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A COMPARISON OF WAYS TO SELL LAND TO CHILDREN

— by Neil E. Harl*

Parents wishing to sell land to children have an array of choices available to them.¹ The transfer could be accomplished using an installment sale,² a private annuity³ or a self-cancelling installment note.⁴ Of course, the transaction could involve a sale for cash, although that is relatively unlikely, both because of the necessity for the parents as sellers to report the gain in the year of sale and because the children as purchasers may not be able to finance a cash purchase.

For the three basic deferred payment options, the tax and non-tax consequences to the parents as sellers may be quite different.

Retained security interest

For an installment sale transaction, the parents as sellers may retain a security interest in the land transferred. This enables the parents to recover the property on default by the children as buyers. The same applies to a sale under a self-cancelling installment note. The seller may retain a security interest in the land that permits the seller to take action to repossess the property in the event of default in making payments by the buyer.

For a private annuity, however, the annuitant as "seller" cannot retain a security interest in the asset or assets transferred under the private annuity. If the promise by the obligor to make payments is secured, taxable gain may be recognized to the annuitant measured by the difference between the annuitant's basis in the property transferred and the present value of the annuity contract.⁵ Private annuities escape treatment as a sale because there is no ascertainable fair market value inasmuch as there is uncertainty as to the ability of the obligor as an individual to pay when the time for payment arrives.⁶ If the promise to pay is secured, there is more certainty as to value and taxable gain may be recognized.⁷

Consequences of repossession to seller

In the event the buyer defaults, the income tax consequences of repossession are a major concern to the seller. For transfers involving land, the availability of the special relief provision on repossession of land may be of substantial importance to the seller.⁸ Under that provision, Section 1038 of the Internal Revenue Code, repossessions of land are not treated as completed sales as is the case with

sales of personal property. Rather, on repossession of land the amount of gain recognized is the lesser of — (1) the payments received by the seller before reacquisition (the cash and the fair market value of other property received) or (2) the amount of gain remaining in the contract.⁹ By contrast, repossession of personal property ordinarily produces gain or loss to the seller measured by the fair market value of the property repossessed less the seller's basis in the obligation held by the seller and given up on the repossession.

- For installment contract sales, Section 1038 is normally available where the indebtedness was secured by the real property which is required.¹⁰ Ordinarily, the indebtedness is secured by real property under an installment sale.¹¹ The gain on the repossession of real property is limited to the lesser of- (1) the amount of cash and other property received prior to the reacquisition or (2) the remaining gain in the transaction.¹²

- The same treatment applies to a self-cancelling installment note. The relief provision in Section 1038 should be available to the seller.

- Under a private annuity, however, the obligation is not secured by the assets funding the private annuity.¹³ Therefore, reconveyance of the property by the obligor to the annuitant under a private annuity would appear not to come within Section 1038. Therefore, a default under a private annuity typically produces more painful income tax consequences to the annuitant if the private annuity is funded with land and the land is conveyed to the annuitant upon default by the obligor.

Income tax consequences after death

The income tax consequences to the seller are substantially different for the three alternative concepts for land transfer.

- With a private annuity, payments by the obligor cease at the death of the annuitant with no adverse tax consequences to the annuitant or the with no adverse tax consequences to the annuitant or the annuitant's estate. The obligor adjusts the obligor's basis to the property involved after death to equal the payments made on the obligation.¹⁴

- For self-cancelling notes, the deferred gain in the payments cancelled at death is recognized by the decedent's estate and reported on the estate's first income tax return.¹⁵

- In the case of an installment sale, the payments remaining at the death of the seller are not necessarily taxable in the estate but the contract becomes an item of income in respect of decedent¹⁶ and the payments received

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after death are taxable to the recipient in the same manner as the decedent would have reported the payments had the decedent survived.¹⁷

FOOTNOTES

- ¹ See generally 6 Harl, **Agricultural Law** chs. 47, 48 (1993); Harl, **Agricultural Law Manual** §§ 6.02–6.05 (1993).
- ² See 6 Harl, **Agricultural Law** § 48.03.
- ³ *Id.*, ch 49.
- ⁴ *Id.*, § 6.05.
- ⁵ *Est. of Bell v. Comm'r*, 60 T.C. 469 (1973); *212 Corp. v. Comm'r*, 70 T.C. 788 (1978).
- ⁶ See *Commissioner v. Kann's Estate*, 174 F.2d 357, 359 (3d Cir. 1949); *Rev. Rul. 69-74*, 1969-1 C.B. 43; *Stern v. Comm'r*, T.C. Memo. 1992-374 (gain on transfers of stock to foreign trust in exchange for private annuity deferrable).
- ⁷ See n. 5 *supra*.
- ⁸ I.R.C. § 1038.
- ⁹ I.R.C. § 1038(b)(2).
- ¹⁰ *Treas. Reg. § 1.1038-1(a)(1)*.

¹¹ See *Ltr. Rul. 8736026*, June 5, 1987 (Section 1038 applied to repossession of farmland by seller through forfeiture of installment sales contract after several modifications of payment terms).

¹² I.R.C. § 1038(b)(2).

¹³ See n. 5 *supra*.

¹⁴ See *Rev. Rul. 55-119*, 1955-1 C.B. 352.

¹⁵ *Est. of Frane v. Comm'r*, 98 T.C. 341 (1992), *aff'd and rev'd*, 998 F.2d 567 (8th Cir. 1993) (cancellation of installment note treated as disposition).

¹⁶ I.R.C. §§ 691(a)(4), 453B(c).

¹⁷ *Treas. Reg. § 1.691(a)-5*. See *Claiborne v. U.S.*, 648 F.2d 448 (6th Cir. 1981) (closing of land transaction after owner's death); *Ltr. Rul. 9023012*, March 6, 1990 (land contract cancellable if mortgage commitment not obtained within 45 days and decedent died within 45 day period; mortgage commitment not obtained but parties proceeded to closing and gain was income in respect of decedent); *Trust Co. of Georgia v. Ross*, 262 F. Supp. 900 (N.D. Ga. 1966), *aff'd*, 392 F.2d 694 (5th Cir. 1967), *cert. denied*, 393 U.S. 830 (1968); *Hedrick v. Comm'r*, 63 T.C. 395 (1974).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKING

CHECKS. The plaintiff sold cattle to a cattle market agency which resold the cattle to third parties. The agency used an account with the defendant bank to issue checks for these purchases, often with insufficient funds in the account and with the defendant's knowledge and acceptance that payment for the checks would be deposited several days later. The agency had made a purchase of cattle from the plaintiff and had issued a check when sufficient funds were in the account. However, the defendant received a return of a prior deposit for insufficient funds, leaving a negative balance in the agency account. When the payment from the agency's later sale of the cattle arrived at the bank, the bank offset the deposit against the negative balance, closed the account and returned the agency's check to the plaintiff for insufficient funds. The plaintiff argued that the bank had knowledge that the agency was a cattle broker and that the deposit from the buyer was probably meant to be used by the agency to pay the check issued to the plaintiff for the same cattle. The court held that the bank had a duty to inquire as to the nature of the deposit before setting it off against prior charges against the agency's account. **Blackwell Livestock v. Community Bank**, 864 P.2d 1297 (Okla. Ct. App. 1993).

BANKRUPTCY

GENERAL-ALM § 13.03.*

AUTOMATIC STAY. The debtor's Chapter 12 case was converted to Chapter 7 for fraud by the debtors. A creditor held a judgment lien against the debtors' farm which exceeded the debtors' equity in the farm after a mortgage and the debtors admitted that they had no equity

in the farm. The court held that the automatic stay would be lifted as to the judgment creditor because the debtors had no equity in the farm and the farm would not be part of any reorganization. **In re Kingsley**, 161 B.R. 995 (Bankr. W.D. Mo. 1994).

The debtor was an S corporation in Chapter 11 with a confirmed plan. A bank obtained a judgment in state court against a 25 percent shareholder in the corporation and sought relief from the automatic stay to execute the judgment against the shareholder's stock. The corporation had incurred substantial tax losses which were passed through to the shareholder but the losses were not currently deductible because the shareholder did not have sufficient stock basis to claim the deductions. The suspended losses were held to be estate property to the extent the corporation benefited from not having to make distributions to the shareholder to pay taxes on any pass-through income. The corporation, therefore, resisted the bank's motion because the sale of the stock to a third party would cause the loss of the suspended tax losses since the losses were personal to the shareholder. The corporation also argued that the sale of the stock to an individual or entity not eligible to be an S corporation shareholder could cause the complete loss of the suspended tax losses. The court noted that the stock was subject to restrictions which prevented sale to an ineligible shareholder and which prevented sales except upon the consent of the other shareholders and subject to a right of first refusal of the other shareholders and the corporation. The court held that the bank was adequately protected because the reorganization of the corporation would likely result in a substantial increase in the book value of the stock. The court held that the bank would be granted relief from the automatic stay because the relief would not injure