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Complications in Leaving Farmland or a Personal Residence to Charity

-by Neil E. Harl*

For those who want to leave farmland or a personal residence to a charitable organization, with an income tax or federal estate tax deduction¹ but set it up such that the income goes to the surviving spouse, it's been possible to use a very simple procedure – a life estate to the surviving spouse and a remainder interest to the charity.² The alternative, if a charitable deduction is desired, as is nearly always the case, is to set up a charitable remainder annuity trust, charitable remainder unitrust or a pooled income fund.³ The simplicity of a legal life estate to the surviving spouse with a remainder interest to the charity has been an appealing choice for many and still assures favorable tax treatment.

The question is whether the value of the surviving spouse's legal life estate is eligible for a marital deduction⁴ under the qualified terminable property (QTIP) election⁵ and a charitable deduction for the remainder.⁶

Eligibility of limited interests for the charitable deduction

In general, limited interests in property passing to a charitable organization have not been deductible under the federal estate tax charitable deduction (or for the income tax charitable deduction) if the charitable interest is preceded by a noncharitable interest.⁷ Such "split interest" trusts have been ineligible for a charitable deduction since 1969 unless the property interests are set up in a charitable remainder annuity trust, charitable remainder unitrust or a pooled income fund.⁸ However, the 1969 legislation tightening the rules on charitable giving provided specifically for an exception for a remainder interest in a farm transferred to a qualified charitable organization even though a life estate is held by a family member or another noncharitable person.⁹ To obtain the income tax, gift tax or estate tax charitable deduction for the value of the remainder interest, the transfer need not be in trust as is required for most other property including stocks and bonds;¹⁰ in fact, leaving a farm or personal residence in a trust may render the remainder interest nondeductible unless the trust qualifies as a charitable remainder annuity trust, unitrust or pooled income fund.¹¹

Eligibility of the life estate for the QTIP election

At the death of the property owner, with a legal life estate passing to the surviving spouse, the question is whether the value of the life estate interest is eligible for the QTIP election¹² with a vested remainder in the charitable organization.¹³ The statute provides specifically _

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for a marital deduction if the surviving spouse is the only beneficiary of a *qualified charitable remainder trust* who is not a charitable beneficiary or an ESOP beneficiary.¹⁴ A “qualified charitable remainder trust is defined as a charitable remainder annuity trust or unitrust.¹⁵ The statute does not have a similar provision for legal life estates for farm or personal residences although some argue that a provision was not necessary.

The regulations for the federal estate tax charitable deduction state that no charitable deduction is allowed from the decedent’s gross estate¹⁶ for property with respect to which a deduction is allowed by reason of I.R.C. § 2056(b)(7) (the QTIP provision).¹⁷ The statutory authority for a marital deduction involving qualified charitable remainder trusts is an exception to that provision.¹⁸

In a 1987 private letter ruling,¹⁹ the question was the eligibility of the estate for a marital deduction where property passed to a charitable organization. As the ruling states, “in the case of a qualified charitable remainder trust, Congress limited the allowance of the section 2056 marital deduction to those trusts that satisfy the section 2056(b)(8) requirement that the surviving spouse is the sole noncharitable beneficiary. Further, there is nothing in the legislative history of section 2056(b)(8) to suggest that Congress intended section 2056(b)(7) to be available in such cases.”²⁰ In a 1991 private letter ruling, a charitable deduction was allowed at the surviving spouse’s death based on the present value of the remainder interest passing from the surviving spouse’s estate to a unitrust.²¹

In a 2005 private letter ruling,²² the residue of a decedent’s estate was to be held in a marital trust for the benefit of the spouse. On the death of the spouse, the remaining principal was to be distributed to a charitable organization. The estate claimed a marital deduction based on the actuarial value of the spouse’s income interest and a charitable deduction based on the actuarial value of the charitable remainder interest. On audit of the federal estate tax return, the charitable deduction was disallowed. The estate sought a ruling-(1) allowing the executor to make a QTIP election for all assets in the trust and (2) an extension of time to make the QTIP election with respect to the trust. In response to ruling request (1), the ruling takes the position that the QTIP election was only a partial QTIP election and, with respect to ruling request (2), since the executor had made an election, relief is not possible to alter or modify the election.²³

Bar on double deductions

It is also important to note the provision in the marital deduction statute²⁴ disallowing double deductions under that section (I.R.C. § 2056) or Chapter 11 of Title 26 of the U.S. Code. Chapter 11 is the federal estate tax chapter of the Internal Revenue Code. Thus, careful attention is needed to assure that the same property value is not used to claim a marital deduction and a charitable deduction.

In conclusion

With the increase that has already occurred in the applicable

exclusion amount (\$2 million for deaths in 2006, 2007 and 2008),²⁵ not to mention the proposed increases pending in Congress, the availability of a marital deduction for a life estate in property ultimately passing to a charitable organization may not be a major concern in planning for the death of the first of the spouses to die except in very large estates. However, where federal estate tax is a matter of concern, careful planning is needed to assure both a marital deduction and a charitable deduction.

Footnotes

- 1 I.R.C. §§ 170(f)(3)(B), 2055(e)(2).
- 2 See generally 5 Harl, *Agricultural Law* § 44.04[3] (2006); Harl, *Agricultural Law Manual* § 5.04[4][a] (2006).
- 3 I.R.C. §§ 170(f)(2)(A), 2055(e)(2)(A).
- 4 I.R.C. § 2056(b).
- 5 See I.R.C. § 2056(b)(7).
- 6 I.R.C. § 2055.
- 7 Treas. Reg. § 20.2055-2(a), (e), (f).
- 8 See note 1 *supra*.
- 9 I.R.C. §§ 2055(e)(2), 170(f)(3)(B). See Rev. Rul. 84-97, 1984-2 C.B. 196 (remainder interest in farm bequeathed to charitable organization deductible even though state mortmain statute required charitable organization to divest property within 10 years of receipt); Ltr. Rul. 8225158, March 29, 1982 (remainder interest in farm rented to tenants eligible for income tax charitable deduction); Ltr. Rul. 8217073, January 28, 1982 (remainder interest in operating ranch eligible for income tax charitable deduction).
- 10 *Id.*
- 11 See Rev. Rul. 76-357, 1976-2 C.B. 285.
- 12 I.R.C. § 2056(b)(7).
- 13 See I.R.C. § 2056(b)(1) (terminable interest rules).
- 14 I.R.C. § 2056(b)(8).
- 15 I.R.C. § 2056(b)(8)(B)(iii).
- 16 See I.R.C. § 2055.
- 17 Treas. Reg. § 20.2055-6.
- 18 I.R.C. § 2056(b)(8).
- 19 Ltr. Rul. 8730004, April 15, 1987.
- 20 *Id.*
- 21 Ltr. Rul. 9122029, Feb. 28, 1991.
- 22 Ltr. Rul. 200540003, June 20, 2005.
- 23 Treas. Reg. § 301.9100.
- 24 I.R.C. § 2056(b)(9).
- 25 I.R.C. § 2010(c).