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CASH RENT LEASES BY MARITAL TRUSTS

— by Neil E. Harl*

Where special use valuation has been elected,¹ a question since publication of regulations in 1980² has been whether cash rent leasing in the post-death period triggered recapture of special use valuation benefits.³ The cases⁴ and the rulings⁵ have been in agreement that a cash rent lease⁶ or a "net lease"⁷ led to recapture of special use valuation benefits after the two-year "grace" period immediately after death.⁸ Because cash rent leases in the pre-death period have been permitted (for purposes of special use valuation eligibility) if to a member of the family of the decedent-to-be,⁹ the two-year grace period was created to allow time for pre-death cash rent leases to be renegotiated to crop share leases or other arrangements after death.

Amendment in 1988

Although no cash rent leasing was allowed in the post death period after publication of the regulations in 1980,¹⁰ an amendment in 1988 allowed a surviving spouse who inherited qualified real property to lease the land on a "net cash basis" to a member of the spouse's family without causing recapture.¹¹ The provision added in 1988 was made retroactive to 1977.

It is clear from the 1988 amendment that cash rent leases *by the surviving spouse* to a member of the surviving spouse's family are acceptable and do not result in recapture of the special use valuation benefits obtained earlier on the land.¹² The situation becomes more complex if the land is left in trust for the surviving spouse in a marital and non-marital share arrangement or is left in a legal life estate for the surviving spouse with the remainder interest left to children or other qualified heirs.

In a 1990 private letter ruling,¹³ land was left in a marital trust for the surviving spouse and in a non-marital trust with the trustee having discretion to distribute income to the spouse and to the decedent's issue during the spouse's life. The land in both trusts was cash rented to a member of the surviving spouse's family.

The ruling held that the cash rent lease by the marital trust was not a disposition leading to recapture. The surviving spouse held the entire interest in the income and

the principal, as is required for the marital deduction.¹⁴ To be eligible for the marital deduction, the interest passing to the surviving spouse must not be terminable by the passage of time, the occurrence of a contingency or the failure of a contingency to occur except for the special election to treat life estates as eligible for the marital deduction.¹⁵

As for the non-marital trust, the cash rent lease constituted a recapture disposition inasmuch as the spouse was not the sole beneficiary.¹⁶ The trustee's "sprinkling" power to distribute income to the surviving spouse and the decedent's issue during the spouse's life was sufficient to make the 1988 amendment inapplicable.¹⁷ Technically, it was not a cash rent lease by the surviving spouse to a member of the surviving spouse's family. Therefore, the cash rental arrangement was evaluated under the law applicable to qualified heirs generally with the result that it was a cessation of qualified use.¹⁸

In another 1990 private letter ruling,¹⁹ a similar situation was involved. Land had been left in a marital trust for the surviving spouse and a non-marital trust. Under the non-marital trust, the surviving spouse had a life estate. The trustee had the right to make discretionary principal distributions to others. Land in both trusts was cash rented to a member of the surviving spouse's family.

The cash rent lease by the marital trust posed no problem. Again, the surviving spouse had to be given the rights to income and control over the principal in order for the marital deduction to be available.²⁰

The problem was with the non-marital trust. The ruling, however, approved the cash rent lease by the non-marital trust because the cash rent lease was set to terminate at the death of the surviving spouse or, if discretionary distributions were made, during the spouse's lifetime.²¹ This provision in the lease saved the land in the non-marital trust from recapture. It should be noted, however, that providing for the termination of a cash rent lease at the spouse's death or upon the occurrence of discretionary distributions of principal can cause problems of a different sort.²² Indeed, several states have provided statutorily for continuation of leases beyond the death of the life tenant-lessee because of the practical problems of lease termination during the lease year.²³

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A better solution may be to utilize a crop share lease, rather than a cash rent lease. Crop share leases meet the qualified use test in the post-death period.²⁴

FOOTNOTES

- ¹ I.R.C. § 2032A. See generally, 5 Harl, *Agricultural Law* §43.03[2](1994); Harl, *Agricultural Law Manual* § 5.03[2](1994).
- ² Treas. Reg. § 20.2032A-3(b)(1).
- ³ See I.R.C. § 2032A(c)(6)(A).
- ⁴ E.g., *Williamson v. Comm'r*, 93 T.C. 242 (1989), *aff'd*, 974 F.2d 1525 (9th Cir. 1992) (cash rent lease to nephew was cessation of qualified use).
- ⁵ E.g., Ltr. Rul. 8240015, June 29, 1982 (surviving spouse did not have equity interest in land which was rented to children under "net lease").
- ⁶ See n. 4 *supra*.
- ⁷ See n. 5 *supra*.
- ⁸ I.R.C. § 2032A(c)(7)(A).
- ⁹ I.R.C. § 2032A(b)(1)(C)(i).

¹⁰ See n. 2 *supra*.

¹¹ I.R.C. § 2032A(b)(5)(A).

¹² *Id.*

¹³ Ltr. Rul. 9043044, July 31, 1990.

¹⁴ I.R.C. § 2056.

¹⁵ I.R.C. § 2056(b)(1).

¹⁶ Ltr. Rul. 9043044, July 31, 1990.

¹⁷ *Id.*

¹⁸ I.R.C. § 2032A(c)(6)(A).

¹⁹ Ltr. Rul. 9022007, Feb. 27, 1990.

²⁰ See n. 15 *supra*.

²¹ Ltr. Rul. 9022007, Feb. 27, 1990.

²² See 8 Harl, *Agricultural Law* § 62.02[2] (1994).

²³ *Id.*, § 62.02[2][d][i].

²⁴ E.g., Ltr. Rul. 8330016, April 26, 1983 (50-50 crop share met qualified use test; lease was to member of family as tenant so material participation requirement met by tenant).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

BANKRUPTCY REFORM ACT OF 1994

The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, (the Act) made several important changes to the Bankruptcy Code. The Act expressly waives the governmental immunity for money judgments against the IRS for violation of the automatic stay and other provisions. However, the Act limits the amount of attorney's fees recoverable to \$75 per hour unless special expertise was required and prohibits awards of punitive damages.

The Act also limits the actions which constitute a violation of the automatic stay, excluding tax audits, assessments, demands for tax returns and issuing of notices and demands for payment of assessments.

The Act extends the period for governmental entities to file claims after the first creditors' meeting to 180 days but expressly provides that late filed claims may be disallowed.

The Act increases the debt limit for Chapter 13 eligibility to \$250,000 of unsecured debt and \$750,000 of secured debt.

GENERAL-ALM § 13.03.*

ATTORNEY'S FEES. The debtors filed for Chapter 11 and because they could not afford to give their bankruptcy attorney a retainer, the attorney took a second mortgage on the debtors' farm. The fair market value of the farm was sufficient to cover the other secured debt. The trustee objected to the second mortgage as disqualifying the attorney under Section 327(a). The court, sitting *en banc*, held that the attorney's second mortgage gave the attorney an adverse interest in the estate sufficient to disqualify the attorney. *In re Escalera*, 171 B.R. 107 (Bankr. E.D. Wash. 1994).

CONSOLIDATION. The debtors, husband and wife, owed a corporation which operated a horse breeding ranch. The husband had made a personal guarantee of a corporation loan to purchase a horse and had listed the farm as the husband's asset, even though the farm was owned solely by the wife. The court found that the creditor had not relied on the farm in making the loan because no check was made as to actual ownership and the farm was not taken as security for the loan. The debtors filed a joint Chapter 11 petition, listing all of their assets on one schedule. The cases were also jointly administered. The creditor sought to have the cases declared substantively consolidated, subjecting the wife's farm to the husband's guarantee, because the assets of the debtors were commingled and the cases were jointly administered. The appellate court reversed the order for consolidation, holding that the joint administration of cases was insufficient to make them consolidated and that the wife's assets and proceeds of assets were sufficiently identifiable to be subject only to her debts. The court also held that, because the creditor did not rely on the farm as security for the loan and did not attempt to clarify ownership of the farm before making the loan, the equities favored not subjecting the wife's farm to the husband's guarantee. *In re Reider*, 31 F.3d 1102 (11th Cir. 1994).

SALES TAXES. The debtors were the owners of a corporation which operated a pizza restaurant which owed the state for sales taxes collected but not paid. The debtors were personally liable for the corporation's sales taxes. The debtors argued that the sales taxes were a form of excise tax dischargeable under Sections 523(a)(1)(A), 507(a)(7)(E). The court held that because the debtors were personally liable for the taxes, the sales taxes were a trust fund type of tax under Section 507(a)(7)(C) and nondischargeable. *In re Kelley*, 171 B.R. 113 (Bankr. N.D. Okla. 1994).

CHAPTER 12-ALM § 13.03[8].*