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Publisher/Editor  
Robert P. Achenbach, Jr.  
Contributing Editor  
Dr. Neil E. Harl, Esq.

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## CARE NEEDED IN DRAFTING QTIP PROVISIONS AND IN POST-DEATH PLANNING TO REPAIR DEFICIENCIES

— by Neil E. Harl\*

Action by the Court of Appeals for the Federal Circuit in late 1998 in *Rinaldi v. United States*,<sup>1</sup> affirming a 1997 U.S. Court of Federal Claims case<sup>2</sup> has focused attention on an approach to disposing of an interest in a closely-held business that can render the property ineligible for qualified terminable interest property (QTIP) treatment.<sup>3</sup> The problem related to a will provision giving a son the right to purchase stock in a closely-held corporation at less than fair market value.<sup>4</sup> The result was ineligibility for the QTIP election.<sup>5</sup>

### The QTIP concept

The QTIP election, enacted in 1981,<sup>6</sup> permits a decedent to leave a life estate to a surviving spouse and to designate the recipients of the remainder interest, thus controlling who ultimately receives the property.<sup>7</sup> Before enactment of the QTIP concept, for a marital deduction it was necessary to leave property to the surviving spouse outright or to leave the surviving spouse a life estate but the life estate had to be coupled with a general power of appointment.<sup>8</sup> In either event, the decedent lost control over who ultimately received the property.

With a QTIP election, it is necessary for two conditions to be met: (1) The surviving spouse must be entitled to all of the income from the entire interest or all of the income from a specific part of the interest payable annually or more frequently, for a period measured solely by the surviving spouse's life<sup>9</sup> and (2) there must not be a power in any person to appoint any part of the property subject to the qualifying income interest to any person other than the spouse during the spouse's life.<sup>10</sup> It was the second of those conditions that was the focus of the *Rinaldi* case.<sup>11</sup>

### *Rinaldi v. United States*

In *Rinaldi v. United States*,<sup>12</sup> The decedent left stock in a closely-held printing company by will under a QTIP arrangement to his wife for life with the stock distributed at her death to his son. If the son were to give up day-to-day management of the company, the trustee was to offer to sell the printing company stock to the son at book value.<sup>13</sup> The book value was \$1,390,178 with a fair market value of \$1,520,067.<sup>14</sup>

After the decedent's will was executed, the printing company elected to be taxed under Subchapter S of the Internal Revenue Code.<sup>15</sup> At that time, trusts could own stock in an S corporation but only for a limited time after death.<sup>16</sup> Eleven months after the decedent's death, the stock in the printing company was redeemed at fair market

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

value from the trust to avoid loss of the Subchapter S election.<sup>17</sup> Seven days later the federal estate tax return was filed.

The court agreed that the will provision giving the son the right to purchase the stock at book value (if the son ceased day-to-day management of the company) was at a price substantially below fair market value. That, the court agreed, would run counter to the QTIP requirement that “no person has a power to appoint any part of the property to any person other than the surviving spouse.”<sup>18</sup> This, the court reasoned, would permit property which had avoided taxation in the decedent’s estate through the QTIP election to escape taxation in the surviving spouse’s estate, also.

The estate argued that the redemption of the stock—seven days before the QTIP election was made—removed the obstacle inasmuch as of the date of the election, the trust owned none of the shares and the son had no right to purchase the shares at a bargain price—book value.<sup>19</sup> The court rejected the IRS argument that the eligibility requirements for QTIP must be met at the date of death.<sup>20</sup> But the court agreed that the post-death redemption of the shares did not bring the will into compliance with the statutory requirements for QTIP eligibility.<sup>21</sup> Thus, the trust property did not qualify for a marital deduction under the QTIP provision.

#### Lessons from *Rinaldi*

The opinion in the U.S. Court of Federal Claims<sup>22</sup> was affirmed by the U.S. Court of Appeals for the Federal Circuit.<sup>23</sup> The U.S. Supreme Court denied certiorari on March 9, 1999.

The case contains two clear lessons: (1) If a QTIP election is contemplated, be wary of any bargain purchase arrangements (which are not uncommon in farm and ranch estate planning as testators often struggle with how to pass ownership interests in the family business to the on-farm heir or heirs); and (2) circumstances which are fatal to the QTIP election may not be correctible by post-death but pre-election planning maneuvers.

#### FOOTNOTES

- <sup>1</sup> 98-2 U.S.T.C. ¶ 60,332 (Fed. Cir. 1998), *cert. denied*, 3/9/99.
- <sup>2</sup> *Rinaldi v. United States*, 38 Fed. Cl. 341 (Ct. Cl. 1997).
- <sup>3</sup> See generally, 5 Harl, *Agricultural Law* § 44.02[6][b] (1999), Harl, *Agricultural Law Manual* § 5.04[3][b][iii] (1999).
- <sup>4</sup> *Rinaldi v. United States*, n. 2 *supra*.
- <sup>5</sup> I.R.C. § 2056(b)(7)(B).
- <sup>6</sup> Pub. L. 97-34, Sec. 403(d)(1), 95 Stat. 302 (1981), enacting I.R.C. § 2056(b)(7)(8).
- <sup>7</sup> See I.R.C. § 2056(b)(7)(B).
- <sup>8</sup> I.R.C. § 2056(b).
- <sup>9</sup> I.R.C. § 2056(b)(7)(B)(ii)(I).
- <sup>10</sup> I.R.C. § 2056(b)(7)(B)(ii)(II).
- <sup>11</sup> See n. 1 *supra*.
- <sup>12</sup> 99-1 U.S.T.C. ¶ 60,332 (Fed. Cir. 1998), *cert. denied*, 3/9/99.
- <sup>13</sup> *Id.*
- <sup>14</sup> The opinion of the U.S. Court of Federal Claims contains inconsistencies as to the book value per share and fair market value per share in comparison to the book values and fair market values for the block of stock. 38 Fed. Cl. 341 (Ct. Cl. 1997).
- <sup>15</sup> See I.R.C. § 1361 *et seq.*
- <sup>16</sup> I.R.C. § 1361(e).
- <sup>17</sup> 38 Fed. Cl. 341 (Ct. Cl. 1997).
- <sup>18</sup> I.R.C. § 2056(b)(7)(B)(ii)(II).
- <sup>19</sup> 38 Fed. Cl. 341 (Ct. Cl. 1997).
- <sup>20</sup> See *Estate of Spencer v. Comm’r*, 43 F.3d 226 (6th Cir. 1995); *Estate of Clayton v. Comm’r*, 976 F.2d 1486 (5th Cir. 1992); *Estate of Robertson v. Comm’r*, 15 F.3d 779 (8th Cir. 1994).
- <sup>21</sup> *Id.*
- <sup>22</sup> *Id.*
- <sup>23</sup> 98-2 U.S.T.C. ¶ 60,332 (Fed. Cir. 1998).

## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

### BANKRUPTCY

#### GENERAL-ALM § 13.03.\*

##### EXEMPTIONS

**HOMESTEAD.** The debtors owned a residence which included 80 acres which they claimed as a rural homestead exempt under Tex. Prop. Code § 41.002(b). The residence area was situated within the municipal boundaries of a city and had a city street running in front of the house. The street had other residences on the other side and some small businesses. The residence had access to and used city water and sewage and was serviced by the city police and fire departments. The rest of the property was outside of the city limits and was used to graze cattle and grow wheat and hay but the debtor’s income came

primarily from a separate business. The court held that the property was not a rural homestead and that the debtors were entitled to exempt only the residence and the surrounding one acre of land. *In re Grisham*, 230 B.R. 529 (Bankr. N.D. Tex. 1998).

**TOOLS OF THE TRADE.** The debtor was 38 years old and owned a 73 acre rural residence. The debtor had not farmed the land for the past two years and was employed full time off the farm. The debtor owned 35 beef cows and 35 calves which were kept on the debtor’s father’s farm and tended to by the father. The debtor did not give any estimate of when the debtor would return to active farming. The debtor sought to exempt several pieces of farm machinery as tools of the trade of farming. The court acknowledged that a debtor could qualify as a farmer while having full time employment off-farm but held that the debtor did not qualify as a farmer because the debtor was not actively engaged in a farming business and had no