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Post-Death Cash Renting With Special Use Valued Real Estate

-by Neil E. Harl*

The statute creating special use valuation for real property as enacted in 1976 effective in 1977¹ did not permit cash rent leasing in the after-death period² except for the two year “grace period” immediately after death³ for purposes of further meeting the “qualified use” test (which was enacted in 1981).⁴ However, that requirement has been modified twice, once in 1988 and once in 1997 as discussed below, and made retroactive to 1976.⁵

Cash rents by surviving spouses

The relaxation of the rule barring cash rents after the end of the two-year grace period, was first enacted for surviving spouses in 1988⁶ and provided as follows ---

“For purposes of subsection (c), such surviving spouse shall not be treated as failing to use such property in a qualified use solely because such spouse rents such property to a member of such spouse’s family on a net cash basis.”

The effective date was with respect to rentals occurring after December 31, 1976.⁷ The legislation included a waiver of the statute of limitations.⁸

That legislation was repealed in 1997 with re-enactment of that provision in a different form and enacting a similar rule for lineal descendants cash renting to a member of the lineal descendant’s family.⁹ The revised section provides as follows –

“ . . . a surviving spouse or lineal descendant of the decedent shall not be treated as failing to use qualified real property in a qualified use solely because such spouse or descendant rents such property to a member of the family of such spouse or descendant on a net cash basis. For purposes of the preceding sentence, a legally adopted child of an individual shall be treated as the child of such individual by blood.”¹⁰

Limiting the discussion for the moment to surviving spouses, note that the property must be rented to “. . . a member of the family of such spouse . . . on a net cash basis.”¹¹ The term “net cash basis” is not defined in the amendment. Notably, the amendment does not address so-called “hybrid” leases.¹² The amendment was effective retroactively to leases entered into after December 31, 1976.¹³

Situation with marital deduction trusts. For cash rent leases by two trust marital deduction wills or trusts, a cash rent lease *by the marital trust* comes within the exception if the surviving spouse either has outright ownership or a life estate coupled with a general power of appointment.¹⁴ A cash rent lease by the non-marital trust (the so-called “bypass” trust) was held to be a recapture disposition where the spouse was not the sole beneficiary because

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the trustee had “sprinkling” powers in favor of the spouse and the decedent’s issue during the spouse’s life.¹⁵ In another private letter ruling, cash rent leases by the marital trust and non-marital trust (and where in the non-marital or “bypass” trust the surviving spouse had a life estate with the right in the trustee to make discretionary principal distributions to others) a cash rent lease came within the exception because the lease (under a “drop dead” clause) was set to terminate at the death of the surviving spouse or, if discretionary distributions were made, during the spouse’s lifetime the lease would also terminate.¹⁶

Would a QTIP trust be eligible for the exception? Under a QTIP (qualified terminable interest property) trust, the spouse has a “qualifying interest for life” which includes the right to the income for life and an assurance that the principal will not be subject to a power of appointment in favor of anyone but the surviving spouse during the spouse’s lifetime.¹⁷ Thus, it would appear that a cash rent lease by such a trust to a member of the spouse’s family would not be eligible for the exception.

Cash renting by lineal descendants of the decedent to members of the lineal descendant’s family

The emphasis in this provision, enacted for the first time in 1997,¹⁸ is on “lineal descendant of the decedent.” In one instance, the decedent had no children or other descendants and left a ranch to her niece (who was not a lineal descendant of the decedent). The niece was unable to cash rent the ranch to her son who had been operating the ranch. In that instance, the parties agreed to work out a sharing of the calf crop as rent.

Warnings

The Committee Reports for the 1997 enactment¹⁹ state that the amendment “assumes” the lessor “. . . continues to operate the farm or closely-held business.”²⁰ Particularly in light of the IRS position of assessing self-employment tax on mere investors who are well short of trade or business status,²¹ that language in the committee reports could be used to counter the exception.

Also, the 1997 amendments added a provision²² which states –

If property is qualified real property with respect to a decedent . . . and such property was acquired or passed from the first decedent to the surviving spouse of the first decedent, for purposes of applying this subsection and subsection (c) in the case of an estate of such surviving spouse, active management of the farm or other business by the surviving spouse shall be treated as material participation by such surviving spouse in the operation of the farm or business.”²³

The reference to subsection 5 “(in I.R.C. § 2032A(b)(5)) is not worrisome but the reference to also making that language applicable to subsection (c) could be troublesome inasmuch as subsection (c) contains in Subsection (c)(7)(E) the rules for “net cash basis” leasing. One question is whether “material participation” is inconsistent with “net cash basis” leasing. Certainly, that language could have implications for self-employment tax liability, also.²⁴

ENDNOTES

¹ Tax Reform Act of 1976, Pub. L. No. 94-455, § 2003, 90 Stat. 1520 (1976).

² I.R.C. § 2032A(c)(1)(B).

³ I.R.C. § 2032A(c)(7)(A). See generally 5 Harl, *Agricultural Law* § 43.03[2][g][1] (2014); Harl, *Agricultural Law Manual* § 5.03[2][f][i][C] (2013). See, e.g., Harl, “Recapture Under Special Use Valuation on Sale of Non-elected Property,” 22 *Agric. L. Dig.* 41 (2011). See generally Harl, “Special Use Valuation: The Complexities of Economic Engineering,” 60 *N.D. L. Rev.* 7 (1984).

⁴ Economic Recovery Tax Act of 1981, § 421(c)(2)(A).

⁵ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 504(a), 111 Stat. 788, 853 (1997).

⁶ Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6151, 102 Stat. 3724 (1988).

⁷ *Id.*, § 6151(b)(1).

⁸ *Id.*, § 6151(b)(2).

⁹ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 504(a), 111 Stat. 788, 853 (1997).

¹⁰ I.R.C. § 2032A(c)(7)(E).

¹¹ I.R.C. § 2032A(c)(7)(E).

¹² See *Ltr. Rul.* 8217193, Jan. 29, 1982.

¹³ *Id.*

¹⁴ *Ltr. Rul.* 9043044, July 31, 1990 (cash rent lease by marital trust was not a disposition because the spouse was the sole beneficiary).

¹⁵ *Id.*

¹⁶ *Ltr. Rul.* 9022007, Feb. 27, 1990.

¹⁷ I.R.C. § 2056(b)(7)(B)(ii)(II).

¹⁸ I.R.C. § 2032A(c)(7)(E).

¹⁹ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 504(a), 111 Stat. 788, 853 (1997).

²⁰ Conf. Rep. 105-220, Taxpayer Relief Act of 1997, 105th Cong., 1st Sess. (1997).

²¹ See *Morehouse v. Commissioner*, 140 T.C. No. 16 (2013), appealed to the Eighth Circuit Court of Appeal on 9/23/13/. See Harl, “The Latest Chapter in the CRP Saga,” 24 *Agric. L. Dig.* 97 (2013); Harl, “Surprising Move by the Tax Court on Self-Employment Tax Liability,” 140 *Tax Notes* 931 (No. 9, August 26, 2013).

²² I.R.C. § 2032A(b)(5).

²³ *Id.*

²⁴ I.R.C. § 1402(a)(1).