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DEDUCTING MORTGAGES ON JOINT TENANCY PROPERTY

— by Neil E. Harl*

The "fractional share" rule for joint tenancy property,[1] which was enacted initially in 1976 and became fully effective for deaths after 1981, has generated a problem for deductibility of mortgage obligations on the property involved. Careful planning attention should be given to the situation if problems of deductibility are to be avoided.

Fractional share rule

Under the fractional share rule, for deaths after 1981, one-half the value of property is included in the gross estate of the first of the spouses to die.[2] The rule is limited to property owned by husbands and wives who are married to each other.[3]

For joint tenancies involving owners, some of whom are not husbands and wives married to each other, the "consideration furnished" rule applies.[4] Under that rule, joint tenancy property is subjected to federal estate tax in the estate of the first to die except to the extent it can be proved that the survivor contributed to its acquisition.[5] Pre-1977 joint tenancies between husband and wife could be subjected to the fractional share rule by election on a timely filed federal gift tax return filed for any quarter through 1979 if the donor was still living.[6] Any gift involved had to be duly reported and federal gift tax, if any, paid.

For property acquired after 1976 and before 1982 by a husband and wife in joint tenancy or tenancy by the entirety under the fractional share rule, the property was treated as belonging 50 percent to each for federal estate tax purposes if the joint interest was created by a transfer subject to gift tax. Before 1982, the creation of husband wife joint interests in land was not subject to federal gift tax unless so reported on a gift tax return timely filed.[7]

As noted, however, for deaths after 1981, the fractional share rule applies even though the transfer was not subject to federal gift tax.[8] The outcome usually is that half the value of joint tenancy or tenancy by the entirety property is included in the estate of the first of the spouses to die.

Deducting mortgages

A problem with the fractional share rule is that typically, only one-half of the mortgage on the joint tenancy property is deductible.[9] As the regulations state —

> "A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest...provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate, "[10]

The rulings confirm that only one-half the mortgage amount is deductible for husband wife joint tenancy property.[11] The court decisions also support the outcome that the estate can deduct only one-half of the note secured by a mortgage on husband-wife owned property held in joint tenancy.[12]

The outcome can create surprising outcomes.

Example: The husband, to finance a new $80,000 tractor and a $140,000 combine, borrows $220,000 from the bank and secures the obligation with a mortgage on 320 acres of land (owned in joint tenancy with his wife) which was previously free of debt. At the husband's death only one-half of the balance remaining on the mortgage obligation would be deductible for federal estate tax purposes.

Claims against the estate

Under a separate provision, a deduction from the gross estate is allowed for claims against the estate that are allowable by the law of the jurisdiction in which the estate is being administered.[13] The deduction is limited to those claims representing personal obligations of the decedent existing and enforceable against the decedent at the time of death.[14] A deduction can be claimed only to the extent the obligation was bona fide and contracted for adequate and full consideration.[15]

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* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

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Example: returning to the above example, of $220,000 of machinery loans secured by a mortgage on land owned jointly by husband and wife, only $110,00 would be deductible as a mortgage on the jointly owned land. However, the other $110,000 should be deductible as a claim against the estate *if the decedent was personally liable on the obligation.* Thus, if the husband's name appears on the note, the other half of the note balance should be deductible as a claim against the estate. Of course, had the obligation been secured by the machinery items, the entire amount would have been deductible in the husband's estate assuming the machinery was in the husband's name.

In conclusion

The obvious lesson from all of this is that it is important how obligations are structured if a deduction for federal estate tax purposes is desired. To obtain a full deduction, the safest approach is to secure obligations by assets owned by the individual for whom the deduction is anticipated.

FOOTNOTES

[1] See generally 5 Harl, *Agricultural Law* § 43.02[2][b] (1995); Harl, *Agricultural Law Manual* § 5.02[1] (1995). See also Harl "Taxing Joint Tenancy Property", 3 *Agric. L. Dig*. 181 (1992).
[2] I.R.C. § 2040(b).
[3] *Id*.
[4] I.R.C. § 2040(a). See Estate of Stimson v. Comm'r, T.C. Memo. 1992-242 (balance in joint bank accounts included in gross estate even though daughter's names on account for convenience in managing financial affairs); Estate of Hicks v. Comm'r, T.C. Memo. 1977-215 (father-son stock margin account).
[5] I.R.C. § 2040(a).
[6] I.R.C. § 2040(d).
[7] I.R.C. § 2515.
[8] I.R.C. § 2040(b).
[9] I.R.C. § 2053(a)(4). See Treas. Reg. § 20.2053-7.
[10] Treas. Reg. § 20.2053-7. See Estate of Theis v. Comm'r, 81 T.C. 741 (1983), *aff'd*, 770 F.2d 981 (11th Cir. 1985) (property included in gross estate because of retained life estate but mortgage placed on property not deductible; decedent not personally liable and had signed only as accommodation with mortgage proceeds going to holder of remainder interest (children)); Rev. Rul. 84-42, 1984-1 C.B. 194 (property in which decedent retained life estate includible in gross estate with no deduction for mortgage placed on property by holder of remainder interest even though decedent was guarantor).
[11] Rev. Rul. 79-302, 1979-2 C.B. 328; Rev. Rul. 81-183, 1981-2 C.B. 180; Rev. Rul. 81-184, 1981-2 C.B. 181.
[12] Estate of Fawcett v. Comm'r, 64 T.C. 889 (1975) (ranch property); Estate of Seagrist v. Comm'r, 42 B.T.A. 1159 (1940).
[13] I.R.C.§ 2053(a)(3); Treas. Reg. § 20.2053-1(a)(1)(iii).
[14] Treas. Reg. § 20.2053-4.
[15] *Id*.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

POSSESSION. When the plaintiff purchased the disputed property, a fence separated the plaintiff's land from the neighbors' land and the plaintiff believed that the fence was the actual boundary. The plaintiff used the land for pasturing cattle and the cattle did roam over the land up to the fence. The plaintiff and the defendant's predecessor in interest both contributed to the maintenance of the fence and the fence was treated as the boundary. After the defendant purchased the neighboring land, a survey indicated that the true boundary was inside the land occupied by the plaintiff. The plaintiff claimed ownership of the disputed strip by adverse possession for over 10 years. The defendant argued, and the trial court ruled, that the plaintiff's possession was not sufficiently open because the defendant, or the predecessor in interest, could not see the cattle on the disputed strip when the defendant was in the defendant's house. The appellate court reversed, holding that the plaintiff had already obtained title to the land by adverse possession by the time the defendant acquired the neighboring property and that the pasturing of cattle was sufficient open and notorious use to constitute adverse possession. **Davis v. Parke, 898 P.2d 804 (Or. Ct. App. 1995)**.

ANIMALS

CATTLE. The plaintiff was the wife of the son of the defendant who owned and operated a farm and ranch. The plaintiff was injured while helping the defendant, the plaintiff's husband, and the defendant's other son herd stock cattle to a new pasture. The plaintiff was inexperienced at moving cattle and was trampled by a stray cow while attempting to move the cow to the pasture. The plaintiff sued for negligence in keeping, harboring and transporting the cow and in failing to warn and instruct the plaintiff about handling stock cows. The defendant argued that the plaintiff failed to prove that the defendant knew that the cow had any dangerous propensities. The court held that such proof was not required in an action for negligence and that the trial court had sufficient evidence to find negligence in this case. **Sybesma v. Sybesma, 534 N.W.2d 355 (S.D. 1995)**.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

EXEMPTIONS

HOMESTEAD. Within two months before filing for bankruptcy, the debtor conveyed the homestead to the debtor's son for "love and affection" at a time when the