wis. Stat. § 815.18(3)(i)1.c, d, which provided an exemption for awards for personal injury and pain and suffering. The court held that the settlement