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Handling a “Split-Interest” Arrangement With a Life-Estate Preceding a Charitable Remainder for Farms and Personal Residences

-by Neil E. Harl*

The rapid run-up in farm and ranch real estate values in recent years has resulted in some property owners considering a charitable contribution but often with a life estate for the surviving spouse.¹ That result was made possible by an amendment in the Tax Reform Act of 1969.² Such a plan can be implemented rather simply with a legal life estate followed by a remainder interest to the charitable organization.

The general rule disallowing that approach

Since 1969, the rule has been that, except for a personal residence or farm, the value of a remainder or other limited interest transferred to a charitable organization is not allowed as a federal estate tax (or gift or income tax) deduction *if there is a non-charitable income beneficiary* unless the transfer of the limited interest is in trust and meets the requirements to be a charitable remainder annuity trust, a charitable remainder unitrust or a pooled income fund.³

Defective split-interest trusts can be reformed if specified conditions are met.⁴

The requirements for a successful split-interest arrangement

“*Personal residence or farm.*” As noted, the special exception for creating a life estate (often for the surviving spouse) with the remainder interest to a charitable organization is limited to a “personal residence” or “farm.”⁵ A “farm” for this purpose includes the improvements and is defined as “any land used by the decedent or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock.”⁶ A “personal residence” includes a vacation home.⁷

Leaving proceeds of sale of a farm (or personal residence) to charity. Leaving a charity an interest in the proceeds of a sale of a personal residence or farm may not qualify for the exception.⁸ However, if local law permits the charitable organization to take the property itself, the charitable deduction may be allowed.⁹ The Tax Court has allowed the deduction even in the face of a will provision to sell the property at the death of the life tenant.¹⁰

Placing the residence or farm in trust. Placing the farm (or personal residence) in trust with the remainder interest to charity disqualifies the remainder for the charitable deduction unless the property is in a charitable remainder unitrust, annuity trust or pooled income fund.¹¹

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Straight line depreciation or depletion. If a remainder interest in a farm or personal residence is transferred during life to a qualified charity, the amount of the federal income tax deduction must take into account straight-line depreciation or depletion.¹² Transfer of a remainder interest subject to a mortgage is treated as part sale (to the extent of the mortgage) and part charitable gift.¹³

Areas to watch

The Internal Revenue Code allows a QTIP election at the first death where there is a vested interest in the remainder held by a charitable organization.¹⁴ That is specifically authorized if it involves a charitable remainder annuity trust or charitable remainder unitrust.¹⁵ However, there is no mention of that being available under the special exception for farms and personal residences.¹⁶

It is important to note that the regulations for the federal estate tax charitable deduction state that no charitable deduction is allowed from the decedent's gross estate, I.R.C. § 2055, for property for which a deduction is allowed for qualified terminable interest property (QTIP).¹⁷ It is also important to note that the Internal Revenue Code¹⁸ disallows double deductions under that section (I.R.C. § 2056) or elsewhere in Chapter 11 of the Internal Revenue Code.

ENDNOTES

¹ See Duffy, "2013 Iowa Farmland Value Survey," Iowa State University, December 2013 (5.1 percent increase in 2013 to an average of \$8,716 per acre; sales of farmland in Iowa have been reported as high as \$21,900 per acre).

² Pub. L. No. 91-172, § 201(a)(1), 83 Stat.527 (1969). See generally 5 Harl, *Agricultural Law* § 44.04 (2014); Harl, *Agricultural Law Manual* § 5.04[4] (2014).

³ I.R.C. §§ 170(f)(3)(B), 2055(e)(2). See, e.g., Galloway v. United States, 492 F.3d 219 (3d Cir. 2007) (split-interest trust; charitable deduction denied, subject to disallowance rules of I.R.C. § 2055 (e)(2)).

⁴ I.R.C. § 2055(e)(3). See Estate of Tamulis v. Comm'r, 509 F.3d 343 (7th Cir. 2007). See also Oetting v. United States, 712 F.2d 358 (8th Cir. 1983) (where property was left in trust for non-charitable beneficiaries for life, remainder interest to charities, charitable deduction was available; judicial modification of trust so property not subject to diversion to a non-charitable purpose).

⁵ I.R.C. § 170(f)(3)(B)(i). See Estate of Proctor v. Comm'r, T.C.Memo. 1994-208 (charitable deduction allowed for value of ranch left to charitable organization); Ltr. Rul. 9714017, Dec. 30, 1996 (gift tax deduction allowed for contribution of remainder interest in farm and personal residence to exempt foundation).

⁶ Treas. Reg. § 20.2055-2(e)(2)(iii). See Rev. Rul.78-303, 1978-2 122 (gift of remainder interest in farm leased to a tenant allowed as a deduction).

⁷ Treas. Reg. § 20.2055-2(e)(2)(ii).

⁸ Rev. Rul. 77-169, 1977-1 C.B. 286. See Ltr. Rul. 9347002, July 29, 1993 (remainder interest in farmland to be sold not

eligible for charitable deduction; surviving spouse entitled to income from proceeds of sale during administration of the estate).

⁹ Rev. Rul. 83-158, 1983-2 C.B. 159; Ltr. Rul. 8141037, July 9, 1981.

¹⁰ Estate of Blackford v. Comm'r, 77 T.C. 1246 (1981), *acq.*, 1983-2 C.B. 1.

¹¹ Rev. Rul. 76-357, 1976-2 C.B. 285.

¹² See Treas. Reg. § 1.170A-12.

¹³ Ltr. Rul. 9329017, April 26, 1993) (eligible for charitable deduction for remainder interest in difference between fair market value and outstanding mortgage).

¹⁴ I.R.C. § 2056(b)(8).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ I.R.C. 2056(b)(7)(A)(2).

¹⁸ I.R.C. § 2056(b)(9).

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