



**Agricultural Law Press**

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# Agricultural Law Digest

Volume 20, No. 10

May 15, 2009

ISSN 1051-2780

## **Split-Interest Purchases of Land Clarified; Another Way to Acquire Additional Farmland?**

-by Neil E. Harl\*

In recent years, split-interest purchases of land and other assets have been known principally as a study in trying to stay ahead of federal limitations imposed by Congress.<sup>1</sup> As an example, changes in the handling of depreciation have discouraged so-called split-interest purchases.<sup>2</sup> However, a 2008 letter ruling has clarified some aspects of depreciation for property interests acquired in a split-interest purchase and opened up some areas of possible advantageous use.<sup>3</sup>

### **Limits on depreciation and amortization**

For several years, a remainder holder who purchased a term interest in property (a life estate or an interest for a term of years) was entitled to claim an amortization deduction for income tax purposes with the cost amortized over the term of the interest.<sup>4</sup> This had encouraged the joint purchase of assets such as farmland with a parent typically purchasing a life estate or other term interest and a child purchasing the remainder interest.

However, some courts had denied an amortization deduction where a term or life interest was carved out of a fee simple interest.<sup>5</sup> Both the “anti-freeze” rules enacted in 1987<sup>6</sup> (repealed in 1990)<sup>7</sup> and the rules enacted to replace the freeze provisions<sup>8</sup> targeted joint purchase or split-interest transactions of the type involving the purchase of a life or term interest and a remainder interest by related parties. Under the 1990 “freeze” rules, if two or more related party purchasers acquire property in a transaction whereby one acquires a term interest, the one acquiring the term interest is treated as having acquired the entire property and then transferred to the other party the interests acquired by the other party in the transaction.<sup>9</sup> This can lead to gift tax concerns.

The Revenue Reconciliation Act of 1989, for term interests acquired or created after July 27, 1989,<sup>10</sup> specified that no depreciation or amortization deduction was allowed for a term interest in property for any period during which the remainder interest in the property is held, directly or indirectly, by a related person.<sup>11</sup> A term interest in property means a life interest, an interest for a term of years or an income interest in a trust.<sup>12</sup> A “related person” is as defined in I.R.C. § 267(b) or (e), a broad definition.<sup>13</sup> The term “related party” includes brothers and sisters, spouse, ancestors and lineal descendants as well as entities under a detailed set of rules.<sup>14</sup>

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Next issue will be published on June 5, 2009.

Under the 1989 change, the taxpayer's basis in the term interest is reduced by the deductions disallowed by the provision<sup>15</sup> and the remainder person's basis is increased by the amount of the disallowed deduction, reduced by any depreciation allowable to the term holder with respect to the underlying property.<sup>16</sup> However, the remainder holder's basis is not increased by any disallowed deductions attributable to periods during which the term interest was held by (1) an organization exempt from tax under subtitle A of the Internal Revenue Code or (2) a nonresident alien individual or foreign corporation if income from the term interest is not effectively connected with the conduct of a trade or business in the United States.<sup>17</sup>

### The 2008 letter ruling

The letter ruling, dated September 24, 2008,<sup>18</sup> involved the sale of a tract of real estate including buildings, a parking structure and a surface parking lot owned by land trusts to a remainder holder with a retained term interest in the property by the seller and with the purchase of a term interest by the taxpayer. The sellers were not related to the remainder holder or the taxpayer. The taxpayer represented that the intent was to use the term interest in its active business of renting commercial and residential property.

The ruling notes that a taxpayer who purchases a term interest is entitled to deduct the cost of that interest over its expected life.<sup>19</sup> The ruling explains that this is the case even though the property underlying the term interest is not depreciable (such as land). However, if a taxpayer, without additional investment, splits its interest in nondepreciable property into a term interest and a remainder interest, and the taxpayer retains the term interest, depreciation deductions are not allowable for the term interest.<sup>20</sup> In addition, no depreciation deductions are allowable for any term interest in property for which the remainder interest is held, directly or indirectly, by a related person.<sup>21</sup> The ruling goes on to state that if the property is used in the taxpayer's trade or business or held for the production of income, the portion of the taxpayer's basis in the term interest allocable to the land is an intangible asset with limited use and, as a result, can be depreciated over the period of the term interest. The depreciable assets are also subject to depreciation in the usual manner under MACRS rules.<sup>22</sup> All of this assumes the transactions do not involve related parties.

### Planning possibilities

The letter ruling raises the question of whether such split-interest purchases between unrelated parties (such as between a farm tenant wanting to acquire additional land and an investment firm interested in a long-term investment opportunity) might be viewed as an alternative to long-term rental arrangements which, in recent years, have been characterized by wildly fluctuating rental rates. That is the type of situation covered by the letter ruling although in a commercial setting. That strategy would not be possible where land ownership is limited for some corporate and limited liability company investors as well as for trusts in a few states.

### ENDNOTES

<sup>1</sup> See I.R.C. §§ 273, 1001(2), 2702(c)(2). See generally 4 Harl, *Agricultural Law* § 29.03[9] (2009); Harl, *Agricultural Law Manual* § 4.03[6] (2009); Harl, *Farm Income Tax Manual* § 3.20[4][a][iv][C] (2009).

<sup>2</sup> E.g., I.R.C. § 273.

<sup>3</sup> Ltr. Rul. 200852013, Sept. 24, 2008.

<sup>4</sup> *Gist v. United States*, 423 F.2d 1118 (9th Cir. 1970); *Bell v. Harrison*, 212 F.2d 16 (7th Cir. 1954). See *Richard Hansen Land, Inc. v. Comm'r*, T.C. Memo. 1993-248 (corporation's estate for years interest in farmland depreciable, although remainder interests purchased by shareholders, where corporation's interest purchased with separate funds); Rev. Rul. 62-132, 1962-2 C.B. 73.

<sup>5</sup> See, e.g., *Lomas Santa Fe, Inc. v. Comm'r*, T.C. Memo. 1874-662, *aff'd*, 693 F.2d 71 (9th Cir. 1982).

<sup>6</sup> Pub. L. No. 100-203, § 10402(a), 100 Stat. 1330-431 (1987).

<sup>7</sup> Pub. L. No. 101-508, § 11601(a), 104 Stat. 1388-491 (1990).

<sup>8</sup> *Id.*, § 11602, adding I.R.C. § 2702(c)(2).

<sup>9</sup> I.R.C. § 2702(c).

<sup>10</sup> Pub. L. No. 100-239, § 7645, 103 Stat. 2381 (1989), amending I.R.C. § 167(r), subsequently designated as § 167(e) by the Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11812(a)(1), 104 Stat. 1388 (1990).

<sup>11</sup> *Id.* See *Kornfeld v. Comm'r*, 137 F.3d 1231 (10th Cir. 1998), *aff'g*, T.C. Memo. 1996-472 (step transaction doctrine applied to deny appreciation; bonds purchased by taxpayer with remainder interest purchased by children but held by taxpayer's secretary).

<sup>12</sup> See I.R.C. §§ 167(e)(5)(A), 1001(e)(2).

<sup>13</sup> I.R.C. § 167(e)(5)(B).

<sup>14</sup> I.R.C. § 267(b), (e).

<sup>15</sup> I.R.C. § 167(e)(3)(A).

<sup>16</sup> I.R.C. § 167(e)(3)(B).

<sup>17</sup> I.R.C. § 167(e)(4)(A).

<sup>18</sup> Ltr. Rul. 200852013, Sept. 24, 2008.

<sup>19</sup> *Gordon v. Comm'r*, 85 T.C. 309, 322-323 (1985). See also *Lomas Santa Fe, Inc. v. Comm'r*, 74 T.C. 662, 683 (1980), *aff'd*, 693 F.2d 71 (9th Cir. 1982).

<sup>20</sup> *Lomas Santa Fe, Inc. v. Comm'r*, 74 T.C. 662 (1980), *aff'd*, 693 F.2d 71 (9th Cir. 1982).

<sup>21</sup> I.R.C. §§ 167(e)(1), 267(b), (e).

<sup>22</sup> I.R.C. § 168.