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MORE ON FOBE

— by Neil E. Harl*

The family-owned business exclusion,[1] enacted as part of the Taxpayer Relief Act of 1997[2] contained numerous omissions and ambiguities as enacted.[3] A letter from the Joint Committee on Taxation to Sen. Charles E. Grassley of Iowa[4] has provided additional insights into JCT's view of how the statute should be interpreted.

Pre-death cash rent leasing

It is clear from the statute that assets rented under a cash rent lease aren't eligible for the exclusion.[5] That's because assets producing "rent" are classified as passive assets which are not considered part of a "qualified family-owned business interest."[6] The same outcome is expected for non-material participation share leases with minimal involvement in management under the lease.

The Joint Committee on Taxation agrees that "land which is cash leased prior to death of its owner does not qualify for the family-owned business exclusion. This would be the result regardless the [sic] cash lease was to a family on [sic] nonfamily member."

Post-death cash rent leasing

The recapture rules under FOBE do not specifically refer to the passive asset test but the statute does refer repeatedly to "business" and "qualified family-owned business interest."[7] Passive assets are specifically excluded from such interests.[8] Therefore, it has appeared that assets could not be cash rented in the post-death recapture period.

However, the Joint Committee on Taxation has taken the position 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." That conclusion is based on a passage in the committee report on the Taxpayer Relief Act of 1997—

> "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."[9]

Arguably, all that passage does is point out that the material participation requirement can be met by the qualified heir or a member of the qualified heir's family. That point is clearly established in the statute.[10] The Joint Tax Committee position seemingly ignores the fact that passive assets are specifically excluded from "qualified family-owned business interests"[11] and the term "qualified family-owned business interests" appears in the recapture provision.[12]

Therefore, until further guidance is received from the Department of the Treasury or the Internal Revenue Service, qualified heirs should endeavor, if possible, to meet the passive asset test throughout the recapture period.

Shares in farmer cooperatives

The issue of whether shares owned by the decedent in a farmer cooperative are eligible to meet the "50 percent" test[13] for purposes of FOBE has been unclear. However, the Joint Committee on Taxation has taken the position that the "look through" rule[14] applies and the value of the cooperative "is separately tested to determine whether all interests in 30-percent family-owned business collectively meet the 50-percent test. Where a farmer owns more than a 30 percent interest in a cooperative, the value of a cooperative can be used to meet the 50 percent test. On the other hand, where that [sic] a farmer does not own more than a 30 percent interest in a cooperative, the value of a cooperative can not be used to meet the 50 percent test."

Assets not yielding a current return

The passive asset test contains a statement that assets producing no income are ineligible to be included in calculating a qualified family-owned business interest.[15] The Joint Committee on Taxation has stated that—

> "Section 2033A(d) provides that 'the adjusted value of any qualified family-owned business interest is the value of such interest for purposes of this chapter (determined without regard to this section).' Treasury Regulation section 20.2031-1(b) states that an asset's fair market value is the price at which property would

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change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. There are several cases holding that the gross estate includes the value of growing crops. Estate of R.E. Tompkins, 13 T.C. 1054 (1949); Estate of L.A. Keller, T.C. Memo. 1980-450, 41 T.C.M. 147. This conclusion is supported by Estate of R.S. Sturgis, T.C. Memo. 1987-415, 54 T.C.M. 221, holding that the value of timberland was determined by adding the value of timber to the value of the land."

Thus, growing crops, even trees, are apparently eligible for the exclusion.

Post-death sale of inventory

The family-owned business exclusion statute does not contain provisions for the sale of grain or livestock or the sale or exchange of equipment in the post-death recapture period. The conference committee report, however, states—

> "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."[16]

The Joint Tax Committee's position is that "presumably, Treasury regulations will provide such a rule and, accordingly, additional statutory guidance is not necessary."

FOOTNOTES

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

2 Pub. L. 105-34, Sec. 502(a), 111 Stat. 788 (1997).

3 See Harl, "The Family-Owned Business Exclusion: How Useful Is it?" 8 *Agric. L. Dig.* 137 (1997). See also Harl, "Meeting the '50 Percent' Test for the FOBE," 8 *Agric. L. Dig.* 161 (1997).

4 Letter from Kenneth Kies, Chief of Staff, dated November 3, 1997.

5 See Harl, "The Family-Owned Business Exclusion: How Useful Is It?" *supra* n. 3 at 137-138.

6 I.R.C. § 2033A(e)(2)(D)(ii).

7 I.R.C. § 2033A(f).

8 I.R.C. § 2033A(e)(2)(D).

9 Rep't 105-33, S. 949, Committee on Finance, U.S. Senate 44 (1997).

10 I.R.C. §§ 2033A(f)(1)(A), 2032A(c)(6)(B).

11 I.R.C. § 2033A(e)(2)(D)(ii).

12 I.R.C. § 2033A(f)(1).

13 I.R.C. § 2033A(b)(1).

14 I.R.C. § 2033A(e)(3).

15 I.R.C. §§ 954(c)(1)(B)(iii), 2033A(e)(D)(ii).

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

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

Chapter 12-*ALM* § 13.03[8].*

ELIGIBILITY. The debtors were dairy and tobacco farmers who operated the farm with their two sons, one of whom owned some of the dairy cows and the other was the tenant of land on which tobacco was grown. The sons were not included as debtors in the bankruptcy case. A creditor argued that the debtors were not eligible for Chapter 12 because much of the assets used in the farm operation were owned by nondebtors. The court noted that the sons substantially participated in the farm operation and did so with little compensation in order to maintain the family farm which they hoped to inherit someday. The court held that, under these circumstances, the assets and efforts of the sons could be considered in determining the debtors' eligibility for Chapter 12; therefore, the debtors were family farmers eligible for Chapter 12. ***In re* Howard, 212 B.R. 864 (Bankr. E.D. Tenn. 1997)**.

PLAN. The debtors were dairy and tobacco farmers who operated the farm with their two sons. The debtors were 57 and 62 years old and proposed a 20 year plan. The court found that the debtors' projection of annual income of $80,000 was unreasonable, given three years of losses and one year of $5,000 in income and the failure of the debtors to accumulate any savings or reduction in debt during the pendency of the current or a prior Chapter 12 case. The debtors' Chapter 12 plan provided for payment of one secured creditor in an amount for the first year and a half of the plan which was less than the interest due on the claim, resulting in a negative amortization. The court denied this aspect of the plan because the debtors did not have sufficient equity cushion in the collateral for the claim to protect the creditor if the debtors were unable to make all plan payments. The court held that the plan could not be confirmed because the income projections were unreasonable given the debtors' past performance and the advanced ages of the debtors. ***In re* Howard, 212 B.R. 864 (Bankr. E.D. Tenn. 1997)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

PREFERENTIAL TRANSFERS. The debtor had made a substantial payment to the IRS just before filing for Chapter 7. The trustee sought to avoid the payment as a preferential transfer, arguing that the IRS received more than it would post-petition because substantial administrative expenses from attorney's fees would diminish the share of the estate payable to the IRS. The court held that the determination of whether the IRS received more than it would have post-petition was to be made at the time of the Chapter 7 filing; therefore, the payment to the IRS was not preferential, since, at the time

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