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FUNDING MARITAL AND NON-MARITAL DEDUCTION PORTIONS: THE POSSIBILITY OF A DISCOUNT

— by Neil E. Harl*

Funding the marital and non-marital shares in a farm or ranch estate is always an important decision if a spouse survives unless all property is left outright to the surviving spouse. Planning attention needs to be given to - (1) the type of clause used to create and fund the marital deduction, (2) whether gain is triggered on funding the marital share, (3) how to assure compliance with Rev. Proc. 64-19, (4) how to fund the shares with land under special use valuation, (5) planning for sale of property after the death of the surviving spouse with a minimum amount of gain and how to use the generation skipping transfer tax $1 million exemption for maximum advantage. In addition, a recent Fifth Circuit Court of Appeals case has opened up another possible funding consideration-obtaining a discount for co-ownership of the property involved at the death of the surviving spouse.8

Availability of a discount

Discounts in valuing minority interests and discounts for non-marketability have become almost routine in recent years in valuing farm and ranch real property for federal gift tax and federal estate tax purposes. Since 1989, the courts have generally approved discounts ranging up to 40 percent even though the Internal Revenue Service continues to assert that discounts should be limited to the cost of partitioning the property.12

Discounts related to marital share ownership

The case of Estate of Bonner v. United States has opened up the possibility of a discount for property interests held by the marital share even though the non-marital share ownership interest is held by family members.13

In Bonner, individual interests in ranchland, other real property and a boat were left at the first spouse's death in a qualified terminable interest property (QTIP) arrangement (eligible for the federal estate tax marital deduction) with the surviving spouse as the life beneficiary. At the surviving spouse's death, which was the focus of the case, the undivided interests in the property in question held in the QTIP were included in the surviving spouse's estate.15

with the remainder interest presumably held by unidentified beneficiaries. The other undivided interests in the property were also held by the surviving spouse and were included in the surviving spouse's estate. Thus, the entire ownership interest in the property ended up being included in the surviving spouse's estate.

The estate claimed a 45 percent discount on the value of the ranchland and also claimed a discount on the other real property and the boat. The Internal Revenue Service objected on the grounds that the property ownership merged at the time of the surviving spouse's death, extinguishing the fractional undivided interest and resulting in 100 percent fee simple ownership of assets by the estate. The IRS position was consistent with published rulings in similar fact situations.

The court was unimpressed by the IRS argument, reversed the district court decision and took the position that the case was controlled by Estate of Bright v. United States. In that case, the surviving spouse held a 27 1/2 percent interest in an asset as executor of his wife's estate and an additional 27 1/2 percent interest in the same asset in his individual capacity. The court rejected the argument that the interests should be treated as one 55 percent interest in the asset.21

The Bright decision has been followed by the Ninth Circuit Court of Appeal but criticized by the Seventh Circuit.

The court in Bonner concluded that, for federal estate tax purposes, the determination of tax liability is made as of the moment of death, not before death and not after death. The Fifth Circuit remanded the case to the lower court to calculate the appropriate discount.

Implications for planning

One lesson from Bonner is that funding marital and non-marital shares with undivided interests such as with a fractional share clause positions the estate to claim a discount in valuation at death. That assumes, of course, that the Bonner result will be possible outside the Fifth Circuit Court of Appeal area. Bonner arose in a community property state but the same argument can be made with tenancy in common ownership in other jurisdictions.
The potential disadvantage of undivided interests is that IRS may take the position that, on later sale by individuals receiving undivided interests through both the marital and non-marital shares, it may not be possible to maintain the different (usually higher) income tax basis for the interest passing through the marital share with the result that a sale of an undivided interest involves a proportionate part of each basis amount. Thus, the basis amounts for the two interests may merge after death.

**FOOTNOTES**

2. Id.
3. 5 Harl, supra n. 1, § 44.02[4]; Harl, supra n. 1, § 5.04[3][c][ii].
4. 5 Harl, supra n. 1, § 44.02[5][a]; Harl, supra n. 1, § 5.04[3][c].
5. 1964-1 (pt. 1) C.B. 682.
7. 5 Harl, supra n. 1, § 44.08[3]; Harl, supra n. 1, § 5.04[6][d].
8. Estate of Bonner v. United States 84 F.3d 196 (5th Cir. 1996) (ranchland and other property).
11. Estate of Wildman v. Comm'r, T.C. Memo. 1989-667 (decedent's 20 percent interest in farmland discounted total of 40 percent for minority interest and for restrictions on transferability).
13. 84 F.3d 196 (5th Cir. 1996).
14. Id.
15. I.R.C. § 2056(b)(7).
16. 84 F.3d 196 (5th Cir. 1996).
17. See I.R.C. § 2044.
18. 84 F.3d 196 (5th Cir. 1996).
19. Id.
20. See Ltr. Rul. 9550002, Aug. 31, 1995 (stock included in gross estate under I.R.C. § 2044 aggregated with stock of same class owned outright by decedent and included in gross estate under I.R.C. § 2033); Ltr. Rul. 9608001, Aug. 18, 1995 (partnership interest included in gross estate under I.R.C. § 2044 aggregated with another interest in same partnership under I.R.C. § 2038); Ltr. Rul. 9140002, June 18, 1991 (undivided interests in real estate included under I.R.C. § 2044 aggregated with undivided interest included under I.R.C. § 2033; facts reflect Estate of Bonner, 84 F.3d 196 (5th Cir. 1996)).
21. 658 F.2d 999 (5th Cir. 1981).
22. Id.
23. Id.
24. Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982).
27. Id.
28. See 5 Harl, supra n. 1, § 44.02[4][b].
30. Id.

**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

**BANKRUPTCY**

**GENERAL-ALM § 13.03.***

**PLAN.** The debtor's plan provided for satisfaction of a secured claim by transferring a portion of the farm land collateral to the creditor. The creditor objected to the plan as not providing payment of the value of its claim. The court valued the farm land on the basis of the land's development potential because much of the land in the area was held for investment. However, because only a portion of the collateral land was being transferred the court required that the plan provide for an "indubitable equivalent" of the debtor's claim to be paid to the creditor. The court noted that, because the valuation of the land was uncertain and any sale would not be feasible for at least two years, any valuation established by the court could lead to the creditor receiving less than the value of the claim when the land was sold. Although the court did not require any specific remedy for approval of the plan, the discussion suggests that the creditor receive a lien on any collateral retained by the debtor until the land is sold so that the creditor can seek any deficiency against the remaining collateral. In re Arnold & Baker Farms, 85 F.3d 1415 (9th Cir. 1996), aff’g, 177 B.R. 648 (Bankr. 9th Cir. 1994).

**CHAPTER 12-ALM § 13.03[8].**

**ELIGIBILITY.** Prior to filing for Chapter 12, the debtors operated a hog farm. The debtors suffered losses in their herd from disease which precipitated the bankruptcy filing. Prior to filing a plan, the debtors turned over all remaining livestock to the secured creditor. The plan provided for full payment on an installment contract for the purchase of the farm land. The land was owned by the debtors and one debtor’s mother, who was not a co-debtor in bankruptcy. One effect of the plan payments was to pay the mother's share of the obligation on the farm without any contribution from the mother. During the life of the plan, the debtors’ primary income would be from nonfarm employment and the debtors expressed the intent to use

*Agricultural Law Manual (ALM). For information about ordering the Manual, see the last page of this issue.