Split Interest Land Acquisitions – Is it For You? (Part 1)

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In General

A split-interest transaction involves one party acquiring a temporary interest in the asset (such as a term certain or life estate), with the other party acquiring a remainder interest. The temporary interest may either refer to a specific term of years (i.e., a term certain such as 20 years), or may be defined by reference to one or more lives (i.e., a life estate). The remainder holder then succeeds to full ownership of the asset after expiration of the term certain or life estate.

A split-interest transaction is often used as an estate planning mechanism to reduce estate, gift as well as generation-skipping transfer taxes. But there are related party rules that can apply which can impact value for estate and gift tax purposes.

Another way that a split-interest transaction may work is as a mechanism for removing after-tax income from a family corporation. In addition, if the farmland is being purchased, the split-interest arrangement allows most of the cost to be covered by the corporation, but without trapping the asset inside the corporation (where it would incur a future double tax if the corporation were to be liquidated).

Split-interest land transactions – it's the topic of today's post.

Split-Interest Transactions

The *Hansen* case. In *Richard Hansen Land, Inc. v. Comr., T.C. Memo. 1993-248*, the Tax Court affirmed that related parties, such as a corporation and its controlling shareholder, may enter into a split-interest acquisition of assets. The case involved a corporation that acquired a 30-year term interest in farmland with the controlling shareholder acquiring the remainder interest. Based on interest rates in effect at the time, the corporation was responsible for about 94 percent of the land cost and the controlling shareholder individually paid for six percent of the land cost. Under the law in effect at the time, the court determined that the term interest holder's ownership was amortizable. The corporation was considered to have acquired a wasting asset in the form of its 30-year term interest.

Tax implications. The buyer of the term interest (including a life estate) may usually amortize the basis of the interest ratably over its expected life. That might lead some taxpayers to believe that they could therefore take depreciation on otherwise non-depreciable property. For instance, this general rule would seem to allow a parent to buy a life estate in farmland from a seller (with the children buying the remainder) to amortize the amount paid over the parent's lifetime. If that is true, then that produces a better tax result than the more common approach of the parent buying the farmland and leaving it to the children at death. Under that approach no depreciation or amortization would be allowed. However, the Tax Court, in *Lomas Santa Fe, Inc. v. Comr., 74 T.C. 662 (1980),* held that an amortization deduction is not available when the underlying property is non-depreciable and has been split by its owner into two interests without any new investment. Under the facts of the case, a landowner conveyed the land to his wholly owned corporation, subject to a 40-year retained term of years. He allocated his basis for the land between the retained term of years and the transferred remainder and amortized the former over the 40-year period. As noted above, the court denied the amortization deduction.

In another case involving similar facts, *Gordon v. Comr., 85 T.C. 309 (1985),* the taxpayer bought life interests in tax-exempt bonds with the remainder interests purchased by trusts that the taxpayer had created. The taxpayer claimed amortization deductions for the amounts paid for his life interests. The Tax Court denied the deductions on the basis that the substance of the transactions was that the taxpayer had purchased the bonds outright and then transferred the remainder interests to the trusts.

Related party restriction. For term interests or life estates acquired after July 28, 1989, no amortization is allowed if the remainder portion is held, directly or indirectly, by a related party. *I.R.C. §167(e)(3).*

Note: I.R.C. §167(e) does not apply to a life or other terminable interest acquired by gift because I.R.C. §273 bars depreciation of such an interest regardless of who holds the remainder. *I.R.C. §167(e)(2)(A).* This provision is the Congressional reaction to the problem raised in the *Lomas Santa Fe* and *Gordon* cases. Under the provision, "term interest" is defined to include a life interest in property, an interest for a term of years, or an income interest held in trust. *I.R.C. §§167(e)(5)(A); 1001(e)(2).* The term "related person" includes the taxpayer's family (spouse, ancestors, lineal descendants, brothers and sisters) and other persons related as described in I.R.C. §267(b) or I.R.C. §267(e). *I.R.C. §167(e)(5)(B).* It also encompasses a corporation where more than half of the stock is owned, directly or indirectly by persons related to the taxpayer. Also, even if the transaction isn't between related parties, amortization deductions could still be denied based on substance over form grounds. *See, e.g., Kornfeld v. Comr., 137 F.3d 1231 (10th Cir. 1998), cert. den. 525 U.S. 872 (1998).*

If the acquisition is non-amortizable because it involves related parties, the term holder's basis in the property (i.e., the corporate tax basis, in the context of a family farm corporation transaction) is annually reduced by the amortization which would have been allowable, and the remainder holder's tax basis (i.e., the shareholder's tax basis) is increased annually by this same disallowed amortization. *I.R.C. §167(e)(3).* Thus, in a split-interest corporation-shareholder arrangement, the corporation would have full use of the land for the specified term of years, and the individual shareholder, as remainderman, would then succeed to full ownership after the expiration of the term of years, with the individual having the full tax basis in the real estate (but less any depreciation to which the corporation was entitled during its term of ownership, such as for tiling, irrigation systems, buildings, etc.).

On the related party issue, the IRS has indicated in Private Letter Ruling 200852013 (Sept. 24, 2008) that if the two purchasers are related parties, the term certain holder could not claim any depreciation with respect to the land *or* with respect to the buildings on the land during the period of the life estate/term interest.

A couple of points can be made about this conclusion:

- The ruling is correct with respect to the land. That's because I.R.C. §167(e)(1) contains a general rule denying any depreciation or amortization to a taxpayer for any term interest during the period in which the remainder interest is held, directly or indirectly, by a related person.

- However, the ruling is incorrect with respect to the conclusion that no depreciation would be available for the buildings on the land. R.C. §167(e)(4)(B) states that if depreciation or amortization would be allowable to the term interest holder other than because of the related party prohibition, the principles of I.R.C. §167(d) apply to the term interest. Under I.R.C. §167(d), a term holder is treated as the absolute owner of the property for purposes of depreciation. Thus, this exception would allow the term holder to claim depreciation with respect to the buildings but not the land, in the case of a related party term certain-remainder acquisition.

Observation. The IRS guidance on this issue is confusing and, as noted, incorrect as to the buildings on the land. It is true that the value paid for the term interest is not depreciable. However, the amount paid for the building and other depreciable property remains depreciable by the holder of the property. Thus, the term interest holder claims the depreciation on the depreciable property during the term. The remainderman takes over depreciation after the expiration of the term. Basis allocated to the intangible (the split-interest) is a separate basis, which is not amortizable. Likewise, the basis allocated to the split-interest may not be attributed over to the depreciable property to make it amortizable.

Allocation procedure. To identify the proper percentage allocation to the term certain holder and the remainderman, the monthly IRS-published AFR interest rate is used, along with the actuarial tables of IRS Pub. 1457 (the most recent revision is June 2023). The relevant interest rate is contained in Table 5 of the IRS monthly AFR ruling.

Example. RipTiller, Inc. is a family-owned C corporation farming operation. The corporation is owned by Dave Sr. and Dave Jr. The corporation has a build-up of cash and investments from the use of the lower corporate tax brackets over a number of years. The family would like to buy additional land, but their tax advisors have discouraged any land purchases within the corporation because of the tax costs of double tax upon liquidation. On the other hand, both Dave Sr. and Dave Jr. recognize that it is expensive from an individual standpoint to use extra salaries and rents from the corporation to individually purchase the land.

The proposed solution is to have the corporation acquire a 30-year term interest in the parcel of land, with Dave Jr. buying the remainder interest. Assuming that the AFR at the time of purchase is 4.6

percent, and assuming a 30-year term, the corporation will pay for 74.0553 percent of the land cost and Dave Jr. will be obligated for 25.9447 percent. RipTiller, Inc. may not amortize its investment, but it is entitled to claim any depreciation allocable to depreciable assets involved with this land parcel. Also, each year, 1/30th of the corporate tax basis in the term interest is decreased (i.e., the nondeductible amortization of the term interest reports as a Schedule M-1 addback, amortized for book and balance sheet purposes but not allowable as a deduction for tax purposes) and added to Dave Jr.'s deemed tax cost in the land. As a result, at the end of the 30-year term, Dave Jr. will have full title to the real estate, and a tax cost equal to the full investment (although reduced by any depreciation claimed by the corporation attributable to depreciation allocations).

Caution. Related party split-interest purchases with individuals (e.g., father and son split-interest acquisition of farmland) should be avoided, due to the potentially harsh gift tax consequences of I.R.C. §2702 which treats the individual acquiring the term interest, typically the senior generation, as having made a gift of the value of the term ownership to the buyer of the remainder interest. For this purpose, the related party definition is very broad and includes in-laws, nieces, nephews, uncles and aunts. Similarly, any attempt to create an amortizable split-interest land acquisition, by structuring an arrangement between unrelated parties, must be carefully scrutinized in terms of analyzing the I.R.C. §267 related party rules and family attribution definitions.

Conclusion

In Part 2, I'll take a deeper look at the relative advantages and disadvantages of of split-interest transactions with additional examples.