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Publisher/Editor
Robert P. Achenbach, Jr.
Contributing Editor
Dr. Neil E. Harl, Esq.

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A NEW FACE FOR FOBE?

— by Neil E. Harl*

The family-owned business exclusion (FOBE),[1] enacted as part of the Taxpayer Relief Act of 1997[2] has been severely criticized for being poorly drafted, failing to provide adequate guidance in several areas and imposing eligibility requirements so limiting as to constrain the provision's usefulness for farm and ranch firms.[3] The Senate Finance Committee, in its version of technical corrections for the 1997 legislation,[4] has addressed some of the concerns in the 1997 law.

Recasting the provision as a deduction

The Senate Finance Committee approach in the proposed amendments is to recast the family-owned business exclusion as a deduction from the gross estate,[5] rather than as an exclusion from the gross estate.[6] Accordingly, the provision would be shifted from Section 2033A to Section 2057. The maximum deduction would be set at $675,000 under the proposed provision.[7] The exemption equivalent of the unified credit would be set at $625,000 and would continue at that level.[8] Thus, the combined amount would be $1,300,000 for 1998 and thereafter as is the case under the present provision.[9] The difference would be that the unified credit exemption equivalent amount (for those electing the family-owned business deduction) would not phase up from $625,000 to $1,000,000 but would remain at $625,000; the family-owned business deduction would remain at $675,000 rather than phasing down to $300,000.

Under the proposed provision, if the estate includes less than $675,000 of qualified family-owned business interests, the unified credit exemption equivalent amount would be increased on a dollar-for-dollar basis but only up to the applicable exclusion amount otherwise available for the year of death.[10]

By shifting the provision from an exclusion from the gross estate to a deduction from the gross estate, the questions relating to whether the assets involved would receive a new income tax basis at death[11] have been resolved. With the assets involved included in the gross estate, a new basis at death should be assured.[12]

Pre-death gifts to family members

The proposed legislation would make minor changes in the numerator of the formula[13] for determining eligibility for the deduction.[14] The proposed changes would clarify the calculation procedure.

Pre-death "trade or business" requirement

Although the family-owned business exclusion drew heavily from special use

* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

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valuation,[15] the FOBE did not include the special use valuation "qualified use" test which laid down the requirements to be a "trade or business."[16] Rather, the FOBE invoked a "passive asset" test which excluded from eligibility assets producing various types of passive income including "rents."[17] The result was that leased assets, under some circumstances would likely not be eligible for the exclusion—

- Those rented under a cash rent lease regardless of the identity of the lessee (family member (or family-owned entity)).[18]
- Assets rented under a non-material participation crop share lease with minimal involvement in decision making under the lease,[19] again regardless of the identity of the lessee.

The proposed legislation, in an attempt to remedy that problem,[20] would specify that a decedent would be "treated as engaged in a trade or business if any member of the decedent's family is engaged in such trade or business."[21] Focusing just on the statutory language, if a decedent were renting land to a son under a cash rent lease, would the land be eligible for the deduction? The question is whether land cash rented by the son would be deemed to be used in the son's trade or business. If it were, the land would be eligible. The statutory language, standing alone, does not make that clear. Indeed, a good argument could be made that all the proposed addition would do is to make the father eligible to claim the deduction for the son's business—which the father does not own.

The Senate Finance Committee report[22] clarifies the matter by stating—

> "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."[23]

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.

Post-death "trade or business" requirement

Notwithstanding the fact that the FOBE statute did not specifically articulate a post-death "qualified use test"[24] for purposes of recapture of benefits, and the Joint Committee on Taxation insisted that cash rented leasing post-death would not lead to recapture "if the heirs cash lease the farmland to a member of the decedent's family[25] who operates a business on that land,"[26] the FOBE statute refers six times to "business" and "qualified family-owned interest"[27] and passive assets are excluded from such interests.[28] This would suggest that cash rent leasing (and non-material participation share leasing with minimal involvement in management by the property owner) would lead to recapture in the post-death recapture period.

The proposed legislation would amend 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."[29]

The proposed amendment thus would provide protection for lease, gift, sale or death-time transfer of business interests or assets from the qualified heir to any member of the qualified heir's family when the assets continue to be used in the business. However, the proposed language would provide 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. Thus, while the proposed language represents an improvement over FOBE language, the provision would still be deficient in those respects. It is noted that the earlier Committee report recognized the post-death transfer problem for grain, livestock and machinery.[30]

What the proposal would not do

The proposed amendments do not address several other problems with the family-owned business provision—

- The problem of interest being imposed, in the event of recapture, from the time the federal estate tax was due until the time the additional estate tax is due.[31]
- The problem of meeting the minimum five-year holding period[32] for machinery, livestock, stored crops and growing crops in farm sole proprietorships[33] is not addressed in the proposed amendments.
- The proposed amendments do not fully resolve the issues relating to the relationship to the generation skipping transfer tax, corporate stock redemption and 15-year installment payment of federal estate tax.[34]
- The proposed changes do not address whether the decision to claim a deduction can be made on an asset-by-asset basis or on a fractional share basis.[35]

Other Proposed Amendments

Several additional amendments have been urged[36] including-(1) changing the period for computing interest on the recapture tax for the family-owned business interest to make the provision parallel to that for special use valuation;[37] (2) clarifying further the matter of pre-death cash rent leasing; (3) making it clear that inventory items and depreciable property used in the business would not be required to be owned for at least five years before death;[38] (4) allowing up to 50 percent of the date of death value of assets to be disposed of or withdrawn without triggering recapture;[39] and (5) resolving the *Mizell*[40] problem by amending the Code to narrow the scope of activity to the lease agreement in determining liability for self-employment tax.[41]

In conclusion

The Senate Finance Committee proposals are clearly a step in the direction of making the family-owned business provision workable and a useful tool for farm and ranch estate planning. However, additional changes are needed before practitioners will feel completely comfortable in using the concept.

FOOTNOTES

1 I.R.C. § 2033A. See generally 5 Harl, *Agricultural Law* § 43.04 (1997); Harl, *Agricultural Law Manual* § 5.03[3] (1998).

2 Pub. L. 105-34, 111 Stat. 787 (1997).

3 See Harl, "The Family-Owned Business Exclusion: In Need of Repairs," 76 *Tax Notes* 1219 (1997); Harl, Kelley and McEowen, "Qualified Family-Owned Business Exclusion: Problems to Resolve," 79 *Tax Notes* 1219 (1998).

4 H.R. 2676, Internal Revenue Service Restructuring and Reform Act of 1998, Sec. 6002(b), as reported by the Senate Finance Committee, 105th Cong., 2d Sess. (1998).

5 Prop. I.R.C. § 2057(a).

6 I.R.C. § 2033A(a).

7 Prop. I.R.C. § 2057(a)(2).

8 Prop I.R.C. § 2057(a)(3)(A).

9 See I.R. C. § 2033A(a).

10 See I.R.C. § 2010(c).

11 See I.R.C. § 1014.

12 See I.R.C. § 1014(b)(9); Treas. Reg. § 1.1014-2(b)(1).

13 See 5 Harl, *Agricultural Law* § 43.04[2] (1997); Harl, *Agricultural Law Manual* 5.03[3](1998).

14 Compare I.R.C. § 2033A(b)(3) with Prop. I.R.C. § 2057(b)(3).

15 I.R.C. § 2032A.

16 See I.R.C. § 2032A(b)(2).

17 See I.R.C. §§ 2033A(e)(2)(D)(ii), 954(c)(1), 542(c)(2), 543(a).

18 See 5 Harl, *supra* n. 1, § 43.04[2]. See also Letter, Kenneth Kies, Chief of Staff of Joint Committee on Taxation to Sen. Charles Grassley, Nov. 3, 1997.

19 See 5 Harl, *supra* n. 1, § 43.04[2].

20 See Harl, Kelley and McEowen, *supra* n. 3, at 117.

21 Prop. I.R.C. § 2057(e)(1).

22 S. Rep. No. 105-174, 105th Cong., 2d Sess. (1998).

23 *Id*.

24 See 5 Harl, *supra* n. 1, § 43.04[4].

25 The drafters of the JCT letter seemingly did not realize that post-death involvement is evaluated with respect to members of the qualified heir's family, not members of the decedent's family. See 5 Harl, *supra* n. 1, § 43.04[4].

26 Letter from Kenneth Kies, Chief of Staff of Joint Committee on Taxation to Sen. Charles Grassley, dated November 3, 1997.

27 I.R.C. § 2033A(f).

28 I.R.C. § 2033A(e)(2)(D).

29 Prop. I.R.C. § 2057(f)(3).

30 Rep't 105-220, Conference Committee Report of the Taxpayer Relief Bill at 400, 105th Cong., 1st Sess. (1997).

31 I.R.C. § 2033A(f)(2)(A).

32 I.R.C. § 2033A(b)(1)(D)(i).

33 See Harl, Kelley and McEowen, *supra* n. 3, at 120.

34 See Harl, Kelley and McEowen, *supra* n. 3, at 121.

35 *Id*.

36 See McEowen and Harl, Letters to Office of Sen. Charles Grassley, Dated May 5, 1998, and May 8, 1998.

37 *Id*. See Prop. I.R.C. § 2057(f)(2)(A)(ii).

38 See Prop. I.R.C. § 2057(b)(1)(D).

39 Prop. I.R.C. § 2057(i)(3)(Q). See I.R.C. § 6166(g)(1).

40 Mizell v. Comm'r, T.C. Memo. 1995-571.

41 See I.R.C. § 1402(a)(1) (substituting "…a lease agreement…" for "…an arrangement…"). See also S. 519, H.R. 1261, 105th Cong., 2d Sess. (1997).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

SHARED APPRECIATION AGREEMENTS. The debtor had borrowed money from the FSA and defaulted on the original loan. As part of a refinancing agreement, the FSA agreed to write down the loan and the debtor agreed to a shared appreciation arrangement under which the FSA would receive a portion of any appreciation in the value of the debtor's farmland during the period of the loan. The debtor borrowed funds from another creditor and granted a security interest in the same real property. The creditor argued that the creditor's lien took priority over the shared appreciation agreement. The court held that the shared appreciation agreement was secured by the same security agreement as the loan and had priority over subsequently perfected security interests. The court also held that the shared appreciation agreement was not an executory agreement capable of rejection by the debtor. The court further held that, although the value of the FSA claim under the shared appreciation agreement was not capable of accurate valuation before the end of the loan, the court could make an estimate, with the FSA filing for an adjustment when the loan was terminated. ***In re* Tunnissen, 216 B.R. 834 (Bankr. D. S.D. 1996)**.

CONTRACTS

BREACH. The plaintiffs sold their dairy farm to their son and daughter-in-law. The sale included a promissory note for