Split-Interest Land Acquisitions – Is it For You? (Part 2)

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Overview

Yesterday's article looked at what a split-interest transaction is, how it works, and when it can be useful as part of an estate plan. In particular, the focus of Part 1 was on removing after tax income from a family farming corporation and how it can work when farmland is purchased.

Today's article looks at the relative advantages and disadvantages of the split-interest transaction, and what the rules are when property that is acquired in a split-interest transaction is sold.

Part 2 of split-interest transactions – it's the topic of today's post.

Advantages and Disadvantages

Advantages. Because land is not depreciable, the most efficient form of acquisition is to use earnings exposed to a low tax rate. A closely-held C corporation is a relatively efficient entity for creating after-tax dollars with the current tax rate at a flat 21 percent. Even though C corporation after-tax dollars are used for the acquisition of most of the cost of land, the split-interest technique avoids the long-term negative aspect of having the farmland trapped inside the C corporation, and thus avoids the risk of double taxation of land appreciation.

Even though corporate dollars are used to acquire the asset, the individual succeeds to full tax basis in the asset (reduced by any tax depreciation allowable to the corporation on the depreciable portion of the property). The remainderman acquires basis in the real estate even though no economic outlay has occurred by that individual.

Disadvantages. The individual who buys the remainder interest must do so entirely from other sources of after-tax earnings. The land produces no income to the remainderman during the period that the land is available for use by the corporation under the specified term certain. Also, if the land is purchased on a contract or installment payment arrangement, each party must provide its contribution, either to the down payment or the contract.

Note. The party with the cash for the down payment may provide any portion or all of such down payment, with an adjustment for that party's contribution to the contract. The contract may provide for interest only payments by one party, until the other party's contribution toward the purchase has been fully paid.

Example. Sow's Ear, Inc. has been retaining equity of approximately $40,000 per year ($50,000 taxable income minus state and federal taxes) for a number of years. Chuck, the corporate president would

like to purchase additional land with the funds that the corporation has accumulated. Chuck wants the corporation to buy the land with those available funds. However, having the corporation purchase the land would trap up that land inside the corporation and potentially expose it to the double tax upon liquidation as well as eliminating capital gain rates if the corporation would have to sell the land.

An alternative solution would be a split interest purchase. Assume that the land could be purchased for $1 million, with $450,000 down and a contract at 5 percent for the balance, payable $52,988.26 annually for 15 years. Chuck would like to farm for another 20 years via the corporation. Assume that the monthly IRS purchased interest rate for a 20-year split-interest purchase requires the term interest holder to pay 58 percent of the total purchase price or $580,000. Sow's Ear, Inc. may pay $200,000 of the down payment. It's share of the remaining balance due is $380,000. Chuck, as the remainder holder, is responsible for $420,000. The balance due for the down payment may be made by either party. If Sow's Ear, Inc. borrows to satisfy the remaining down payment of $250,000, it will assume $130,000 of the note payable for the balance due ($580,000 less $200,000 cash less $250,000 remaining down payment). Chuck will assume the remaining balance due of $420,000.

Each party must pay interest that economically accrues on its share of the seller-financed debt, otherwise the below-market rate loan rules apply, which tie in with OID requirements. The parties may determine the share of principal to be paid by each, as long as a total of $52,988.26 annually is paid to satisfy the requirements of the seller-financed note. Because Chuck, as the remainderman, has no cash flow coming from the property for the next 20 years, he will have to obtain funds from sources other than rents from the property to fund his payments. The deductibility of interest expense will be subject to the passive activity rules of I.R.C. §469. The interest expense is a passive activity deduction, even though no rent is currently received by Chuck. If Chuck has no passive income from other activities, the interest expense will create a passive loss carryover, to be available to offset net rental income after the term interest held by the corporation expires.

Observation. The split-interest technique is essentially limited to C corporations, because if two related individuals are involved the person acquiring the term interest is treated as having made a gift of the value of the term right to the purchaser of the reminder right.

Observation. In times of low interest rates (i.e., low AFR factors that determine the percentage to be paid by each party), the corporate share will be smaller than occurs in periods when interest rates are higher.

Sale of Split-Interest Property

If a sale occurs during the split ownership of the property, the sale proceeds must be allocated between the corporate term holder and the individual remainderman based on the IRS interest rate and the remaining term certain periods as of the date of the sale. After allocating the sale proceeds to each party, gain or loss is recognized by each party (the corporate term holder and the individual remainderman) by comparing the sale proceeds to the adjusted tax basis of the property. The

adjusted tax basis needs to reflect the nondeductible amortization adjustment occurring annually and the shift of this basis to the remainderman in accordance with I.R.C. §167(e)(3).

Example. Assume that RipTiller, Inc. and Dave Jr. (from the prior example) purchased another farm seven years ago for $200,000, with the corporation acquiring a 32-year term certain. Assume that using interest rates in effect at that time, Dave Jr. was required to pay $25,000 and the corporation paid $175,000 toward the farm purchase price. The corporate basis was further allocated as $20,000 attributable to depreciable tiling and $155,000 attributable to the land cost. By the current year, the corporation would have depreciated about $9,000 of the $20,000 of tiling, leaving an adjusted basis of approximately $11,000. The land basis of $155,000 would also have been reduced annually under straight-line amortization over the 32-year term certain. Assume that about $4,800 per year of amortization occurred over the seven-year holding period of the corporation, resulting in a total reduction to the corporate basis of $33,600. The amortization would be treated as land basis reductions to the corporation, and as land basis increases to Dave Jr. Accordingly, at the time of the sale of the farm, the adjusted tax basis to each party is as follows:

Corporate Basis

	Land	Tiling	Total
Basis at Purchase	$155,000	$20,000	$175,000
Deductible Depreciation		($9,000)	($9,000)
Statutory Amortization	($33,600)		($33,600)
Adjusted Basis	$121,400	$11,000	$132,400

Dave Jr.'s Basis:

At Purchase	$25,000
Statutory Increase for Amortization	$33,600
Total Adjusted Tax Basis	$58,600

If the farm is sold for $250,000, the term certain percentage and remainder percentage must be calculated for a term certain with 25 years remaining. Assume that the current IRS mid-term annual AFR is 6.0 percent. According to the IRS term certain table for 6.0 percent, the 25-year income right is to be allocated 76,7001 percent and the remainderman is to be allocated 23.2999 percent. Accordingly, about $192,000 of the sale proceeds are allocable to the corporation and the remaining $58,000 is allocable to the individual. The corporation would compare its $192,000 of approximate proceeds to its adjusted tax basis in the land and tiling of approximately $132,000. In this example RipTiller, Inc. would report $60,000 of gain. Dave Jr. would report a small capital loss ($58,000 allocated sale price vs. $58,600 adjusted tax basis).

Observation. Interest rates at the time of purchase compared to interest rates at the time of sale can have a major influence on the allocations under the split-interest rules. In the example, if interest rates

rise from the time of purchase to the time of sale, Dave Jr. would have a lower percentage of the sale price allocable to his remainder interest, and could incur a significant capital loss that was not immediately deductible.

Split-Interest Purchases with Unrelated Parties

The IRS has addressed the tax effects of split-interest purchases where the term holder and the remainder holder were unrelated. In two Private Letter Rulings *(200852013 (Sept. 24, 2008) and 200901008 (Oct. 1, 2008))* that appear to address the same set of facts, two unrelated buyers acquired several parcels of commercial real estate that included both depreciable buildings and land. The first buyer acquired a 50-year term interest in the property, and the second buyer acquired a remainder interest in that same property. The IRS determined that the buyer of the term interest was entitled to depreciate the commercial real estate (which the buyer of the term interest intended to use in its active conduct of renting commercial and residential property) ratably over the 50-year period of the term certain. The portion of the taxpayer's basis allocable to the buildings was held to be depreciable under the normal I.R.C. §168 MACRS recovery periods. In addition, the IRS determined that the holding period for the buyer of the remainder interest began at the time of the purchase.

Observation. A term certain remainder purchase arrangement of farmland (that is used in the taxpayer's trade or business) where the two parties are unrelated could result in a term certain amortizable interest in the land. This is the case, according to the IRS, even though the farmland is not depreciable. But see the *Lomas* case referenced in Part 1). Examples of unrelated parties under I.R.C. §267 for these rules would include cousins and in-laws, such as a father-in-law, brother-in-law, or sister-in-law.

Estate Tax Implications

For transactions that are between unrelated parties (as defined in I.R.C. §267), several federal estate tax advantages can be achieved. If the "split" property is fairly valued (by a qualified appraiser), there is no gift upon creation of the split interest if IRS tables are used to value each party's contribution. Also, because the life estate interest ends upon the death of the life estate holder, there is no taxable transfer by that person that would trigger estate tax. There is no inclusion in the life estate holder's estate (and no interest subject to probate). The property becomes fully vested in the remainder holder upon the life estate holder's death. As a result, there is no basis "step-up" to fair market value at the time of the life estate holder's death in the hands of the remainder holder. The basis of the property in the hands of the remainder holder is the cost of the remainder interest (the amount paid for the remainder interest).

Conclusion

Is a split-interest transaction for you? The answer, of course, is that it "depends." For transactions involving individuals, the tax advantages (income tax as well as estate tax) are lost if the parties to the transaction are related. Also, it's important to make sure to the remainder holder provides consideration for the acquisition of the remainder interest (and not simply the life estate holder providing the financing to the holder of the remainder interest). If that doesn't happen, the IRS will

likely claim that the life estate holder made a gift of a future interest that is subject to gift tax and can't be offset by the present interest annual exclusion (currently $17,000 per year per donee).

Still uncertain is whether, for example, a split-interest purchase between unrelated parties (such as between a farm tenant that is looking to farm additional land and an investment firm). The IRS letter rulings seem to address this issue in a commercial context. Another issue in some states is that the strategy won't work in some states if the investor is a corporation, limited liability company or trust that is disqualified from owning and/or operating agricultural land by statute.

For split-interest transactions involving a C corporation, if done correctly, the technique can be beneficial from a tax standpoint.

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