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Issue Contents

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CONFUSION OVER MATERIAL PARTICIPATION

— by Neil E. Harl*

The confusion over the pre-death and post-death material participation requirements for special use valuation[1] and the family-owned business deduction[2] has been heightened by incorrect statements in the committee reports[3] and the instructions to Schedule T of Form 706.[4] Unfortunately, our own article in the September 15, 2000, issue of the *Digest* did not contribute much to clearing up the confusion.[5] The importance of the issue justifies another try at clarification.[6]

The special use valuation rule

The time when the material participation test had to be met in the pre-death period for special use valuation purposes was originally expressed as five or more years "during the eight-year period ending on the date of the decedent's death."[7] In 1981, the provision was amended to require material participation only for five or more years during the eight-year period ending with *the earlier of retirement, disability or death*.[8] Thus, if a decedent had five or more years of material participation before beginning to receive social security benefits in retirement,[9] eligibility is assured so long as the individual continues to receive social security benefits.[10]

Family-owned business deduction

For purposes of the family-owned business deduction, the main part of the statute[11] requires pre-death material participation "…during the 8-year period ending on the date of the decedent's death"[12] by "the decedent or member of the decedent's family in the operation of the business to which such interests relate" within the meaning of I.R.C. § 2032A(e)(6). The reference to Section 2032A(e)(6) was to the standard for determining the adequacy of involvement, not the standard used in determining the *period* when material participation is required.[13]

However, Congress added a provision at the end of the statute specifying that rules *similar to the material participation rules applicable to decedents who are retired or disabled* under special use valuation are to apply to decedents under the family-owned business deduction.[14] Thus, under FOBD, material participation is required only for five or more years in the eight-year period ending with the decedent's retirement, disability or death.[15] The pre-death requirement is the same as with special use

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valuation.

Unfortunately, the instructions to Schedule T, the schedule on which the family-owned business deduction is claimed, states as follows—

> "For 5 of the 8 years before the decedent's death, there was material participation by the decedent or a member of the decedent's family in the business to which the ownership interest relates."

That passage is obviously based on the relevant language in the main part of the statute[16] but ignores the modifications at the end of the statute.[17]

Also, the instructions to Schedule T state, several paragraphs farther on, as follows—

> "To make the section 2057 election, either the decedent or a member of the decedent's family must have materially participated in the trade or business to which the ownership interest relates for at least 5 of the 8 years ending on the date of the decedent's death."

Again, that passage is based on the relevant language in the main part of the FOBD statute[18] and ignores the further guidance on the topic near the end of the statute.[19]

Moreover, a 1998 Senate Finance Committee report,[20] the General Explanation of Tax Legislation Enacted in 1998 (The "Blue Book,")[21] the Conference Report to the Taxpayer Relief Act of 1997,[22] a letter from the Joint Committee on Taxation to Sen. Charles Grassley,[23] and the Senate Finance Committee Report to Accompany the Taxpayer Relief Act of 1997[24] all contain nearly identical language requiring material participation for five or more years in the eight-year period ending on the date of the decedent's death.

In conclusion

The statute itself is relatively clear as to the pre-death material participation rule. Unfortunately, the explanation by the Internal Revenue Service, the Senate Finance Committee and the Joint Committee on Taxation reflect only part of the rule applicable for purposes of the family-owned business deduction. Hopefully, the long-awaited regulations under I.R.C. § 2057 will clarify the situation and confirm the statutory language.

FOOTNOTES

1 I.R.C. § 2032A(b)(4), (5). See generally 5 Harl, *Agricultural Law* § 43.03[2][d][vi]; Harl, *Agricultural Law Manual* § 5.03[2][d][iv] (2000).

2 I.R.C. § 2057(b)(1)(D), 2057(i)(3)(A). See generally Harl, *supra note* 1, § 44.03[2](c).

3 See, e.g., S. Rep. No. 105-174, 105th Cong., 2d Sess. (1998). See notes 20-24 *infra*.

4 The instructions for Schedule T, Form 706, contain two incorrect references to the pre-death material participation test for FOBD. See notes 16-17 *infra* and accompanying text.

5 See Harl, "Sorting Out 'Material Participation': The Trap in FOBD," 11 *Agric. L. Dig.* 137 (2000).

6 We are indebted to David Crumley, a tax attorney from Fort Dodge, Iowa, for useful insights into the problem.

7 I.R.C. § 2032A(b)(1)(C), before enactment of the Economic Recovery Tax Act of 1981, Sec. 421(b)(2), adding I.R.C. § 2032A(b)(4). See 5 Harl *supra note 1*, § 43.03[2][d][vi].

8 I.R.C. §§ 2032A(b)(1)(C), 2032A(b)(4).

9 I.R.C. § 2032A(b)(4)(A)(i).

10 I.R.C. § 2032A(b)(4)(A).

11 I.R.C. § 2057(b)(1)(D)(ii).

12 I.R.C. § 2057(b)(1)(D).

13 See I.R.C. § 2032A(e)(6).

14 I.R.C. § 2057(i)(3)(A).

15 I.R.C. § 2057(b)(1)(D), 2057(i)(3)(A).

16 I.R.C. § 2057(b)(1)(D).

17 I.R.C. § 2057(i)(3)(A).

18 I.R.C. § 2057(b)(1)(D).

19 I.R.C. § 2057(i)(3)(A).

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

21 Joint Committee on Taxation, November 24, 1998, pp. 170-174.

22 H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 399 (1997).

23 See letter, dated November 3, 1997, reprinted in Harl and McEowen, "The Family-Owned Business Exclusion—Section 2033A," *TM 829*, 1998, Worksheet 21, 2000 revision forthcoming.

24 S. Rep. No. 33, 105th Cong., 1st Sess. 43 (1997).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

EXEMPTIONS

HOMESTEAD. The debtor was of advanced age and living in a retirement community when the debtor caused an automobile accident. The injured party sued the debtor for an amount in excess of the insurance carried by the debtor. The debtor's family members worked with the debtor to convert most of the debtor's liquid, non-exempt assets into the purchase of a residence, effectively removing the assets from the reach of the injured party who was a creditor in the bankruptcy case. In order to move to the residence, the debtor had to hire a live-in nurse. The residence was clearly larger than needed by the debtor and was expanded in order to use

**Agricultural Law Manual* (ALM).