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CASH RENTAL OF LAND AFTER DEATH TO FAMILY CORPORATION: NO SPECIAL USE VALUATION RECAPTURE

— by Neil E. Harl*

The rule has been well settled since publication of the "qualified use" regulations in 1980[1] that land must meet a pre-death qualified use test[2] to be eligible for special use valuation. A similar requirement was imposed in the recapture period after death to avoid recapture of the special use valuation benefits.[3] A recent case has addressed an important issue in application of the post-death test;[4] the case could also be important in pre-death eligibility as well.

Pre-death test

The qualified use test requires, in the pre-death period, that the decedent-to-be or member of that person's family have an equity interest in the farm operation.[5] That interpretation, permitting the test to be met by a member of the family of the decedent-to-be, was made in 1981[6] but made retroactive by statute to January 1, 1977.[7] The cases since that time have confirmed that a cash rent lease does not provide an equity interest to the lessor;[8] therefore, a cash rent least to someone who is not a member of the family[9] of the decedent-to-be has been fatal to special use valuation.[10] Cash rent leases to tenants who are members of the family meet the qualified use test.[11]

After-death test

The after-death test was not modified by the 1981 amendment[12] and requires that **each qualified heir** meet the qualified use test.[13] Thus, each qualified heir must have an equity interest in the farm operation. Even a cash rent lease to a son has triggered the recapture tax.[14] The only exception, added in 1988 but retroactive to 1977, permits a surviving spouse who inherits qualified real property to lease the land on a "net cash basis" to a member of the spouse's family without causing recapture.[15]

To sum up, the major difference between the pre-death and post-death qualified use tests is that cash rent leases are permitted in the pre death period if to a member of the family as tenant; cash rent leases are not permitted in the post-death period except for the exception noted above[16] and the two-year grace period immediately after death when the qualified use test need not be met.[17]

The Minter case

The Eighth Circuit Court of Appeals has now decided a case, *Minter v. United States*,[18] involving a cash rental of land in the post death period to a family corporation. The facts of the case were that a family trust cash rented the land to the family corporation. The three children (two daughters and a son) were equal beneficial owners of the farmland in the trust but the daughters each held only about six percent of the corporation's stock. The IRS assessed a recapture tax against the two daughters on the grounds they had failed to meet the post death test.[19] The district court, in an unpublished opinion, granted summary judgment in favor of IRS on the grounds that the post-death qualified use test was not met. The Eighth Circuit reversed, holding that the daughters could retain the benefits of special use valuation.

Aside from the fact that the Eighth Circuit seemed not to understand the difference between the pre-death and post-death tests, and made much of the fact that an identical leasing arrangement had passed muster with IRS at the mother's death earlier for purposes of special use valuation eligibility, the appellate court decision is questionable on the grounds that the holders of the two-thirds interest in the land bore only about 12 percent of the risk. Neither the statute nor the regulations discuss the effect of a cash rent lease to a family entity in which the qualified heirs own an interest. However, a reasonable interpretation of the statute requiring each qualified heir to meet the equity interest test would be that each qualified heir own an interest in the entity proportionate to the qualified heir's ownership interest in the land. It seems reasonable to assume that a modest departure from that rule would not be fatal, but for the holder of a one-third interest in land to be able to meet the test by owning less than six percent of the lessee seems well outside reasonable bounds.

In conclusion

Until this matter is resolved by statute, regulations or further litigation, it would seem prudent in all circuits, including the Eighth, to assure that each qualified heir be fully at risk where the land is cash rented to a family entity.

FOOTNOTES

1 See Treas. Reg. § 20.2032A-3(b)(1) (1980).

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[2] I.R.C. § 2032A(a)(1),(b)(1)(C). See 5 Harl, *Agricultural Law* § 43.03[2][d][i] (1994); Harl, *Agricultural Law Manual* § 5.03[2][d][iii] (1994).
[3] I.R.C. § 2032A(c)(6)(A).
4 Minter v. U.S., 94-1 U.S. Tax Cas. (CCH) ¶ 60,160 (8th Cir. 1994).
[5] Treas. Reg. § 20.2032A-3(b)(1), *added by* T.D. 7786, Aug. 25, 1981.
[6] *Id*.
[7] I.R.C. § 2032A(b)(1)(c)(i), *as amended by* Pub. L. 97-34, Sec. 421(b)(1), 95 Stat. 306 (1981).
[8] E.g., Estate of Heffley v. Comm'r, 89 T.C. 265 (1987, *aff'd*, 884 F.2d 279 (7th Cir. 1989) (special use valuation denied where decedent cash rented farm to non-family members, son-in-law and cousin); Estate of Sherrod v. Comm'r, 774 F.2d 1057 (11th Cir. 1985), *rev'g*, 82 T.C. 523 (1984) (non-timber tracts not eligible because cash rented to unrelated parties).
[9] See I.R.C. § 2032A(e)(2).
[10] *Id*.
[11] See, e.g., Ltr. Rul. 8149006, Aug. 26, 1981 (cash rent lease to son as farm tenant met qualified use test).
[12] See n. 7 *supra*.
[13] I.R.C. § 2032A(c)(1)(B).
[14] See Shaw v. Comm'r, T.C. Memo. 1991-372.
[15] I.R.C. § 2032A(b))(5)(A).
[16] See n. 15 *supra* and accompanying text.
[17] I.R.C. § 2032A(C)(7)(A).
[18] N. 4 *supra*.
[19] *Id*.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

AVOIDABLE TRANSFERS. Prior to filing bankruptcy, the debtors fraudulently transferred their farm homestead to third parties. One of the debtors' creditors filed suit in state court and received a judgment of fraudulent transfer which was filed prior to the debtors' bankruptcy filing. In the bankruptcy case, the trustee also moved for avoidance of the transfer as fraudulent. The trustee objected to the creditor's judgment lien claim against the homestead, arguing that the judgment lien did not attach to the property because the debtors did not have ownership and possession of the property when the lien was recorded. The court held that, under state law, the judgment attached to the property when filed and remained a senior interest against the property after the bankruptcy filing and during the trustee's avoidance of the transfer. ***In re* Mathiason, 16 F.3d 234 (8th Cir. 1994), *aff'g unrep. D. Ct. dec. aff'g*, 129 B.R. 173 (Bankr. D. Minn. 1991)**.

EXEMPTIONS

AVOIDABLE LIENS. The debtor had granted a creditor a nonpossessory, nonpurchase money security interest in personal property which the debtor claimed as exempt under state law in the Chapter 13 bankruptcy case. The debtor sought to avoid the lien as impairing the exemption. The creditor argued that under the state exemption laws, the exemption did not apply to nonpossessory, nonpurchase money liens; therefore, the lien did not impair the exemption. The court held that *Owen v. Owen, 500 U.S. 305 (1991)* overruled the Fifth Circuit's prior case precedent; therefore, the lien was avoidable as impairing the exemption. **Matter of Maddox, 15 F.3d 1347 (5th Cir. 1994)**.

TOOLS OF THE TRADE. The debtor operated a farm fertilizer business in which the debtor removed cattle manure from feedlots and sold the manure as fertilizer to other farmers. The debtor owned a front-end loader, a truck, radios used for communicating between the loader and truck, an interest in a radio tower on which the radio antennas were affixed, and a trailer for the loader. The debtor claimed the equipment as exempt tools of the trade. The court rejected the trustee's argument that the equipment be adapted exclusively for the debtor's trade or business and ruled that the equipment was eligible for the tools of the trade exemption. ***In re* Legg, 164 B.R. 69 (Bankr. N.D. Tex. 1994)**.

CHAPTER 12-*ALM* § 13.03[8].*

NOTICE TO CREDITORS. The FmHA filed a proof of claim in the debtor's Chapter 12 case and requested that notices be sent to the state office. The debtors sent notice of their proposed plan and confirmation hearing to the state office of the United States Attorney and the FmHA national office. The FmHA did not appear at the confirmation hearing and argued that sufficient notice was not sent. The court held that the notice was not sufficient and ordered a new confirmation hearing. ***In re* Miller, 16 F.3d 240 (8th Cir. 1994), *aff'g unrep. D. Ct. dec. aff'g*, 140 B.R. 499 (Bankr. E.D. Ark. 1992)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

ALLOCATION OF PLAN PAYMENTS OF TAXES. The debtor was a corporation which filed for Chapter 11 but the debtor was liquidated under the plan. The IRS had an administrative claim for post-petition taxes. Because of other litigation, only one-half of the IRS claim was promptly paid, with a portion of the litigation proceeds paid after all appeals were exhausted. However, the IRS claim continued to accrue penalties and interest during the appeals such that the proceeds of the litigation were insufficient to pay the total administrative claim. The IRS applied the proceeds first to penalties and then to principal and interest and sought payment of the deficiency from the debtor's principals. The principals sought an order requiring the proceeds to be allocated first to principal and interest because the principals had contributed their personal assets and services without compensation to increase the bankruptcy estate from the liquidation of the debtor.