THE FAMILY-OWNED BUSINESS DEDUCTION: STILL IN NEED OF REPAIRS

Neil E. Harl[*]

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University, Ames, Iowa.

I. INTRODUCTION

When originally enacted in 1997, the family-owned business exclusion was a model badly in need of an overhaul.[1] Amendments to the family-owned business deduction (FOBD) in 1998[2] transformed the exclusion into a deduction[3] and remedied problems relating to property leasing.[4] However, several problem areas remain, with further amendments needed to make the concept fully workable.[5] Many of the provisions in the FOBD parallel and resemble special use valuation.[6] However, in certain critical areas, such as in defining what is needed to have a "business," the FOBD rules venture into uncharted territory.[7]

II. GENERAL

A. *Amount of the Deduction*

The legislation enacted in 1997[8] authorized an exclusion from a decedent's estate for federal estate tax purposes, effective for deaths after December 31, 1997.[9]

---

1. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 502, 111 Stat. 788, 847 (codified at I.R.C. § 2033A (West 1998)); *The Family-Owned Business Exclusion—Section 2033A*, Tax Mgmt. (BNA) No. 829, at A-23 to A-27 (Aug. 3, 1998); 5 NEIL E. HARL, AGRICULTURAL LAW § 43.04 (1998) [hereinafter HARL, AGRICULTURAL LAW]; NEIL E. HARL, AGRICULTURAL LAW MANUAL § 5.04(4) (1998) [hereinafter HARL, AGRICULTURAL LAW MANUAL].

2. *See* IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 6007, 112 Stat. 685, 806.

3. *See id.* § 6007, 112 Stat. at 806; I.R.C. § 2057 (West Supp. Oct. 1998).

4. *See* discussion *infra* Part III.C.

5. *See* Neil E. Harl, *Suggested Legislation for the Agricultural Sector*, 9 AGRIC. L. DIG. 125, 127 (1998).

6. *See* IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 6007, 112 Stat. at 868; I.R.C. §§ 2032A(a)(1)(A)-(B), 2032A(b)(1)(C), 2033A(b)(1)(A)-(B), 2033A(b)(1)(D) (West Supp. 1998).

7. *See* discussion *infra* Part III.C.1.a.

8. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 502, 111 Stat. 788, 847 (codified in scattered sections of 26 U.S.C.).

The exclusion, as enacted in 1997, equaled the difference between the applicable exclusion amount from the available unified credit ($625,000 in 1998)

9. *See id.* § 502, 111 Stat. at 847.

and $1.3 million.[10] The 1998 amendments converted the exclusion[11] to a deduction[12] from the gross estate for federal estate tax purposes.[13]

Under the 1998 amendment, the maximum deduction is set at $675,000 and remains at that level.[14] The applicable exclusion amount from the unified estate and gift tax credit[15] is set at $625,000 and continues at that level.[16] Thus, the combined amount is $1.3 million for 1998 and thereafter.[17] For this purpose, the applicable exclusion amount from the unified estate and gift tax credit does not phase up to $1 million in 2006 as scheduled.[18] However, if an estate includes less than $675,000 of qualified family-owned business interests, the applicable exclusion amount is increased on a dollar-for-dollar basis, but only up to the applicable exclusion amount otherwise available for the year of death.[19]

B. *Scope of the Deduction*

The FOBD applies only for federal estate tax purposes and is not available for federal gift tax or generation skipping tax purposes.[20] One major difference between the FOBD and special use valuation is that special use valuation applies only to land and contains detailed rules on how eligible land is to be valued for federal estate tax purposes.[21] The FOBD, by contrast, is applicable to all assets used in the farm or other closely-held business.[22] Thus, machinery, equipment, livestock, stored grain, and cash needed in the business are eligible for the deduction. The assets are valued at fair market value in the traditional manner.[23] Up to the available amount for the

---

10. *See* I.R.C. § 2057(a) (West Supp. Oct. 1998). Legislation has been introduced to index the $1.3 million amount for inflation. *See* H.R. 3227, 105th Cong. § 1(a) (1998).

11. *See* I.R.C. § 2057.

12. *See id.*

13. *See* IRS Restructuring and Reform Act of 1998 Pub. L. No. 105-206, § 6007, 112 Stat. 685, 807 (to be codified as I.R.C. § 2057).

14. *See* I.R.C. § 2057(a). Legislation has been introduced to make the FOBD limitations inapplicable to farm businesses and to reduce the recapture period to three years for farm businesses. *See* H.R. 4587, 105th Cong. § 1(b) (1998). Legislation has also been introduced to remove the FOBD limitation for businesses owned by a single entity. *See* H.R. 4521, 105th Cong. § 2 (1998).

15. *See* I.R.C. §§ 2010(c), 2001 (West Supp. 1998).

16. *See* I.R.C. § 2057(a)(3)(A) (West Supp. Oct. 1998).

17. *See id.* § 2057(a).

18. *See* I.R.C. § 2010(c) (West Supp. 1998).

19. *See* I.R.C. §§ 2010(c), 2057(a)(3)(B) (West Supp. Oct. 1998).

20. *See id.* § 2057(a)(1) (stating that this deduction is only applicable "for purposes of the tax imposed by section 2001").

21. *See* I.R.C. § 2032A (1994); 5 HARL, AGRICULTURAL LAW, *supra* note 1, § 43.03(2).

22. *See* I.R.C. § 2057(e) (West Supp. Oct. 1998).

23. *See id.* §§ 2031, 2057(a)(1).

year of death, the assets are deducted from the gross estate for federal estate tax purposes.[24]

C. *Adjusted Income Tax Basis at Death*

When the exclusion was originally enacted in 1997,[25] a question existed as to whether assets involved or ownership interests in eligible entities would receive an adjusted income tax basis at death.[26] Under the general rule, the income tax basis of property held by a decedent at death is to be the fair market value.[27] However, property "acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment)" receives a new basis *if included in the gross estate*.[28] Also, a passage in the current regulations suggests that property not included in the gross estate does not receive a new basis at death.[29] In converting the provision from an exclusion to a deduction, any doubt about eligibility for a new income tax basis at death is eliminated.[30] Interestingly, Congress has provided by statute for a reduced basis or carryover basis to the extent assets escape tax at death under both special use valuation[31] and the qualified conservation easement.[32] It seems inconsistent to reward taxpayers electing FOBD with a completely new basis, but Congress did not provide for a reduced or carryover basis.

D. *Holding Period for Assets Held Until Death*

Because FOBD assets are considered to be held until death, the assets receive an automatic "more than 1 year"[33] holding period at death.[34] That provision does not, however, apply to livestock held for draft, dairy, breeding, or sporting purposes,

---

24. *See id*. § 2057(a).

25. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 502, 111 Stat. 788, 847 (to be codified at I.R.C. § 2033A).

26. *See* 5 HARL, AGRICULTURAL LAW, *supra* note 1, § 43.04.

27. *See* I.R.C. § 1014(a)(1) (1994).

28. *Id.* § 1014(b)(9).

29. *See* Treas. Reg. § 1.1014-2(b)(1) (1998).

30. *See* I.R.C. § 1014(a)(1).

31. *See* I.R.C. § 1014(a)(3) (West Supp. 1998).

32. *See id*. § 1014(a)(4).

33. *See id*. § 1(h)(8). The "more than 1 year" provision was not amended in 1997 when the general holding period was increased, for sales or exchanges after July 28, 1997, to "more than 18 months." In anticipation of technical corrections legislation, the IRS indicated that property held until death would be entitled to a "more than 18 month" holding period. *See* I.R.S. Notice 97-59, 1997-45 I.R.B. 7. That period appeared not to apply to livestock. Effective for taxable years ending after December 31, 1997, the holding period has been reduced to "more than 1 year." *See* IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 5001(a)(5), 112 Stat. 685, 787-88.

34. *See* I.R.C. § 1223(11) (West Supp. 1998).

which have different holding periods (twenty-four months or more for cattle and horses and twelve months or more for other "livestock").[35]

III. REQUIREMENTS FOR ELIGIBILITY

The FOBD, as with most special tax provisions intended to benefit farms and small businesses,[36] contains numerous eligibility requirements designed to: (1) assure that the benefits will go to the targeted group, and (2) avoid abusive use by others (such as by short-term ownership of assets).[37] Among the requirements are various provisions assuring that assets qualifying for the provision are used in a business, rather than being held for investment.[38] Use as a business generally requires that the assets involved are used in such a manner that the owner: (1) bears the risks of production, (2) bears the risks of price change, and (3) is involved more than minimally in management.[39]

A. *Ownership of Business Interests*

The statute specifies that the decedent or a member of the decedent's family must have owned the qualified family-owned business interests for five or more of the eight years ending on the date of the decedent's death.[40] For businesses owned in legally recognizable entities such as corporations or limited liability companies, the requirement appears to be directed toward the time period the ownership interest in the entity has been owned by the decedent or member of the family. However, in farm and ranch businesses owned as a sole proprietorship where no legally recognizable entity is involved (and approximately eighty-five percent of the farm and ranch businesses are so organized),[41] substantial amounts of personal property—particularly machinery, livestock, and stored grain—may not have been held by the decedent or member of the family for the minimum five-year period.[42]

---

35. *See* Rev. Rul. 75-361, 1975-2 C.B. 344.

36. *See, e.g.*, I.R.C. §§ 2032A, 6166 (1994) (addressing special use valuation and installment payment of federal estate tax, respectively).

37. *See id*. § 2032A(b).

38. *See id*.

39. *See* Neil E. Harl, *Self-Employment Tax Issues Affecting Farmers and Ranchers*, 87 J. TAX'N 45, 48 (1997); Webster Corp. v. Commissioner, 25 T.C. 55, 60-61 (1955), *acq*. 1960-2 C.B. 7, *aff'd*, 240 F.2d 164 (2d Cir. 1957).

40. *See* I.R.C. § 2057(b)(1)(D)(i) (West Supp. Oct. 1998).

41. *See* 6 HARL, AGRICULTURAL LAW, *supra* note 1, § 51.03(2)(c).

42. *See* I.R.C. § 2057(b)(1)(D)(i).

B. *Material Participation*

The aspect of a business relating to involvement in management is addressed by the "material participation" test.[43] That test specifies that the requirement is determined "within the meaning of" special use valuation and is to involve material participation by the decedent or a member of the decedent's family "in the operation of the business to which such interests relate."[44] For purposes of special use valuation, material participation is determined "in a manner similar" to the way the term is defined for purposes of determining net earnings from self employment.[45] Under that provision, material participation is required for at least five of the last eight years preceding the decedent's retirement, disability, or death.[46]

It is important to note that material participation cannot be achieved through an agent under the special use valuation rules for those producing agricultural or horticultural commodities.[47] The same limitation applies to the family-owned business deduction.[48] While acknowledging that material participation cannot be achieved through an agent, the regulations under special use valuation note that the presence of an agent does not preclude material participation by a property owner, or member of the family, if material participation is otherwise established.[49] Also, under special use valuation, if a family member is in the role of an agent, family member status prevails for purposes of material participation.[50]

Even though the meaning given to material participation for purposes of the FOBD is the same as for special use valuation,[51] the Senate Finance Committee Report states, "an individual generally is considered to be materially participating in the business if he or she personally manages the business fully, regardless of the number of hours worked, as long as any necessary functions are performed."[52] It is noted that this committee report language is substantially less demanding than is required for material participation under special use valuation which, as the FOBD statute states, is to be used as the guide as to what constitutes material participation.[53] A question is raised as to whether the committee report language can be relied upon. The Senate Finance Committee Report also stated in 1997:

---

43. *See id*. § 2057(b)(1)(D)(ii).
44. *Id.*
45. *See* I.R.C. §§ 1402(a)(1), 2032A(e)(6) (1994).
46. *See id*. § 2032A(b)(1)(C)(ii), (b)(4)(A), (b)(4)(B).
47. *See id*. §§ 1402(a)(1), 2032A(e)(6).
48. *See* I.R.C. § 2057(c) (West Supp. Oct. 1998).
49. *See* Treas. Reg. § 20.2032A-3(g) Ex. 4 (1998).
50. *See id*. § 20.2032A-3(e)(1).
51. *See* I.R.C. § 2057(b)(1)(D)(i).
52. S. REP. NO. 105-33, at 43 (1997).
53. *See* I.R.C. § 2057(b)(1)(D)(ii).

> If a qualified heir rents qualifying property to a member of the qualified heir's family on a net cash basis, and that family member materially participates in the business, the material participation requirement will be considered to have been met with respect to the qualified heir for purposes of this provision.[54]

That language seemed to support the position that the presence of a cash rent lease would not preclude a finding of material participation, even though the context was post-death recapture. It is pointed out that, at that time, both pre-death and post-death cash rent leasing seemed to be inconsistent with the family-owned business exclusion (FOBE) requirements.[55]

The FOBD statute adopts the provisions from special use valuation allowing active management by the surviving spouse to substitute for material participation in the pre-death period for purposes of eligibility.[56] The term "active management" is defined as the making of the management decisions of a business, other than the daily operating decisions.[57]

Under special use valuation, the payment of self-employment tax is not conclusive as to the presence of material participation.[58] However, if no self-employment tax has been paid, material participation is presumed not to have occurred unless demonstrated otherwise, and the tax is then paid.[59] Uncompensated activities by a member or members of the decedent's family may constitute material participation where the decedent was incapable of handling business affairs, and family members handled those affairs without a power of attorney or conservatorship.[60]

C. *"Passive Asset" Test*

---

54. S. REP. NO. 105-33, at 44.

55. *See The Family-Owned Business Exclusion—Section 2033A*, *supra* note 1, at A-10, A-20. It is important to note that the Joint Committee on Taxation indicated that pre-death cash rent leasing was fatal to eligibility, but that post-death cash rent leasing would not cause recapture "if the heirs cash lease the farmland to a member of the decedent's family who operates a business on that land." Letter from Kenneth J. Kies, Joint Committee on Taxation, to Senator Charles Grassley (Nov. 3, 1997), *reprinted in* 5 NEIL E. HARL, AGRICULTURAL LAW app. at 43A-2 (1998). That was the case after the 1998 amendments but not before those amendments were enacted. *See* I.R.C. §§ 543(a) (1994 & Supp. II 1996); I.R.C. § 2057(e)(2)(D)(ii) (West Supp. 1998); Treas. Reg. § 1.543-1(b)(10) (as amended in 1973).

56. *See* I.R.C. § 2032A(b)(5)(A) (1994); I.R.C. § 2057(i)(3)(B) (West Supp. Oct. 1998).

57. *See* I.R.C. § 2032A(e)(12) (1994); S. REP. NO. 97-144, at 134 (1981).

58. *See* Treas. Reg. § 20.2032A-3(e)(1) (1998).

59. *See id*.

60. *See* Tech. Adv. Mem. 81-49-002 (July 22, 1981) (involving a decedent who had suffered a stroke while two sons, who were attorneys, managed the farm under an oral crop share lease, where the decedent had been reporting no self-employment income from farm).

Under special use valuation, from which many of the FOBD provisions are drawn, the "qualified use" test was developed belatedly to address the two other aspects of a business[61]—bearing the risks of production and bearing the risks of price change.[62] The qualified use test emerged in the regulations four years after the enactment of special use valuation, based upon language in the statute requiring the property to be "used as a farm for farming purposes or in another trade or business" other than the trade or business of farming.[63] The inclusion in the special use valuation statute of the term "trade or business of farming" gave rise to the qualified use test.[64] The qualified use test under special use valuation has been heavily litigated and ruled upon often.[65]

1. *Assets Considered "Passive Assets"*

Despite the fact that the qualified use test had been used for seventeen years and was relatively well understood as a requirement, the test was not included in the FOBE statute.[66] Nonetheless, the FOBE statute also required the existence of a "trade or business" or "business"[67] but relied on a new "passive asset" test to separate business assets from investment assets.[68] It appears that this test must be met at the time of death and for five or more years of the eight-year period before death.[69] Under the statute, several categories of assets are considered passive assets and are not included in the calculations of the value of a qualified business interest.

a. Assets producing interest, dividends, rents, royalties, and annuities are considered passive assets.[70] The major concern is the meaning of "rents." Reference to the personal holding company provisions[71] means that "rent" is defined as "compensation (however designated) for the use, or right to use, property."[72] Note that, for personal holding company purposes, active landowner participation personally or through an agent under a crop share or livestock share lease produces business income, not rents.[73] For this purpose, the activities of an agent appear to be

---

61. *See* Treas. Reg. § 20.2032A-3(a) (1998).
62. *See* I.R.C. § 2032A(a)(1), (b)(1)(C) (1994).
63. Treas. Reg. § 20.2032A-3(a) (1998).
64. I.R.C. § 2032A(b)(2)(B).
65. *See* 5 HARL, AGRICULTURAL LAW, *supra* note 1, § 43.03[2][d][i].
66. *See* 5 *id.* § 43.04[2][e].
67. *See, e.g.*, I.R.C. § 2057(a)(1), (b)(2) (West Supp. Oct. 1998).
68. *See id*. § 2057(e)(2); I.R.C. §§ 543(c)(2), 954(c)(1) (1994).
69. *See* I.R.C. § 2057(b)(1)(D)(i), (b)(1)(C)(i) (West Supp. Oct. 1998).
70. *See id*. §§ 2057(e)(2)(D)(ii) (West Supp. 1998); I.R.C. § 543(a) (1994 & Supp. II 1996).
71. *See* I.R.C. § 543(a) (1994 & Supp. II 1996).
72. Treas. Reg. § 1.543-1(b)(10) (as amended in 1973).
73. *See generally* Commissioner v. Webster Corp., 240 F.2d 164, 165 (2d Cir. 1957) (involving farm manager actively involved in decisions under share leases).

imputed to the landowner as principal.[74] Moreover, in 1967, the Internal Revenue Service (IRS) ruled that a corporation was conceded to be materially participating in a farm operation, so payments made in accordance with the United States Department of Agriculture Soil Bank Programs for land idling were not considered to be "rents" for personal holding company purposes.[75] That ruling cited approvingly to a 1961 ruling[76] that held that a corporation renting land under a share-farming arrangement did not have "rents" for the passive income rule applicable to S corporations, if the landowner "participates to a material degree in the production of farm commodities through physical work or management decisions or a combination of both."[77] Thus, as originally enacted, crop share or livestock share leases would likely qualify the property for the FOBE if accompanied by substantial involvement in management, but cash rent leases were fatal to eligibility regardless of the relationship of the tenant to the decedent.[78]

In 1998, in an attempt to remedy the problem of ineligibility of pre-death cash rent leases, an amendment was enacted specifying that:

> In the case of a lease of property on a net cash basis by the decedent to a member of the decedent's family, income from such lease shall not be treated as personal holding company income for purposes of subparagraph (C), and such property shall not be treated as an asset described in subparagraph (D)(ii), if such income and property would not be so treated if the lessor had engaged directly in the activities engaged in by the lessee with respect to such property.[79]

In addition, the 1998 amendments modified the definition of "qualified family-owned business interest" to state that "a decedent shall be treated as engaged in a trade or business if any member of the decedent's family is engaged in such trade or business."[80] Focusing just on that statutory language, if a decedent were renting land to a son or daughter under a cash rent lease, would the land be eligible for the family-owned business deduction? The question is whether land cash rented to a child would be deemed to be used in the child's trade or business. A good argument can be made that all the amendment did was to make the father eligible to claim the deduction for the child's business which the father does not own. The Senate Finance Committee Report clarified the matter by stating:

---

74. *See* 5 HARL, AGRICULTURAL LAW, *supra* note 1, § 41.06[1].
75. *See* Rev. Rul. 67-423, 1967-2 C.B. 221.
76. *See* Rev. Rul. 61-112, 1961-1 C.B. 399.
77. *Id*., 1961-1 C.B. 399.
78. *See* I.R.C. § 2057(e)(2)(D)(ii) (West Supp. Oct. 1998); I.R.C. § 543(a) (1994); Treas. Reg. § 1.543-1(b)(10) (as amended in 1973).
79. I.R.C. § 2057(e)(2) (West Supp. Oct. 1998).
80. *Id*. § 2057(e)(1).

> The provision clarifies that an individual's interest in property used in a trade or business may qualify for the qualified family-owned business provision as long as such property is used in a trade or business by the individual or a member of the individual's family. Thus, for example, if a brother and sister inherit farmland upon their father's death, and the sister cash-leases her portion to her brother, who is engaged in the trade or business of farming, the trade or business requirement is satisfied with respect to both the brother and the sister. Similarly, if a father cash-leases farmland to his son, and the son materially participates in the trade or business of farming the land for at least five of the eight years preceding his father's death, the pre-death material participation and trade or business requirements are satisfied with respect to the father's interest in the farm.[81]

While the statute could be worded more clearly and in a manner less susceptible to other interpretations, the committee report leaves little doubt as to what was intended. Coupled with the amendment specifying that rent from a cash rent lease to a family member is not to be considered personal holding company income, it is reasonably clear that cash rent leasing to a member of the decedent's family or to a family-owned entity owned by members of the decedent's family does not preclude eligibility. By a parity of reasoning, share-rent leasing with minimal involvement by the decedent should not jeopardize eligibility from the standpoint of the "passive asset" test, although that awaits litigation or other guidance.

In terms of implications for structuring farms and small businesses, careful planning is still required for the "business" or "trade or business" requirements for eligibility for the family-owned business deduction to be met, which includes the following points:

> (1) Single entity structuring of the business should meet the requirement. (2) Material participation share leases should meet the test. (3) Non-material participation share leases with active involvement in management under the lease should be eligible. (4) Non-material participation share leases with nominal involvement under the lease may meet the test if to a member of the family as tenant. (5) Cash rent leases should meet the requirement if to a member of the family or a family-owned entity as tenant.[82]

b. The excess of gains over losses from the sale or exchange of assets that are interests in a trust, partnership, or real estate mortgage investment conduit (REMIC), that are not in an active business, are ineligible.[83] While the statute is phrased in terms of gains over losses from the "sale or exchange of property" not being eligible,

---

81. S. REP. NO. 105-174, at 157 (1998).
82. I.R.C. § 2057(e)(1)-(2) (West Supp. Oct. 1998).
83. *See id*. § 2057(e)(2)(D)(ii); I.R.C. § 954(c)(1)(B)(ii) (1994).

it was presumably intended to preclude assets in a trust, partnership, or REMIC that are not in an active business from eligibility.[84]

c. The excess of gains over losses from the sale or exchange of property that produces no income is not eligible.[85] Again, it is believed that the intent was to make assets producing no income ineligible for FOBD.[86] The Joint Committee on Taxation has indicated that growing crops, including trees, would not fail this test.[87] The concern is that this test could lead to a "future interest" test as under special use valuation.[88]

d. The statute states that the excess of gains over losses from speculative futures contracts are ineligible.[89] As with the other provisions expressed in similar terms, the belief is that the commodity transactions themselves are ineligible.[90]

e. Under the statute, income equivalent to interest is ineligible.[91] Again, it was presumably intended that assets producing income equivalent to interest are ineligible.[92]

f. Net income from "notional principal contracts" or, more likely, assets producing net income from notional principal contracts fail the test of eligibility.[93] Notional principal contracts are contracts denominated in the currency of the taxpayer or a business unit of the taxpayer, the value of which is determined solely by reference to interest rates or interest rate indices.[94]

At best, the "passive asset" test is confusing and is stated with a level of imprecision rarely found in a tax statute.

D. *The "50%" Test*

To be eligible for the FOBD, the aggregate value of the decedent's "qualified family-owned business interests" must comprise more than fifty percent of the decedent's adjusted gross estate and that amount or more must pass to or be acquired

---

84. *See* I.R.C. § 2057(e)(2)(D)(ii) (West Supp. Oct. 1998); I.R.C. § 954(c)(1)(B)(ii) (1994).

85. *See* I.R.C. § 2057(e)(2)(D)(ii) (West Supp. Oct. 1998); I.R.C. § 954(c)(1)(B)(ii) (1994).

86. *See* I.R.C. § 2057(e)(2)(D)(ii) (West Supp. Oct. 1998); I.R.C. § 954(c)(1)(B)(ii) (1994).

87. *See* Letter from Kenneth J. Kies, Joint Committee on Taxation, to Senator Charles Grassley, *supra* note 55, at 43A-1 to 43A-4.

88. *See* 5 HARL, AGRICULTURAL LAW, *supra* note 1, § 43.03[2][d][iii][E].

89. *See* I.R.C. § 2057(e)(2)(D)(ii) (West Supp. Oct. 1998); I.R.C. § 954(c)(1)(C) (1994).

90. *See* I.R.C. § 2057(e)(2)(D)(ii) (West Supp. Oct. 1998); I.R.C. § 954(c)(1)(C) (1994).

91. *See* I.R.C. § 2057(e)(2)(D)(ii) (West Supp. Oct. 1998); I.R.C. § 954(c)(1)(E) (1994); Treas. Reg. § 1.954-2(h) (as amended in 1997).

92. *See* I.R.C. § 2057(e)(2)(D)(ii) (West Supp. Oct. 1998); I.R.C. § 954(c)(1)(E) (1994); Treas. Reg. § 1.954-2(h).

93. *See* I.R.C. § 2057(e)(2)(D)(ii) (West Supp. Oct. 1998); I.R.C. § 954(c)(1)(F) (1994).

94. *See* Treas. Reg. § 1.954-2(h)(3)(i).

by qualified heirs.[95] To ascertain whether that test is met, a calculation is used involving a numerator and a denominator.

1. *Numerator*

The numerator is the aggregate of all qualified family-owned business interests that are includible in the decedent's gross estate and are passed from the decedent to a qualified heir, plus any lifetime transfers of such interests by the decedent to members of the decedent's family (other than the decedent's spouse), if those interests have been held continuously by members of the family and were not otherwise includible in the gross estate.[96] For this purpose, transferred interests are valued as of the date of the transfer.[97] That amount is reduced by all indebtedness of the estate except for that on a qualified residence, indebtedness incurred to pay educational or medical expenses of the decedent, spouse, or dependents, and any other indebtedness up to $10,000.[98]

2. *Denominator*

The denominator is the gross estate of the decedent, reduced by estate indebtedness, and increased by lifetime transfers of qualified business interests made by the decedent to members of the decedent's family (other than the spouse) if the interests were held continuously by members of the family, plus transfers (other than de minimis transfers) from the decedent to the spouse within ten years of death, plus any other transfers made by the decedent within three years of death except for nontaxable transfers made to members of the decedent's family.[99]

3. *Example*

The process of calculating the numerator and denominator is clearer if approached on a step-by-step basis:

a. *Calculating the Numerator*

Step One: Determine the value of all qualified family-owned business interests that would be includible in the decedent's gross estate were it not for FOBD and that are passed from the decedent to a qualified heir.[100]

---

95. *See* I.R.C. § 2057(b)(1)(C)(ii) (West Supp. Oct. 1998).
96. *See id.* § 2057(b)(2).
97. *See* I.R.C. § 2702(a) (West Supp. 1998).
98. *See* I.R.C. § 2057(d) (West Supp. Oct. 1998).
99. *See id.* § 2057(c).
100. *See id*. § 2057(b)(1)(C)(i), (b)(2)(A).

> Example: The decedent, Elmer Jones, died owning 700 shares of stock in ABC Farm, Inc. The fair market value of the stock owned by the decedent is $1,800,000. The 700 shares are set to pass by will to Jones' son, Allen, outright (Mrs. Jones predeceased Elmer).

The result of Step One calculations is $1,800,000.

Step Two: Add to the Step One result lifetime transfers of qualified business interests that had been made by the decedent to members of the decedent's family (other than the decedent's spouse), if the interests have been owned continuously by members of the decedent's family and that are not includible in the decedent's estate.[101]

> Example: Elmer Jones in 1990 had given 300 shares of the stock in ABC Farm, Inc. to his son, Allen. The total amount of the gift was $90,000, with $10,000 of that amount covered by the federal gift tax annual exclusion. The taxable gift amount was, therefore, $80,000.

Because the statute specifies[102] that any gift of a "qualified family-owned business interest" is the sum of taxable gifts[103] and the annual exclusion amount, the result of Step Two is $80,000 + $10,000 = $90,000.

Step Three: Add the results of Step One and Step Two.

> Example: In the case of the Elmer Jones Estate, the sum is $1,800,000 + $90,000 = $1,890,000.

Step Four: Calculate all indebtedness of the estate.

> Example: Elmer Jones left a secured mortgage on his residence of $65,000, an unpaid credit card bill of $8500, unpaid medical bills of $22,000, an executive line of credit at a local bank with a balance owing at death of $95,000 and estate settlement costs of $170,000. The grand total of all indebtedness is $360,500.

Step Five: Subtract the qualified residence interest from the indebtedness of the estate.[104]

---

101. *See id.* § 2057(b)(1)(C)(ii), (b)(3).
102. *See id.* § 2057(b)(3).
103. *See* I.R.C. § 2001(b)(1)(B) (1994).

> Example: The "qualified residence interest"[105] totals $65,000 in the Jones' Estate.

The result is $360,500 - $65,000 = $295,500.

Step Six: Subtract the indebtedness, the proceeds of which were used to pay the educational and medical expenses of the decedent, the decedent's spouse, or the decedent's dependents.[106]

> Example: The medical expense portion of the indebtedness was all for Elmer Jones' last illness and totaled $22,000.

The result is $295,500 - $22,000 = $273,500.

Step Seven: Subtract any other indebtedness "to the extent such indebtedness does not exceed $10,000."[107]

> Example: In the Jones Estate, the only indebtedness meeting that criterion is the unpaid credit card bill of $8500.

The result is $273,500 - $8500 = $265,000.

Step Eight: Subtract the remaining indebtedness (from Step Seven) from the Step Three amount (qualified family-owned business interests plus interests transferred to the family and owned continuously).[108]

> Example: For the Jones Estate, the Step Three amount is $1,890,000 and the Step Seven amount is $265,000.

The result is $1,890,000 - $265,000 = $1,625,000. This figure, $1,625,000, is the numerator in the fraction for determining whether qualified family-owned business interests total more than fifty percent of the decedent's adjusted gross estate.[109]

---

104. *See* I.R.C. § 2057(d)(1)(A) (West Supp. Oct. 1998).
105. *See* I.R.C. § 163(h)(3) (1994); I.R.C. § 2057(d)(2)(A) (West Supp. Oct. 1998).
106. *See* I.R.C. § 2057(d)(2)(B) (West Supp. Oct. 1998).
107. *Id.* § 2057(d)(2)(C).
108. *See id.* § 2057(d).
109. *See id.* § 2057(b)(1)(C).

b. *Calculating the Denominator*

The calculation of the denominator is, like that of the numerator, made clearer by approaching the task on a step-by-step basis:

Step One: Determine the fair market value of the decedent's gross estate.[110]

> Example: Elmer Jones left, in addition to 700 shares of stock in ABC Farm, Inc., valued at $1,800,000, mutual fund shares totaling $732,000, certificates of deposit totaling $108,000, and bank accounts with balances as of the date of death of $110,000.

The result of Step One for the Jones' Estate is $2,750,000.

Step Two: Calculate the indebtedness of the estate and subtract from the gross estate.[111]

> Example: For the Jones Estate, the indebtedness (from Step Four of the numerator calculation) is $360,500.

The result is $2,750,000 - $360,500 = $2,389,500.

Step Three: Identify any lifetime transfers of qualified business interests made by the decedent to members of the decedent's family (other than the decedent's spouse), if the interests have been held continuously by members of the decedent's family, and add that amount to the gross estate less allowable deductions from Step Two.[112]

> Example: In the case of Elmer Jones, he had made a gift of 300 shares of stock in ABC Farm, Inc. to his son, Allen, in 1990, valued at $90,000, with $10,000 of that amount covered by the federal gift tax annual exclusion, leaving an amount of $80,000 (see Step Two of the numerator calculation).

The result is $2,389,500 + $80,000 = $2,469,500.

Step Four: Identify any transfers from the decedent to the decedent's spouse (if other than de minimis) made within ten years of the date of the decedent's death,

---

110. *See id*. § 2057(a).
111. *See id.* § 2057(c)(1).
112. *See id.* § 2057(c)(2)(A).

and add that amount to the gross estate less allowable deductions and plus lifetime transfers to members of the family (from Step Three).[113] Although it is not completely clear, breaking up spousal joint tenancies should not result in a transfer if the spouses end up with the same ownership interest as they owned in the joint tenancy.

> Example: Elmer Jones had made no transfers to his spouse prior to his death. She had inherited a sizable amount from her mother's estate which was left in a bypass trust, except for the unified credit amount which was left to Elmer outright and is reflected in his mutual fund balance at his death.

The result is $2,469,500 - 0 = $2,469,500.

Step Five: Identify any other gifts within three years of death other than to members of the family.[114]

> Example: Elmer Jones had made no other gifts within three years of his death.

The result is $2,469,500 - 0 = $2,469,500.

Step Six: Determine whether any of the gifts from Steps Three, Four, and Five are included in the gross estate.[115] If so, the included amount must be added back in.

> Example: None of the family gifts (notably the 300 shares of stock in ABC Farm, Inc. given to son Allen) is included in Elmer Jones' gross estate.

The result is that the adjusted gross estate is $2,469,500.

Final Step: Determine whether the "adjusted value of the qualified family-owned business interests," as augmented by family gifts, (Step Eight of the numerator calculations) exceeds fifty percent of the adjusted gross estate (Step Six of the denominator calculations).[116]

> Example: In the Jones' Estate the calculations are as follows:

---

113. *See id.* § 2057(c)(1).
114. *See id.* § 2057(c)(2)(A)(iii).
115. *See id.* § 2057(c)(2)(B).
116. *See id.* § 2057(b)(1)(C).

$$\frac{\text{Numerator (Step Eight) } \$1{,}625{,}000}{\text{Denominator (Step Six) } \$2{,}469{,}500} \times 100\% = 65.8\%$$

Therefore in this example, the "50%" test has been met.[117]

4. *Conclusion*

In some instances, it will be obvious that the "50%" test can or cannot be met. In close cases, a careful and detailed calculation will be necessary in order to establish whether the estate is eligible to elect the FOBD.[118]

E. *"Qualified Family-Owned Business Interest"*

To be a "qualified family-owned business interest,"[119] ownership must be held to the extent of at least fifty percent by the decedent and members of the decedent's family.[120] Ownership by the decedent and members of the decedent's family can drop to thirty percent, if seventy percent is owned by two families or ninety percent by three families.[121] The Joint Committee on Taxation in late 1997 suggested that interests held by a decedent in a farm cooperative were eligible for the FOBE only if this test was satisfied.[122] This suggestion seems highly questionable and misconstrues the fundamental relationship of a farmer to a farm cooperative. The cooperative is not properly viewed as a subsidiary of the member-farmer.

In applying the ownership tests to a corporation, the decedent and members of the decedent's family must own the required percentage of the total combined voting power of all classes of stock entitled to vote, the required percentage of the total value of all shares of all classes of stock entitled to vote, and the required percentage of the total value of all shares of all classes of stock of the corporation.[123] For a partnership, the decedent and members of the decedent's family must own the required percentage of the capital interest in the partnership.[124] The Senate Finance Committee Report indicates that the required percentage of the profits' interest is also necessary.[125]

---

117. *See id.* § 2057(b)(1)(A)-(C).
118. *See id.* § 2057(b)(1)(C).
119. *See id.* § 2057(a)(1), (b)(2).
120. *See id.* § 2057(e)(1)(B)(i)(I).
121. *See id.* § 2057(e)(1)(B)(i)-(ii).
122. *See* Letter from Kenneth J. Kies, Joint Committee on Taxation, to Senator Charles Grassley, *supra* note 55, at 43A-1.
123. *See* I.R.C. § 2057(e)(3)(A)(i).
124. *See id*. § 2057(e)(3)(A)(ii).
125. *See* S. REP. NO. 105-33, at 41 (1997).

For entities in which a trade or business owns an interest in another trade or business, a "look-through" test is employed with each trade or business owned by the decedent and members of the decedent's family which separately tested to determine whether that trade or business meets the requirements of a qualified family-owned business interest.[126] Any interest that a trade or business owns in another trade or business is disregarded in determining whether the first trade or business is a qualified family-owned business interest.[127] The value of any qualified family-owned business interest held by an entity is treated as owned proportionately by or for the entity's partners, shareholders, or beneficiaries.[128]

F. *Other*

1. *U.S. Citizen or Resident*

In addition to the other requirements, the decedent must have been a U.S. citizen or resident at the time of death.[129] Also, the principal place of business must be in the United States.[130]

2. *Excess Cash or Marketable Securities*

The value of a trade or business for purposes of the estate tax deduction is reduced to the extent the business holds passive assets, excess cash, or marketable securities.[131] The value of a qualified family-owned business interest does not include any cash or marketable securities in excess of the reasonably expected day-to-day working capital needs of the trade or business.[132] The Senate Finance Committee Report acknowledges that the *Bardahl* formula approach may be used in making the determinations.[133] The same approach is now accepted in calculating an interest in a closely-held business for purposes of installment payment of federal estate tax.[134]

3. *Publicly Traded Stock or Securities*

---

126. *See* I.R.C. § 2057(e)(3)(B).
127. *See id.* § 2057(e)(3)(B)(i).
128. *See id.* § 2057(e)(3)(C).
129. *See id.* § 2057(b)(1)(A).
130. *See id.* § 2057(e)(2)(A).
131. *See id.* § 2057(e)(2)(D).
132. *See id.* § 2057(e)(2)(D)(i).
133. *See* S. REP. NO. 105-33, at 42 (1997); Bardahl Mfg. Corp. v. Commissioner, 24 T.C.M. (CCH) 1030, 1040-47 (1965). For a discussion of the application of the *Bardahl* formula to a farm business, see *Family-Owned Business Exclusion—Section 2033A*, *supra* note 1, at A-3 to A-4.
134. *See* Priv. Ltr. Rul. 92-50-022 (Sept. 11, 1992).

An interest in a trade or business does not qualify if stock or securities of the business, or a related entity, were publicly traded within three years of the decedent's death.[135]

4. *Assets Producing Personal Holding Company Income*

An interest in a trade or business does not qualify if more than thirty-five percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income.[136] The personal holding company restriction does not apply to banks or domestic building and loan associations.[137] As noted above,[138] income from "a lease of property on a net cash basis" is not to be treated as personal holding company income.[139]

IV. PASSING TO QUALIFIED HEIRS

As noted,[140] to be eligible for the family-owned business deduction, the aggregate value of the decedent's qualified family-owned business interests must comprise more than fifty percent of a decedent's adjusted gross estate, and that amount or more must pass to or be acquired by qualified heirs.[141] The term "qualified heir" is defined as a "member of the family" as provided in the special use valuation statute.[142] In addition, the term "qualified heir" includes "any active employee of the trade or business to which the qualified family-owned business interest relates if such employee has been employed by such trade or business for a period of at least 10 years before the date of the decedent's death."[143]

A. *Member of the Family*

The term "member of the family" is utilized in the FOBD statute to determine the following: (1) who can be a qualified heir,[144] (2) who can provide material participation before death,[145] (3) who can meet the ownership test before death,[146] (4)

---

135. *See* I.R.C. § 2057(e)(2)(B).
136. *See id.* § 2057(e)(2)(C).
137. *See* I.R.C. § 542(c)(2) (West Supp. 1998); I.R.C. § 2057(e)(2)(C) (West Supp. Oct. 1998).
138. *See* I.R.C. § 2057(e)(2) (West Supp. Oct. 1998).
139. *Id.*
140. *See id.* § 2057(b)(1)(C)(ii).
141. *See id.* § 2057(b)(1)(C).
142. I.R.C. § 2032A(e)(1)-(2) (1994); I.R.C. § 2057(i)(1)(A) (West Supp. Oct. 1998).
143. I.R.C. § 2057(i)(1)(B) (West Supp. Oct. 1998).
144. *See id.* § 2057(i)(1)-(2).
145. *See id.* § 2057(b)(1)(D)(ii).
146. *See id.* § 2057(b)(1)(D)(i).

which pre-death gifts are includible in the "50%" fraction calculation,[147] (5) which family-owned business interests are included in the "50%" fraction calculation,[148] (6) the ownership of "tiered" entities,[149] (7) who can provide material participation to avoid recapture after death,[150] and (8) who can acquire FOBD interests after death from a qualified heir without triggering recapture.[151]

As with special use valuation, it is important to note that "member of the family" is defined in terms of a "base person" which includes: (1) the decedent-to-be in the pre-death period, and (2) the qualified heir in the period the property is held by the qualified heir.[152] Given that the rules for determining who is a member of the family require that the rules be applied from the correct starting point (the "base person"), the term "member of family" includes the ancestors of the individual, the person's spouse, lineal descendants of the individual, lineal descendants of the parents of the individual, and the spouse of any lineal descendant.[153] A legally adopted child of an individual is treated as a child of the individual by blood relationship, with adoption relating back to the date of birth of the adopted person.[154] However, an "acknowledged" child has not been considered a member of the family,[155] nor have children of an unadopted foster child of the decedent been considered members of the family.[156]

B. *Active Employee of the Trade or Business*

As noted,[157] an active employee of a trade or business can be a qualified heir if the employee has been employed by the trade or business for at least ten years before the decedent's death.[158] This means that an owner of a trade or business can, at death, give or sell the business to the employee with the value eligible for the FOBD.[159]

The FOBD statute requires, as a condition of eligibility, that family-owned business interests meet the following characteristics: (1) be included in determining the value of the gross estate,[160] and (2) be "acquired by any qualified heir from, or passed to any qualified heir from, the decedent (within the meaning of section

147. *See id.* § 2057(b)(3).
148. *See id.* § 2057(e)(1)(B).
149. *See id.* § 2057(e)(3)(B).
150. *See id.* § 2057(f)(1)(A).
151. *See id.* § 2057(f)(1)(B).
152. *See* 5 HARL, AGRICULTURAL LAW, *supra* note 1, § 43.03[2][d][iii][A].
153. *See* I.R.C. § 2032A(e)(2) (1994).
154. *See id.*
155. *See* Rev. Rul. 81-179, 1981-2 C.B. 172; Priv. Ltr. Rul. 80-32-026 (Apr. 30, 1980).
156. *See* Tech. Adv. Mem. 80-33-018 (Apr. 30, 1980).
157. *See* I.R.C. § 2057(i)(1)(B) (West Supp. Oct. 1998).
158. *See id.* § 2057(i)(1).
159. *See id.* § 2057(b)(2)(B).
160. *See id.* § 2057(b)(2)(A).

2032A(e)(9)).”[161] Section 2032A(e)(9) reflects a 1981 amendment[162] enacted to permit interests to pass by purchase and still be eligible for special use valuation.[163] Under that amendment, property is considered to have been acquired from or passed from the decedent if: (1) the property is so considered under I.R.C. § 1014(b) relating to income tax basis of property acquired from the decedent; (2) the property was acquired by “any person” from the estate; or (3) the property was acquired by “any person” from a trust, to the extent the property was included in the decedent’s estate.[164] Thus, property acquired by purchase should be eligible for the FOBD.

If a qualified family-owned business interest passes to an unrelated employee with at least ten years of employment, it is important to note that the interest cannot pass outside the employee’s family during the ten-year recapture period.[165] Thus, careful attention is needed in drafting buy-sell agreements, first option agreements, and default provisions in installment sale contracts. Passage of business interests back to the decedent’s family during the recapture period, which could be up to twelve years after death,[166] would appear to lead to recapture.

V. THE FOBD ELECTION

A. *When Election Is Timely*

The executor or personal representative must elect to use the FOBD and file an agreement of personal liability for possible repayment or “recapture” of the tax benefits.[167] The FOBD statute specifies that the rules applicable to special use valuation elections also apply to FOBD.[168] Until specific guidance is provided in the form of temporary or proposed regulations or rulings, reliance is expected to be placed on the special use valuation election procedures. Thus far, the IRS has only published Schedule T to Form 706, in which the election is to be made along with instructions for the use of the schedule.[169]

---

161. *Id.* § 2057(b)(2)(B).

162. *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 421(j)(2)(A), 95 Stat. 175, 312 (codified as amended at I.R.C. § 2032A(e)(9)).

163. *See* 5 HARL, AGRICULTURAL LAW, *supra* note 1, § 43.03[2][d][iii][B].

164. *See* I.R.C. § 2032A(e)(9) (1994).

165. *See id.* § 2057(f)(1)(B) (West Supp. Oct. 1998).

166. *See id.* § 2057(i)(3)(G) (stating the use of the two-year grace period extends the overall recapture period by a like interval).

167. *See id.* § 2057(b)(1)(B).

168. *See id.* § 2057(i)(3)(H).

169. Those consulting the Schedule T instructions are warned that the pre-death material participation requirement is described incorrectly in the instructions. Material participation is properly required by the decedent or a member of the decedent’s family for five or more of the last eight years before the earlier of retirement, disability, or death. *See* I.R.C. § 2057(b)(1)(D)(ii) (West Supp. Oct. 1998); I.R.C. § 2032A(e)(6) (West Supp. 1998).

Under special use valuation, the election is made on the federal estate tax return, and late filing is not barred.[170] The IRS may grant a reasonable extension of time for making elections where that time is not expressly prescribed by statute as with FOBD, the request is made within a reasonable time, and the granting of the extension would not jeopardize the interests of the government.[171] Extensions of time for making the special use valuation election have been allowed.[172] However, an estate has not been entitled to an extension of time when the taxpayer did not take reasonable action to deal promptly with the missed deadline.[173]

B. *Perfecting Defective Elections*

Under special use valuation, a 1984 amendment allowed an estate to perfect a special use valuation election already made if the election, as originally filed, substantially complied with the requirements outlined in the regulations.[174] The Tax Reform Act of 1986 provided that, if "substantially all the information" required by the federal estate tax return had been provided, the election was valid if the estate provided the additional information to perfect the election within ninety days after the information is requested.[175] Legislation was enacted in 1997 to allow subsequent submission of information without regard to the compliance regulations under special use valuation, if the election is made in a timely manner, the notice of election does not contain all required information, or one or more signatures are not included in the agreement filed.[176] The executor or personal representative of the estate may submit the information within the ninety-day period after a request from the IRS.[177]

C. *Agreement of Personal Liability*

Under the special use valuation rules that apply to the FOBD, an agreement signed by all parties with an interest in the property subject to the election must be filed with the notice of final election.[178] In the agreement, the parties to the election must consent to personal liability for any additional estate tax on recapture.[179] The

---

170. *See* I.R.C. § 2032A(d) (West Supp. 1998).
171. *See* Treas. Reg. § 301.9100-3(c) (1997).
172. *See* Priv. Ltr. Rul. 96-12-010 (Mar. 22, 1996).
173. *See* Priv. Ltr. Rul. 92-04-005 (Jan. 24, 1992).
174. *See* Tax Reform Act of 1984, Pub. L. No. 98-369, § 1025(a), 98 Stat. 494, 1031 (codified at I.R.C. § 2032A).
175. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1421(a), 100 Stat. 2085, 2716.
176. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1313(a), 111 Stat. 788, 1045 (to be codified at I.R.C. § 2032A(d)(3)).
177. *See* I.R.C. § 2032A(d)(3) (West Supp. 1998).
178. *See* I.R.C. § 2057(i)(3)(H) (West Supp. Oct. 1998); Treas. Reg. § 20.2032A-8(c)(2) (1998).
179. *See* I.R.C. § 2032A(d)(2) (West Supp. 1998).

IRS has provided a sample form of an agreement for special use valuation.[180] Part Five of Schedule T contains the agreement of personal liability.

Under special use valuation, the requirement for an agreement of personal liability extends to: (1) those holding future interests as well as present interests, including remainder and executory interests; (2) contingent as well as vested interests; (3) holders of general or special powers of appointment; (4) beneficiaries of a gift-over, in default of a general or special power of appointment; (5) trustees of trusts holding any interest in the property and owners of beneficial interests in trust property; (6) co-tenants, joint tenants, and holders of other individual interests when the decedent held only a joint or undivided interest in the property, or when only an undivided interest is presently valued (although the requirement that tenants in common other than the decedent must sign the agreement has been held invalid); (7) corporations and partnerships owning property valued under the provision; (8) a spouse apparently must sign if the spouse's signature is required to release an inchoate dower interest; and (9) minors and incompetents, but a representative must be appointed to bind the interested party.[181]

The statement is to include an agreement consenting to personal liability.[182] Schedule T requires that commitment.[183] For purposes of special use valuation if property under an election is transferred to a transferee who is not already a party to an agreement, the transferee is expected to execute and file an agreement.[184] No specific time is set for filing the agreement.[185] The agent designated in the agreement is required to notify the IRS of the material participator's name.[186]

VI. RECAPTURE

The FOBD rules levy a recapture tax if, within ten years of the decedent's death and before the qualified heir's death, a recapture event occurs.[187] The 1998 amendments clarify that the total amount of additional estate tax imposed if recapture occurs is the difference between the actual amount of estate tax liability for the estate and the amount of estate tax that would have been owed had the qualified FOBD not been taken.[188]

A. *Events Triggering Recapture*

180. *See* Rev. Proc. 81-14, 1981-1 C.B. 669.
181. *See id.*, 1981-1 C.B. 669.
182 *See id.*, 1981-1 C.B. 669.
183. *See id.*, 1981-1 C.B. 41.
184. *See id.*, 1981-1 C.B. 669.
185. *See id.*, 1981-1 C.B. 669.
186. *See id.*, 1981-1 C.B. 41.
187. *See* I.R.C. § 2057(f)(1) (West Supp. Oct. 1998).
188. *See id.* § 2057(f)(2)(C)(ii).

Recapture is triggered upon the occurrence of several events. These four events are outlined in this section.

1. *Absence of Material Participation*

Absence of material participation by the qualified heir or a member of the qualified heir's family for more than three years in any eight-year period ending after death covers recapture.[189] The post-death material participation requirement of FOBD is defined the same as for special use valuation.[190] Thus, absence of material participation for more than three years in any eight-year period ending after death triggers recapture.[191] During periods which the property was held by the decedent, material participation must be by the decedent or a member of the decedent's family.[192] For periods during which the property was held by a qualified heir, material participation is to be by the qualified heir or a member of the qualified heir's family.[193]

The provision in special use valuation allowing "active management" to substitute for material participation by the surviving spouse of the decedent, those under twenty-one years old, those who are disabled, and full-time students, apparently also applies to FOBD.[194] The active management test can be met by a fiduciary for those under twenty-one years old and those who are disabled.[195] "Active management" means the making of management decisions of a business, other than the daily operating decisions.[196] As stated in the Senate Finance Committee report:

> [T]he determination of whether active management occurs is factual, and the requirement can be met even though no self-employment tax is payable under section 1401 by the spouse with respect to income derived from the farm or other trade or business operation. Among the farming activities, various combinations of which constitute active management, are inspecting growing crops, reviewing and approving annual crop plans in advance of planting, making a substantial number of the management decisions of the business operation, and approving expenditures for other than nominal operating expenses in advance of the time the amounts are expended. Examples of management decisions are decisions such as what crops to

189. *See id.* § 2057(f)(1)(A).
190. *See id.* § 2057(f)(1)(A); I.R.C. § 2032A(c)(6)(B) (1994).
191. *See id.* § 2032A(c)(6)(B).
192. *See id.* § 2032A(c)(6)(B)(i).
193. *See id.* § 2032A(c)(6)(B)(ii).
194. *See* I.R.C. § 2057(f)(1)(A) (West Supp. Oct. 1998); I.R.C. § 2032A(c)(6)(B)(ii), (c)(7)(B)-(C) (1994).
195. *See* I.R.C. § 2032A(c)(7)(B)(ii) (1994).
196. *See id.* § 2032A(e)(12).

> plant or how many cattle to raise, what fields to leave fallow, where and when to market crops and other business products, how to finance business operations, and what capital expenditures the trade or business should undertake.[197]

2. *Disposal of an Interest in the Business*

If the qualified heir disposes of a portion of a qualified family-owned business interest to someone other than a member of the qualified heir's family, or through a qualified conservation contribution, recapture occurs.[198] There is no explicit qualified use or "at risk" requirement in the post-death period. Yet, the legislation incorporates the two-year "grace period" under special use valuation.[199] However, for special use valuation purposes, the two-year grace period applies only for purposes of the "qualified use" test.[200] Inasmuch as that test is not imposed in the case of the FOBD, there has been a question about the meaning of the two-year grace period in the context of the FOBD. The widespread use of the term "business" throughout the statute and the reference to passive assets being ineligible for the deduction clearly indicate that Congress contemplated that a business be carried on. That is one possible interpretation of the incorporation of the two-year grace period into FOBD. With that interpretation, the requirement of a "business" is waived during the two-year period after death and the ten-year recapture period is extended for a like time.[201] This interpretation harmonizes with the statute and is believed to be the correct interpretation. It would mean that the decedent could cash rent during the two-year grace period.

The recapture portion of the statute refers repeatedly to "business" and "qualified family-owned business interest."[202] Indeed, those terms appear six times in the recapture portion of the statute.[203] Passive assets are excluded from such interests.[204] That exclusion would suggest that cash rent leasing and non-material participation share leasing with minimal involvement in management by the property owner would not be eligible. However, the Joint Committee on Taxation in late 1997 indicated that "farmland that originally qualified for the family-owned business exclusion will not be subject to recapture if the heirs cash lease the farmland to a member of the decedent's family who operates a business on that land."[205]

---

197. S. REP. NO. 97-144, at 134-35 (1981).
198. *See* I.R.C. § 2057(f)(1)(B) (West Supp. Oct. 1998).
199. *See id.* § 2057(i)(3)(G).
200. *See* I.R.C. § 2032A(c)(7)(A) (1994).
201. *See id.*
202. I.R.C. § 2057(f) (West Supp. Oct. 1998).
203. *See id.*
204. *See id.* § 2057(e)(2)(D).
205. Letter from Kenneth J. Kies, Joint Committee on Taxation, to Senator Charles Grassley,

The Joint Committee's response was unconvincing in light of the clear indication in the statute that Congress contemplated a business would be carried on during the recapture period after death.[206] The 1998 amendments partially addressed that problem by adding language to the recapture part of the statute to state that "[a] qualified heir shall not be treated as disposing of an interest . . . by reason of ceasing to be engaged in a trade or business so long as the property to which such interest relates is used in a trade or business by any member of such individual's family."[207] The amendment provides protection for gift, sale, or death-time transfer of business interests or assets from a qualified heir to any member of the qualified heir's family when the assets continue to be used in the business. Likewise, the amendment appears to permit post-death cash rent leasing so long as the lease is from the qualified heir to a member of the qualified heir's family as tenant or to a family-owned entity as tenant.

However, the language provides no protection for the sale or exchange of grain or livestock in inventory to others, the sale or exchange of machinery and equipment, or transfers of other property to persons other than members of the qualified heir's family. Language in the 1997 conference committee report supports the view that sales or exchanges of inventory, grain, or livestock, and sales or exchanges of assets used in the business, other than land, in the course of business should not lead to recapture:

> The conferees clarify that a sale or disposition, in the ordinary course of business, of assets such as inventory or a piece of equipment used in the business (e.g., the sale of crops or a tractor) would not result in recapture of the benefits of the qualified family-owned business exclusion.[208]

With no statutory provision, however, a question is raised whether language in the conference committee report will be a sufficient basis to sell assets in the course of business without recapture. The Joint Committee on Taxation believed the conference committee report language was sufficient.[209] Legislation has been introduced to specify that the "sale or exchange of property produced through the qualified use of qualified real property" would not be subject to recapture.[210] That amendment would help to make FOBD workable, but an even broader provision is needed. The statute does not provide protection against recapture for the following: transfers of interests in an entity by sale during life to those people other than family

---

supra note 55, at 43A-2.

206. *See* I.R.C. § 2057(f).

207. *Id.* § 2057(f)(3).

208. H.R. CONF. REP. NO. 105-220, at 400 (1997).

209. *See* Letter from Kenneth J. Kies, Joint Committee on Taxation, to Senator Charles Grassley, *supra* note 55, at 43A-2.

210. H.R. 4640, 105th Cong. § 1 (1998) (the proposal is flawed in the reference to I.R.C. § 2057(c)).

members, such as: corporate stock or partnership shares; transfers of interest in an entity by gift during life to people other than family members; mortgages of property after death; declaring dividends or making other distributions from an entity; changing the organizational structure of an entity, including liquidation, during the recapture period; transfers of property after bankruptcy filing; partitioning assets; or granting of an easement or other interest in land, other than a qualified conservation contribution. An amendment to the statute may be necessary to adopt appropriate language or to incorporate by reference I.R.C. § 6166(g), which allows disposition or withdrawal of up to one-half of the assets without causing acceleration of tax.[211]

The IRS has ruled on numerous occasions as to what constitutes a disposition of an interest under a similar provision for special use valuation purposes. In a 1985 revenue ruling, the IRS held that sale of a five acre tract to a qualified heir for construction of a residence for the qualified heir and the qualified heir's spouse did not result in recapture where the qualified heir was involved in the management of the farm business.[212] Similarly, the IRS has ruled that the sale of a parcel of land including a residence, to a child of a qualified heir and the child's spouse was not a recapture event.[213] The child and the child's spouse would manage the farm and receive twenty-five percent of the net income from the operation.[214]

In a 1988 revenue ruling, a grant of a leasehold interest in oil and gas, under special use valued land, was not considered to be a disposition, except to the extent actual extraction operations were to occur and interrupt farm business operations.[215] In an earlier private letter ruling, execution of an oil and gas lease was not deemed to be a disposition where no interruption of farming activity had occurred, but well-drilling activity, to the extent farming operations were interrupted, was a disposition for purposes of recapture of benefits.[216]

The IRS has ruled on several situations involving transfers of property interests by way of corporate stock transactions. For example, sale of corporate stock by a qualified heir to the corporation that was owned by the remaining qualified heirs, who were family members, did not result in recapture.[217] Likewise, incorporation of farm property by the sole qualified heir did not result in recapture where the qualified heir held one hundred percent of the stock.[218] A tax-free exchange to a corporation should not result in recapture.[219] Furthermore, transfers of stock to children would not result in recapture as long as the qualified heir's interest

---

211. *See* I.R.C. § 6166(g)(1) (1994).
212. *See* Rev. Rul. 85-66, 1985-1 C.B. 324.
213. *See* Priv. Ltr. Rul. 93-40-035 (July 7, 1993).
214. *See id.*
215. *See* Rev. Rul. 88-78, 1988-2 C.B. 330; Gen. Couns. Mem. 39,767 (Feb. 12, 1995).
216. *See* Priv. Ltr. Rul. 83-18-070 (Feb. 2, 1983).
217. *See* Priv. Ltr. Rul. 82-17-075 (Jan. 28, 1982).
218. *See* Priv. Ltr. Rul. 84-16-016 (Jan. 13, 1984).
219. *See* I.R.C. § 351 (West Supp. Oct. 1998); Priv. Ltr. Rul. 92-35-028 (May 29, 1992).

was an "interest in a closely-held business."[220] Similarly, the transfer of special use valued property to a corporation with distribution of the corporate stock to the qualified heirs did not cause recapture of special use valuation benefits.[221] A 1985 private letter ruling involving the transfer of a decedent's stock in a closely-held farm corporation, in satisfaction of a debt owed by the estate to the corporation, did not cause recapture of special use valuation benefits where the remaining shareholders were all qualified heirs.[222]

The IRS has ruled that the granting of a subsurface easement for a pipeline was not a recapture event.[223] However, the transfer of an agricultural preservation easement for consideration resulted in recapture of special use valuation benefits.[224] The granting of a qualified conservation easement under the Taxpayer Relief Act of 1997 is not treated as a disposition for purposes of special use valuation recapture, and the existence of a qualified conservation easement does not prevent the property from subsequently qualifying for special use valuation.[225]

In general, no recapture results on transfers of property to a revocable inter vivos trust, but an agreement consenting to personal liability must be filed by the trustees and beneficiaries.[226] One private letter ruling has required that the agreement of personal liability be attached to a Form 706-A.[227]

In the case of a "qualified woodland," the disposition or severance of standing timber is treated as a recapture event for purposes of special use valuation, if the election had been made to treat the trees as part of the land.[228] That provision has not been specifically incorporated into the FOBD statute.[229] However, originally, the special use valuation statute did not contain a specific reference to trees. In 1980, the IRS took the position that merchantable timber and young growth should be treated as a crop and not part of the real estate.[230] The statute was subsequently amended to provide that, for "qualified woodlands," if the executor makes an election, growing trees are not treated as a crop.[231] The term "qualified woodlands"

---

220. I.R.C. § 6166(b)(1) (1994).

221. *See* Priv. Ltr. Rul. 86-17-026 (Jan. 23, 1986).

222. *See* Priv. Ltr. Rul. 86-08-037 (Nov. 22, 1985).

223. *See* Priv. Ltr. Rul. 90-35-007 (May 25, 1990).

224. *See* Priv. Ltr. Rul. 87-31-001 (Mar. 19, 1987). *See also* Estate of Gibbs v. United States, 161 F.3d 242, 250 (3d Cir. 1998) (transfer of perpetual easement to assure land not developed considered "disposition" for recapture purposes; disposition of interest in land under state law).

225. *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 508(a), 111 Stat. 788, 857 (to be codified as I.R.C § 2031(c)).

226. *See* Priv. Ltr. Rul. 87-51-009 (Sept. 11, 1987); Priv. Ltr. Rul. 95-19-015 (May 12, 1995).

227. *See* Priv. Ltr. Rul. 87-51-009 (Sept. 11, 1987).

228. *See* I.R.C. § 2032A(c)(2)(E) (1994).

229. *See* I.R.C. § 2057 (West Supp. Oct. 1998).

230. *See* Tech. Adv. Mem. 80-46-012 (Aug. 8, 1980).

231. *See* I.R.C. § 2032A(e)(13) (1994).

means real property "used in timber operations, and is an identifiable area of land . . . for which records are normally maintained in conducting timber operations."[232]

A partition of real property under a special use valuation election has been held to constitute a disposition, but no recapture tax is due if an eligible transferee agrees to be personally liable for any additional tax.[233] A partition of qualifying property between or among qualified heirs has been held not to be a disposition.[234] A sale and leaseback within the recapture period has been held to constitute a disposition.[235]

Recapture does not occur if qualified real property is exchanged in a tax-free exchange for "qualified exchange property."[236] In one private letter ruling, the IRS agreed that no recapture occurred in a tax-free, like-kind exchange carried out in accordance with I.R.C. § 1031.[237] However, the IRS refused to rule on a request for partial revocation of the election.[238] In a 1985 private letter ruling, the emphasis was on the requirements for a tax-free, like-kind exchange with no mention of "qualified exchange property" in the ruling itself.[239] If both qualified exchange property and other property are received, the recapture tax is reduced by an amount bearing the same ratio to the recapture tax as the fair market value of the qualified exchange property bears to the fair market value of the property exchanged.[240] Qualified exchange property is real property used for the same qualified use as the property transferred.[241]

Recapture does not occur if qualified real property is involuntarily converted and "qualified replacement property" is acquired.[242] The question has been raised

---

232. *Id.* § 2032A(e)(13).

233. *See* Priv. Ltr. Rul. 81-20-127 (Feb. 23, 1981).

234. *See* Priv. Ltr. Rul. 91-13-028 (Dec. 31, 1990); Priv. Ltr. Rul. 87-13-029 (Dec. 24, 1986); Priv. Ltr. Rul. 82-49-014 (Aug. 23, 1982); Priv. Ltr. Rul. 82-13-155 (Dec. 31, 1981).

235. *See* Priv. Ltr. Rul. 79-34-007 (Apr. 30, 1979).

236. *See* I.R.C. § 2057(i)(3)(M) (West Supp. Oct. 1998); I.R.C. § 2032A(i) (1994); Priv. Ltr. Rul. 82-07-050 (Nov. 19, 1981). *See also* Priv. Ltr. Rul. 96-04-018 (Jan. 26, 1996) (finding a tax-free exchange under I.R.C. § 1031 where there was no recapture of special use valuation benefits); Priv. Ltr. Rul. 85-16-077 (Jan. 23, 1985); Priv. Ltr. Rul. 83-04-106 (Oct. 27, 1982); Priv. Ltr. Rul. 83-03-031 (Oct. 18, 1982).

237. *See* Priv. Ltr. Rul. 95-03-015 (Jan. 20, 1995).

238. *See id.*

239. *See* Priv. Ltr. Rul. 85-26-032 (Apr. 1, 1985).

240. *See* I.R.C. § 2032A(i)(1)(B) (1994).

241. *See id.* § 2032A(i)(3); Priv. Ltr. Rul. 88-50-032 (Sept. 19, 1988) (stating that qualified heirs may not avoid recapture of special use valuation tax benefits by substituting estate property for which no election was made for estate property for which election was made but which was involuntarily converted by governmental condemnation); Priv. Ltr. Rul. 85-26-032 (Apr. 1, 1985) (finding the exchange of qualified heir's farm for farm of equal value acquired by unrelated party in order to make exchange was exchange of qualified real property and did not cause recapture).

242. *See* I.R.C. § 2057(i)(3)(M) (West Supp. Oct. 1998); I.R.C. § 2032A(h) (1994).

whether a foreclosure sale is an involuntary conversion for this purpose.[243] Qualified replacement property is real property used for the same qualified use as the property involuntarily converted.[244]

There is no authority on whether a mortgage or other credit obligation would constitute disposition of an interest in property for special use valuation purposes. Arguably, if funds obtained remain invested in the business in farm real or personal property, there should be no recapture.

The transfer of property from an individual debtor to the bankruptcy estate under either a Chapter 7 or 11 bankruptcy should not be considered a disposition.[245] Likewise, a transfer of property back to the debtor at the termination of the bankruptcy estate is not a disposition.[246] Chapter 12 and 13 bankruptcy filings do not involve creation of a new entity under the Bankruptcy Tax Act of 1980.[247] If a qualified heir (or subsequent transferee without recapture) files bankruptcy and the property is transferred to someone other than a member of the qualified heir's (or transferee's) family, a recapture occurs.[248] If insufficient assets are available to pay the recapture tax, it is unclear whether the qualified heir (or subsequent transferee) remains liable under the agreement of personal liability or whether the agreement of personal liability is discharged in bankruptcy.[249]

In a 1989 revenue ruling, the IRS held that where some specially valued estate property was sold to nonqualified heirs to pay off the outstanding debt on other special valued property, both under threat of foreclosure, special use valuation tax benefits were recaptured.[250] However, there is no recapture on foreclosure until expiration of the right to redeem under state law.[251]

Merger of identical residuary trusts does not result in disposition if the merger is court-approved and the trustees and the beneficiaries consent to personal liability for the collection of additional federal estate tax.[252]

The 1998 amendments clarify that property passing to a trust may be treated as having passed to a qualified heir if all of the beneficiaries of the trust are qualified

---

243. *See generally In re* Morgan, 90-1 U.S.T.C. ¶ 60,005 (E.D. Okla. 1990) (holding recapture since no reinvestment took place).

244. *See* I.R.C. § 2032A(h)(3) (1994).

245. *See id.* § 1398(f)(1).

246. *See id.* § 1398(f)(2).

247. *See id.* § 1399.

248. *See* 5 HARL, AGRICULTURAL LAW, *supra* note 1, § 43.03[2][g][i][C][I].

249. *See* 5 *id.*

250. *See* Rev. Rul. 89-4, 1989-1 C.B. 298.

251. *See* Tech. Adv. Mem. 93-33-002 (Apr. 20, 1993) (stating foreclosure was not seizure under § 1033).

252. *See* Priv. Ltr. Rul. 85-26-029 (Mar. 28, 1985).

heirs.[253] The reference to I.R.C. § 2032A(g) covers transfers to partnerships, corporations, and trusts.[254]

The FOBD statute states that recapture tax is due "if, within 10 years after the date of the decedent's death and before the date of the qualified heir's death," a recapture event occurs.[255] In a 1989 private letter ruling issued under the special use valuation requirement, which is similar, there was no recapture of special use valuation benefits upon the death of a qualified heir with a life estate in trust and a general power of appointment, which was sufficient to include the property in the qualified heir's estate.[256] For interests left to qualified heirs in life estate or remainder form, recapture apparently does not cease short of the end of the recapture period unless the holders of all interests die or the remainder is included in the estate of the life tenant.

3. *Loss of Relationship to the United States*

Recapture occurs if the qualified heir loses U.S. citizenship.[257] Likewise, recapture takes place if the principal place of business of the family-owned business ceases to be located in the United States.[258]

4. *Provisions from I.R.C. § 6166*

FOBD contains three provisions from I.R.C. § 6166 regarding acceleration of payment of federal estate tax.[259] Section 303 stock redemptions do not cause acceleration and, presumably, under FOBD, do not cause recapture.[260] Types D, E, or F corporate reorganizations do not cause acceleration and, presumably, do not cause recapture.[261] Transfers at death to a member of the family are not an acceleration or recapture event.[262]

B. *Calculating the Recapture Tax*

253. *See* I.R.C. § 2032A(g) (West Supp. 1998); I.R.C. § 2057(i)(3)(L) (West Supp. Oct. 1998).
254. *See* I.R.C. § 2032A(g).
255. *Id*. § 2057(f)(1).
256. *See* Priv. Ltr. Rul. 89-06-033 (Feb. 10, 1989).
257. *See* I.R.C. § 2057(f)(1)(C) (West Supp. Oct. 1998).
258. *See id.* § 2057(f)(1)(D).
259. *See id.* § 2057(i)(3)(O).
260. *See* I.R.C. § 6166(g)(1)(B)(i) (1994).
261. *See id.* § 6166(g)(1)(C).
262. *See id.* § 6166(g)(1)(D).

The recapture tax is calculated in a manner similar to special use valuation recapture.[263] Interest must be paid at the regular rate on underpayment of federal tax from the due date of the tax until paid.[264] The FOBD statute imposes interest in the event of recapture from the time the federal estate tax was due until the time the additional estate tax is paid.[265] The "additional estate tax" is due six months after the recapture event.[266] Interest at the regular rate on unpaid tax is due on the recapture tax.[267] The recapture rules for the FOBD phase down the recapture tax based on the number of years of material participation.[268]

Recapture event occurring in following year of material participation	Percentage of Recapture Tax Due
1 through 6	100
7	80
8	60
9	40
10	20[269]

It is pointed out that the provision is ambiguous in that it uses "year of material participation" to calculate the recapture tax.[270] Lapses in material participation in the post-death period are allowed without recapture for up to three years; absence of material participation for more than three years in any eight-year period ending after death triggers recapture.[271] This ambiguity should be resolved. Under the FOBD rules, recapture apparently is calculated on a proportionate basis in the event of a partial disposition.[272]

The FOBD statute specifies that the provisions relating to the special lien for additional estate tax[273] are applicable to the FOBD.[274] Under that provision, a special lien is imposed on all qualified farm or closely-held business real property for which an election has been made to utilize special use valuation.[275] The lien arises at the time the election is filed and continues until the potential liability for

263. *See* I.R.C. § 2057(f)(2)(A)(i) (West Supp. Oct. 1998).
264. *See id.* § 2057(f)(2)(A)(ii).
265. *See id.* § 2057(f)(2)(A).
266. *See* I.R.C. § 2032A(c)(4) (West Supp. 1998).
267. *See id.* § 6621(a)(2).
268. *See* I.R.C. § 2057(f)(2)(B) (West Supp. Oct. 1998).
269. *See* I.R.C. § 50(a)(1)(B) (West Supp. 1998).
270. *Id.*
271. *See* I.R.C. § 2032A(c)(6)(B) (West Supp. 1998); I.R.C. § 2057(f)(1)(A) (West Supp. Oct. 1998).
272. *See* I.R.C. § 2057(f)(2)(A) (West Supp. Oct. 1998).
273. *See* I.R.C. § 6324B (1994).
274. *See* I.R.C. §§ 2057(i)(3)(N), 6166(b)(3) (West Supp. Oct. 1998).
275. *See* I.R.C. § 6324B (1994); I.R.C. § 6166(b)(3) (West Supp. Oct. 1998).

recapture ceases, the qualified heir dies, or the tax benefit is recaptured.[276] The Treasury Department may authorize other security to be substituted for the real property in question to secure payment of the tax that could become due if events occur triggering recapture.[277] Moreover, the Treasury Department may subordinate the special lien to other obligations if sufficient collateral exists to protect adequately the Treasury's interests.[278] The special lien is not valid against a purchaser, holder of a security interest, mechanic's lien, or judgment lien creditor unless properly filed.[279]

Even though properly filed, the lien does not take priority over real property taxes and special assessments for public improvements;[280] mechanic's liens for repair or improvement of the property;[281] security interests for the construction or improvement of real property (to the extent of the real property involved in the improvement);[282] a contract to construct or improve real property (to the extent of the proceeds of the contract);[283] or "the raising or harvesting of a farm crop or the raising of livestock or other animals" (to the extent of the crops or livestock involved and the property affected by the general lien for unpaid federal taxes).[284]

The almost casual reference in the FOBD statute to the lien utilized for purposes of special use valuation raises a number of questions of a practical nature regarding the lien to secure the government's interest in the assets involved in electing a qualified family-owned business. A lien on special use valuation land involves establishment of a straightforward lien on real property. With an election under the FOBD statute, the assets involved may include land, of course, but are likely also to involve personal property or "goods." Such movables can serve as collateral for an obligation, but perfection would necessarily have to follow Uniform Commercial Code rules under local law. Moreover, the "movables" typically involve inventory items which are frequently sold in the course of business, necessitating a release of any security interest on a frequent basis. For that reason, it is anticipated that the IRS will require a lien on any land involved and, if that is not sufficient collateral, a security interest in non-inventory assets used in the business. Only if those assets produce insufficient collateral value is it anticipated that a security interest will be required in inventory-type assets.

---

276. *See* I.R.C. § 6324B(b) (1994); Treas. Reg. § 20.6324B-1(b) (1982).

277. *See* I.R.C. § 6324B(d) (1994).

278. *See id.* § 6325(d)(3); Treas. Reg. § 301.6325-1(d)(3) (as amended in 1976).

279. *See* I.R.C. §§ 6323(f), 6324A(d)(1), 6324B(c) (1994).

280. *See id*. §§ 6323B(6), 6324A(d)(3)(A), 6324B(c).

281. *See id.* §§ 6324A(d)(3)(B), 6324B(c).

282. *See id*. §§ 6323(c)(3)(A)(i), 6323(c)(3)(B)(i), 6324A(d)(3)(C), 6324B(c).

283. *See* I.R.C. §§ 6323(c)(3)(A)(ii), 6323(c)(3)(B)(ii) (West Supp. Oct. 1998); I.R.C. §§ 6324A(d)(3)(C), 6324B(c) (1994).

284. I.R.C. §§ 6321, 6323(c)(3)(A)(iii), 6323(c)(3)(B)(iii) (West Supp. 1998); I.R.C. §§ 6324A(d)(3)(C), 6324B(c) (1994).

C. *Personal Liability and Furnishing of Bond*

Under special use valuation, the qualified heir is personally liable for the additional recapture tax with respect to the qualified heir's interest, unless the qualified heir has furnished a bond.[285] That provision has been included by reference in the FOBD statute.[286] Under that provision, if a qualified heir makes written application to the Secretary of the Treasury for a determination of the maximum amount of the additional recapture tax that could be imposed, the Secretary is to notify the qualified heir within one year.[287] A qualified heir furnishing a bond in the amount required for the specified period is discharged from personal liability for any additional recapture tax and is entitled to a discharge in writing.[288]

The FOBD statute incorporates the special use valuation provision specifying that only one recapture tax is imposed even though more than one recapture event occurs.[289] The period of limitation for assessment runs from the time the IRS is notified of the recapture event.[290] In a 1993 Tax Court case, a questionnaire filed with the IRS constituted notification of the cessation of qualified use for special use valuation purposes and commenced the period of limitation on assessment and collection.[291]

In the event of recapture, the recapture form (Form 706-A for special use valuation) must be filed within six months after the recapture event, unless an extension for filing is obtained.[292] Generally, on transfer to a new entity or to an eligible transferee, an agreement of personal liability must be executed.[293] In one private letter ruling, it was stated that the agreement of personal liability must be attached to a Form 706-A.[294]

VII. NON-CITIZEN QUALIFIED HEIR

---

285. *See* I.R.C. § 2032A(c)(5) (1994).
286. *See id.* § 2057(i)(3)(F) (West Supp. Oct. 1998).
287. *See id.* § 2032A(e)(11) (1994).
288. *See id.*
289. *See id.* §§ 2057(i)(3)(D) (West Supp. Oct. 1998); I.R.C. § 2032A(c)(3) (1994).
290. *See* I.R.C. § 2032A(f)(1) (1994).
291. *See* Stovall v. Commissioner, 101 T.C. 140, 154-55 (1993).
292. *See* I.R.C. § 2032A(c) (1994).
293. *See, e.g.*, Priv. Ltr. Rul. 96-42-055 (July 24, 1996) (involving transfer to members of family); Priv. Ltr. Rul. 95-19-015 (Feb. 7, 1995) (involving transfer to revocable inter vivos trust); Priv. Ltr. Rul. 93-40-035 (July 7, 1993) (involving transfer to members of family); Priv. Ltr. Rul. 92-35-028 (May 29, 1992) (involving section 351 exchange to corporation); Priv. Ltr. Rul. 87-51-009 (Sept. 11, 1987) (involving transfer to revocable inter vivos trust).
294. *See* Priv. Ltr. Rul. 87-51-009 (Sept. 11, 1987).

For qualified heirs who are not citizens of the United States, an interest in a business is considered to be a qualified family-owned business interest only if the interest passes to, is acquired by, or is held in a "qualified trust." Exceptions are provided for situations where the acceleration provisions of I.R.C. § 6166 apply and for instances where the qualified heir furnishes a bond.[295] A "qualified trust" is defined as a trust organized under, and governed by, the laws of the United States or of a state in the United States, and the trust instrument requires that at least one trustee be an individual citizen of the United States or a domestic corporation.[296]

VIII. POST-DEATH CONSIDERATIONS

A. *Special Use Valuation*

For businesses with assets exceeding $1.3 million, can part or all of the land be "removed" from the business and valued under special use valuation with the remaining assets passing under the FOBD? Will it be necessary to keep the land, for which special use valuation is desired, outside of the business and rent the land to the business? It would appear that land can be subjected to a special use valuation election with the rest of the business subject to a FOBD election. Although it is not at all clear, it is likely that land under a special use valuation election would be included as a business asset for purposes of the fifty percent test. However, the special use assets would apparently be valued at special use value.[297] It is noted that if both special use value and the FOBD are elected, the post-death recapture rules for the two concepts are similar, but far from identical.

B. *Installment Payment of Federal Estate Tax*

If an estate elected both the FOBE and fifteen-year installment payment of federal estate tax, a major issue under the original enactment was whether assets excluded from the gross estate under the FOBE election were included in the calculation of an "interest in a closely-held business" and in the calculation of "adjusted gross estate" for that purpose.[298] By shifting to a deduction, the family-owned business interest is included in the gross estate and then deducted from the gross estate. A similar set of questions relates to eligibility of the FOBD assets for eligibility of the estate for purposes of I.R.C. § 303 stock redemption.[299]

---

295. *See* I.R.C. §§ 2057(g)(1), 2057(i)(3)(M) (West Supp. Oct. 1998); I.R.C. § 2032A(c)(5) (1994).

296. *See* I.R.C. § 2057(g)(2) (West Supp. Oct. 1998).

297. *See id.* § 2032A(a) (1994) (stating that land subject to special use valuation elections valued at its special use value for purposes of this chapter).

298. *Id.* § 6166(b)(1), (6).

299. *See id.* § 303(a).

IX. CONCLUSION

One effect of the FOBD is to discourage farmers and others in small business from building up savings. Savings beyond the reasonable needs of the business are not eligible for the tax break involved. The provision, especially for older farmers, will encourage individuals to remain fully invested in land and other assets. Sale of land before death will be discouraged. Land sales on contract will be discouraged inasmuch as a land contract is unlikely to be considered a business asset, at least in a sole proprietorship.

The FOBD will be viewed widely as an attractive way to shelter assets. Because of the ready availability of tenants to operate farms under crop share or cash rent leases in almost all areas of the country, investments in farmland are likely to be viewed with particular favor. The barriers to eligibility are relatively modest provided the "trade or business" makes up more than fifty percent of the decedent's adjusted gross estate, and the material participation and passive asset tests can be met. This could mean increased investment in farmland by older taxpayers and higher farmland prices.