The Illinois Fund Concept

Attorneys' Title Guaranty Fund, Inc.

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CASH LEASE IS NOT A SPECIAL USE

According to the U. S. Tax Court, a cash lease on farm property is not a qualified use for estate tax special use valuation, even where the lease is to a family member.

Decedent devised farm property to her son. The estate elected special use valuation under §2032A of the Internal Revenue Code. Prior to decedent's death, her grandson (nephew of decedent's son), farmed the property pursuant to a crop-share lease. Following decedent's death, decedent's son, a qualified heir, executed another lease of the property to the grandson for a four-year, semi-annual cash rental. The IRS found a deficiency in the estate tax and claimed that the qualified use of the property ended when the property owned by decedent's son was leased for cash rent.

The Tax Court noted that, as a general rule, a decedent's property is valued at its highest and best use for estate tax purposes. Section 2032A was enacted to offer some tax relief for farm and small businesses. Section 2032A permits valuation of farm and small business property on the basis of income capitalization rather than on its highest and best use, so long as a qualified heir owns the property for a stated period and uses the property in a "qualified use."

In the event there is an early disposition of the qualified property to a person who is not a qualified heir or an early end of the qualified use, a recapture tax is imposed. There is a two-year grace period after the decedent's death during which the qualified heir is not required to use the property for a qualified use.

The Tax Court held that §2032A contained no provision allowing a qualified heir to cash rent the property even to family members. It stated that, for purposes of the special use valuation rules, the Code definition of "qualified heir" includes only the family member who actually holds the specially valued property. Once he or she ceases to use the property for a qualified use, the special use valuation is disallowed. It makes no difference if another family member continues to use the property for its qualified use.

Petitioner also argued that no recapture tax should be imposed since he "disposed of" the property to a family member in an allowable disposition pursuant to §2032A(c)(1)(A). As a result of the legal disposition of his interest to his nephew, the taxpayer contended, he was relieved of the necessity of personally using the property for a qualified use. The Court held that a leasehold does not qualify as a "disposition of" a property interest for purposes of special use valuation. Therefore, petitioner could not rely upon §2032A(c)(1)(A) to avoid the recapture tax.

The recapture tax is properly imposed if the qualified heir fails to use the qualified property for a qualified use. If the property is leased for cash, the qualified use ceases, even if the lessee is a member of the decedent's family who continues to use the property for farming purposes.

Beryl P. Williamson v. Commissioner, 93 T.C. 242, No. 23, (1989).

IRPTA FROM THE PERSPECTIVE OF THE LAWYER WHO HANDLES TWO-FLATS

By Harold Levine

In college, I was a Humanities major and as a result, I am not very good at science. So, when I first read the provision of the Illinois Responsible Property Transfer Act (IRPTA), I was greatly impressed with the environmental benefits and scientific basis of the statute. However, there seemed to be something basically wrong with the statute and after reading it a few more times, I realized that while IRPTA might be good science, it is bad real estate law.

I realize that in these days of leaky tankers, oil spills and acid rain, coming out against the environment is like attacking motherhood. (I was going to say motherhood and the flag, but I

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1989 Holiday Schedule
Attorneys' Title Guaranty Fund, Inc.

All offices of Attorneys' Title Guaranty Fund, Inc. will be closed on the following holidays:

Christmas Day - Monday, December 25

New Year's Day - Monday, January 1

Happy Holidays to all ATG Members & their staffs!

don't want to get into a discussion of the flag.) Since I don't have a scientific background, all I have to rely on is my experience in getting beat up on the ten o'clock motion call everyday. Anyway, from the perspective of lawyers who close two-flats, IRPTA is defective in at least four ways:

1. The statute does what a statute should never do: It substitutes a subjective criteria for a clear, ascertainable, consistent, objective standard.

2. The statute impairs the stability of executed real estate contracts.

3. The statute surrenders to experts the control and decision on environmental matters.

4. The statute allows the buyer to take unfair advantage of the seller.

The crux of the statute, S.H.A., c. 30, §904, is as follows:

> §4. Duty to Disclose. (a) For all transfers of real property subject to this Act which occur after January 1, 1990, the transferor shall, within 30 days following execution of the written contract, if any, for the transfer of the property, but not later than 30 days prior to the transfer of real property subject to this Act, deliver to the transferee, if any, and to the lender, if any, a disclosure document. Such disclosure document shall be in the form and contain the information required in Section 5 of this Act.
>
> (b) The parties to the transfer of real property subject to this Act may waive the time period specified in subsection (a) of this Section 4 if all such parties indicate in writing that they are aware of the purpose and intent of the disclosure document. Notwithstanding the waiver provision contained in this subsection (b), the disclosure document provided for in Section 5 must be delivered to all parties to the real property transfer on or before the date of transfer of the real property.
>
> (c) If the disclosure document reveals environmental defects in the real property which were previously unknown to the parties to the real property transfer or if the transferor fails to comply with subsection (a) of this Section and fails to obtain a waiver and provide the disclosure as provided for in subsection (b), then any of the parties to the real property transfer may at their discretion, within 10 days after demand for or receipt of the disclosure statement, void any obligation to accept a transfer or finance a transfer which has yet to be closed or finalized.

Any party to the property transfer may void the transfer, prior to closing, if the disclosure statement reveals "environmental defects" in the real property that were previously unknown to the parties or if the transferor fails to provide timely disclosure to transferee and lender. The Act does not define the term "environmental defects," nor is there any indication how serious a defect must be to justify voiding the transfer. The parties, of course, may agree contractually that, notwithstanding IRPTA, the buyer will take the property "as is" with an agreed set aside or a reduction in the sale price to address the cleanup of any contamination of the property.

As to the concept of personal knowledge, a writer has stated:

> It would seem from the language of the disclosure statement certification, which must be signed by the transferor or its representative, that actual knowledge is contemplated. The transferor or his representative must certify that the information supplied in the disclosure statement is true to the best of the transferor's knowledge and belief, based on his inquiry of those persons directly responsible for gathering the information.[1]

So, we have a statute that allows this scenario:

1. Seller says property is okay.

2. Buyer says, "I looked at your disclosure statement and all these substantial environmental considerations were unknown to me. I want to get out of the contract."

3. Seller says, "Based on my personal knowledge, I didn't know of any defects. My engineer made a whole bunch of studies, but I never asked him about it so I had no personal knowledge."

4. Buyer says, "You purposely never asked your engineer, so you would have no personal knowledge."

5. Seller says, "There are no serious environmental defects."

6. Buyer says, "Rubbish, you knew about it and didn't tell me."

So, now the whole issue becomes the subjective state of mind of buyer and seller, like the Iran-Contra affair, the questions are: "What did the seller know and when did he learn it?" "How do we measure the seller's subjective state of mind when he claims that the defects were unknown to him?"

These situations turn into state of mind issues. First, are those cases based on the subjective principle that the state of the property must be acceptable to the purchaser and the sole decision is up to the purchaser? See *In Re Estate of Bajanski*, 129 Ill.App.3d 361, 470 N.E.2d 809 (1985); *Forman v. Benson*, 112 Ill.App.3d 1070, 446 N.E.2d 535 (1983). Or, will some objective standard be upheld? Secondly, get ready for long, time-consuming litigation since intention and state of mind are not the favorite subjects of summary judgment. See *State Farm Mutual Automobile Insurance Company v. Short*, 125 Ill.App.2d 97, 260 N.E.2d 415 (1970).

Now, you may say that the parties can agree, but can they, considering the liability to third parties? One author states:

> The disclosure document must be signed by the transferor on certification that, based on "inquiry of those persons directly responsible for gathering the information," the information submitted is, to the best of transferor's "knowledge" and belief, true and accurate. Whether transferor is held to an objective or subjective standard of knowledge is not defined. If the standard is subjective, the Property Transfer Act permits the transferor to remain blissfully unaware of the environmental status of the property, and the transferee/lender may receive an inaccurate disclosure document without recourse.[2]

Moreover, the transferor is not required to perform his own investiga-

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tion in order to ensure an accurate response. He may rely on information gathered by others, who may or may not make an adequate inquiry.

> In addition, any person failing to comply with IRPTA shall be liable for civil penalties of up to $1,000 for each day the violation continues. Any person or transferor who, with actual knowledge, makes any false statement, representation or certification in the statement is liable for civil penalties of up to $10,000 for each day the violation continues. Persons who fail to record the statement with the county are jointly and severally liable for civil penalties not to exceed $10,000. It is not clear whether the Act imposes similar liability on persons who do not file the disclosure statement with the Illinois Environmental Protection Agency.[3]

The second major problem is that a contract is no longer a critical event in the real estate process. In most cases, the execution of a real estate contract is an event that fixes serious legal rights. Buyer and seller make commitments to each other and to third parties based on executed contracts. Earnest money is deposited and liability to brokers is fixed. It is the start and also completion of a whole set of legal rights and obligations. Under IRPTA, if the contract is executed and thirty days before closing the seller gives the environmental notice required by the statute, and the buyer then seeks to avoid the contract, what happens to the executed contract and the rights and obligations based thereon? What happens to the earnest money? The answer is that real estate decisions will shift to post contract decisions made by the environmental "experts" for buyer and seller.

The real estate decision will pass to so-called experts in the environmental field. Lawyers will be reduced to minor players. One of the issues in litigation today is the misuse of experts. In the September 25, 1989 issue of *Fortune* magazine, the following comment appears:

> Within the thriving business of suing people -- what you might call the disservice sector of the American economy -- expert

Continued on page 54, lower left corner.

CURRENT ILLINOIS SUPERFUND SITES

The United States Environmental Protection Agency maintains a list of Superfund sites that, according to the Agency's guidelines, pose a long-term threat to the public health and environment. There are 39 national hazardous sites identified in Illinois, 23 are considered "final sites" and are eligible for some of the $8.5 billion Superfund money, while another 16 sites are proposed.

The 23 "final sites" in Illinois are:

County	Site
Boone	Belvidere Municipal Landfill, and Parsons Casket Hardware Site
Carroll	Savanna Army Depot
Clark	Velsicol Chemical Corp. Site
Cumberland	A & F Materials Site
Jackson	Crab Orchard Refuge (Sangamo Dump)
Kane	Tri-County Landfill
Kankakee	Cross Brothers Site
Knox	Koppers Site
Lake	Yeoman Creek Landfill; Johns-Manville Corp. Site; Outboard Marine Corp. Site; Petersen Sand & Gravel Site; and Wauconda Sand & Gravel Site
LaSalle	LaSalle Electric Utility Co. Site
Madison	N.L. Industries/Taracorp Site
Ogle	Byron Salvage Yard Site
Will	Joliet Army Ammunition Plant (2 sites)
Winnebago	Acme Solvents Site; Interstate Pollution Control, Inc. Site; Southeast Rockford Groundwater Contamination; and Pagel's Pit

The 16 proposed sites are:

County	Site
Adams	Quincy Municipal Landfill
Alexander	Ilada Energy Site
Bureau	Sheffield (U.S. Ecology Inc.)
Christian	CIPS
Cook	Stauffer Chemical Co.
DuPage	Blackwell Forest Preserve; Kerr-McGee Kress Creek/West Branch of DuPage River; Kerr-McGee Sewage Treatment Plant; Kerr-McGee Reed-Keppler Park; Kerr-McGee Residential Areas; and Lenz Oil Service, Inc.
Lake	H.O.D. Landfill
McHenry	Woodstock Municipal Landfill
Will	Amoco Chemicals Corp. (Joliet Landfill)
Winnebago	Beloit Corp.; and Warner Electric Brake and Clutch Co.

In June of 1984, Illinois launched its own attack on abandoned hazardous sites in Illinois. This program, "Clean Illinois," was established to deal with dozens of landfills and industrial sites that are polluting or threatening to pollute the environment. Currently, there are 29 State Remedial Action Priorities List (SRAPL) sites:

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County	Site
Adams	Quincy Municipal Landfills 2 and 3
Christian	South Central Terminal Co., Inc.
Cook	J.J. Schultz Containers; John Sexton Hinsdale Landfill; Stauffer Chemical Co.; Triem Steel & Processing, Inc.; and Cargill Chemical Products Division
DuPage	Escast
Jackson	Koppers Co.
Kane	Carpentersville Waste Site
Knox	Steagall Landfill
LaSalle	Brockman No. 1, and Owens Illinois Onized Club
Livingston	Smith-Douglass, Inc.
Logan	Hopkins Chemical Co.
Madison	St. Louis Area Support Center (SLASC) (Now the Charles Melvin Price Support Center)
McHenry	Behn Drum
Peoria	Sherex Chemical Co., Inc.
St. Clair	Lanson Chemical Division; Moss American, Inc.; and Sauget Sites
Stephenson	Modern Plating
Vermilion	H & L Landfill No. 1, and Thomas 12th St. Landfill
Whiteside	Morrison City Dump
Will	Bennitt Landfill; C.L. Hale Septic; and Caterpillar Tractor Co.
Winnebago	Frinks Industrial Waste, Inc.

The remedied SRAPL sites are:

County	Site
Adams	Firestone Tire
Christian	Taylorville Landfill
Cook	U.S. Drum

The sites are described in "Cleaning Illinois," issued by the Illinois Environmental Protection Agency (IEPA), Division of Land Pollution Control, summer 1989 edition. Copies are available from the IEPA.

witnesses occupy a fast-growing and controversial niche. Hardly a liability suit goes forward without an engineer or a doctor swearing that the product was misdesigned, or the injury devastating, or the hospital negligent. The other side then calls its expert to say the exact opposite. Both get paid handsomely.

Courts have always relied on expertise in one form or other. But sweeping changes in federal rules of evidence in the mid-1970s vastly widened the definition of an expert -- and what the person can talk about. Says Jack Weinstein, a federal judge in Brooklyn: "An expert can be found to testify to the truth of almost any theory, no matter how frivolous." Unlike other witnesses, experts freely give opinions and can speak in the language of legal conclusions: "In my professional opinion, this was a clear case of malpractice." They are allowed to base their comments on evidence that for other witnesses would be inadmissible as hearsay. And they often make a big hit with juries.

No field is out of the experts' reach. Going through a nasty divorce? A forensic accountant will sketch a dazzlingly prosperous future for your spouse's business. Caught skimming the till? A hired psychologist will arouse sympathy with the jury by calling you a hapless victim of compulsive gambling syndrome. Your son was dropped from his college basketball team because of poor grades? A self-styled sportsologist can swear that if not for this unfairness Kevin could have earned $1 million a year with the pros. [4]

There is absolutely no system of certification of experts. We will be overwhelmed with professional environmental witnesses on both sides.

As I said, I do not know a lot about science since I was a Humanities major, but I have seen buyers and sellers abused on a regular basis by experts in this area and all I can say is "seller beware." Here is the seller's nightmare:

1. Seller enters into contract in a transaction covered by IRPTA.

2. Buyer signs contract and hires an environmental expert to examine the property and the disclosure statement. The expert's findings lead the buyer to say: "Mr. Seller, my expert has reviewed the disclosure statement. It reveals several substantive environmental defects previously unknown to me. In the name of humanity and because I am such a fine person, I will complete the contract and deduct $500,000 for cleanup costs. Otherwise, we can litigate for the next few years as to why your disclosure is not acceptable to me on a subjective basis. We will tie you up for five years. You can't sell the property and the broker is also going to sue you."

As Aristotle once said in *The Rhetoric,* "The best laws should be constructed as to leave as little as possible to the decision of the judge."

ENDNOTES

1. Giller, Thomas, *ISBA Real Property Newsletter* (Jan. 19, 1989), "The Illinois Responsible Property Transfer Act."

2. Pick, Kay L., *Chicago Bar Record,* Feb., 1989, "Responsible Property Transfer Act: A Trap for the Unwary."

3. Giller, Thomas, *ISBA Real Property Newsletter* (Jan. 19, 1989),

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"The Illinois Responsible Property Transfer Act."

4. Olson, Walter, *Fortune,* September 25, 1989, "The Case Against Expert Witnesses."

INSTALLMENT CONTRACT A SECURITY AGREEMENT, NOT EXECUTORY CONTRACT

An installment land contract is not an executory contract to be accepted or rejected by the Trustee in Bankruptcy, but rather is a security interest subject to the plan of reorganization under Chapter 12 of the Bankruptcy Code.

Debtor contracted to purchase a 160-acre farm in Mercer County, Illinois, from vendors. Debtor defaulted on its installment payments and vendors commenced a state court action against debtor under the Illinois Mortgage Foreclosure Law. Debtor then filed a petition for reorganization under Chapter 12 of the Bankruptcy Code. In the bankruptcy schedules debtor listed the farmland as an asset and vendors as secured creditors. Vendors argued that the contract was executory and petitioned the Bankruptcy Court to set a time requiring the Trustee to accept or reject the executory contract.

The Court found that Congress intended the term "executory contract" to apply to contracts in which significant unperformed obligations remained on both sides. To determine the significance of the remaining obligations, the Court looked to state law. In Illinois, under the doctrine of equitable conversion, the debtor became equitable owner of the property upon entering the installment contract. The vendors' only remaining obligation was to deliver legal title upon completion of the payments. The Court found that delivery of legal title was a mere formality and did not represent a "significant legal obligation that would render the contract executory." Therefore, the Court found that the installment land contract was a security instrument in which the vendor holds legal title in trust as security for the payment of the purchase price, and not an executory contract.

In re Streets and Beard Farm Partnership, 882 F.2d 233 (7th Cir. 1989). (contra: *In re Speck,* 798 F.2d 279 (8th Cir. 1986), contract for deed is an executory contract and not a security agreement; see also *In re Alexander,* 670 F.2d 885, (9th Cir. 1982). Where possession and title are denied purchasers, the contract is executory and not merely a security agreement).

RECENT CHANGES IN INSTALLMENT SALE RULES OFFER OPPORTUNITIES TO REAL ESTATE SELLERS

by John S. Elias, Esq.

Keck, Mahin & Cate - Peoria

The installment sale method of reporting gain provides generally that capital gain on deferred payments sales of eligible property is recognized proportionately as principal payments are received under the installment obligation.[1] The Tax Reform Act of 1986 ("1986 Act") substantially restricted the use of the installment method for deferred payment sales of real estate by installing the infamous "proportionate disallowance rules."[2] Under these rules, a real estate seller in a deferred payment sale was in effect denied use of the installment method to the extent that the seller had certain other outstanding indebtedness, which was deemed to be taxable payment under the installment obligation in the year of sale.

Thankfully, the Revenue Act of 1987 ("1987 Act") repealed the 1986 Act's proportionate disallowance rules.[3] As a result, the installment method is again available to deferred payment sales by nondealers of real property.[4] The 1987 Act also repealed the 1986 Act provisions that denied the use of the installment method with respect to certain nondealers' real property sales for alternative minimum tax purposes.[5] This reinstatement of the installment method for tax purposes will no doubt cause renewed interest in the use of deferred payment sales of real property and, in particular, in the use of "wraparound mortgages" to defer again.

In a "wrap," the seller remains liable on existing senior mortgage indebtedness, and the purchaser of the property gives the seller an installment note secured by a junior mortgage (the wraparound) that is larger than (or sometimes equal to) the senior mortgage. Alternatively, the seller will convey the property to the buyer under a conditional sale contract (i.e., "contract for deed" or "land sale contract") where title remains with the seller until all payments under the installment contract are received by the seller. In either case, the seller's obligations under the existing senior mortgage do not depend on receipt of payments from the buyer under the wrap or, more generally, buyer's/compliance with the terms and conditions of the wrap. If successful, the wrap technique permits the seller to include in his "total contract price"[6] (the denominator of the installment sale computation) the existing mortgage indebtedness (thereby decreasing the portion of each installment payment that is taxable) and not to include the existing mortgage indebtedness as a "payment"[7] in the year of sale.

EXAMPLE

Seller ("S") owns real property having a value of $6 million and a basis of $4 million. The property is secured by a nonrecourse mortgage of $3.5 million. If *S* sells the property to buyer ("B"), his total gain is $2 million. If *S* sells the property for $2.5 million cash and *B* agrees to take the property "subject to" the existing mortgage (or if *B* expressly assumes the existing mortgage), the entire $2 million gain is recognized by *S* in the year of sale. If, on the other hand, *S* retains liability on the existing mortgage and *B* gives *S* $2.5 million in cash plus a wraparound note and mortgage for the balance of the purchase price, *S* can take the position that *B* has not assumed the existing mortgage, nor has *B* taken the property subject to the existing mortgage. If *S* is correct, *S* will not have an immediate gain of $2 million. Instead, one-third (1/3) of the $2.5 million cash payment and of each principal payment on the $3.5 million wrap indebtedness will be taxed as gain to *S* under the installment method.

A number of pre-1980 cases, including *Stonecrest v. Commissioner,*[8] support *S'* position. Nevertheless, the Service issued temporary regulations[9] pursuant to the Installment Sales

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