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RECAPTURE UNDER FOBD

— by Neil E. Harl*

The beleaguered family-owned business deduction,¹ which is slated for repeal after 2003,² continues to pose problems of a practical nature.

Calculating recapture tax

If a recapture event occurs, within 10 years after the decedent's death and before the qualified heir's death, recapture tax is levied.³ The amount of the recapture tax is based on the value of all qualified family-owned business interests, at least those listed for purposes of the 50 percent test, not the amount for which the election was filed.⁴ The "adjusted tax difference" attributable to a qualified family-owned business interest is the amount bearing the same ratio to the adjusted tax difference with respect to the estate as the value of the interest bears to the value of *all* qualified family-owned business interests.⁵ The term "qualified family-owned business interests" is defined as interests which are—(1) included in determining the value of the gross estate⁶ and are acquired by a qualified heir.⁷

Therefore, if some assets are included in the qualified family-owned business interest for purposes of meeting the 50 percent test,⁸ but are not specifically elected for the deduction, disposition of the non-elected assets would appear to trigger recapture consequences nonetheless.

While regulations have not yet been issued for the family-owned business deduction provision, no rulings have been issued and no cases have been litigated to courts of record, the recapture form, Form 706-D, is consistent with this conclusion. Line 2 of Form 706-D requires the "total reported value of qualified family-owned business interests (from line 6, Schedule T, of the decedent's estate tax return" to be compared with the "qualified heir's share of the total qualified family-owned business interests" in line 1. Line 6 of Schedule T to Form 706 requires the "total reported value" of all qualified family-owned business interests "reported on this return." The net value of qualified family-owned business interests elected for the deduction is listed in line 15 of Schedule T, after the 50 percent test has been met. The recapture calculations make no reference to the line 15 amount which represents the amount specifically subjected to the FOBD election.

Interest on recapture tax

The FOBD statute⁹ imposes interest in the event of recapture from the time the "estate tax liability was due under this chapter and ending on the date such additional estate tax is due."¹⁰ That suggests that the time for calculating interest begins nine months after death (when the estate tax liability "was due") and ends, presumably, six months after the recapture event.¹¹ For a recapture event late in the recapture period, that could mean a substantial amount of interest. It is doubtful that Congress intended such a punitive result.

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For special use valuation, which was the pattern of much of the statutory content of the family-owned business deduction, the statute specifies that the “additional tax” imposed is due and payable six months after “the date of the disposition or cessation.”¹² A revenue ruling issued in 1981 specifies, in the case of special use valuation, that interest on the additional federal estate tax due commences six months after the disposition and ends on the date the additional estate tax is paid.¹³

Unfortunately, Congress in drafting the family-owned business deduction statute undertook to state the interest rules in a more definitive manner and, in the process, created a bizarre result. Amending legislation will be needed to rectify the apparent error. Unfortunately, with FOBD slated for repeal,¹⁴ the chances for an amendment appear to be slim.

Disposal of property in recapture period

Under the family-owned business deduction,¹⁵ if a qualified heir disposes of a portion of a qualified family-owned business interest other than to a member of the qualified heir’s family or through a qualified conservation contribution, recapture occurs.¹⁶ Obviously, that means that any disposition of farm-produced commodities or any sale of farm equipment or breeding stock, for example, would lead to recapture if the transfer was to persons other than members of the qualified heir’s family.

When that was called to the attention of the tax-writing committees, language was added to the conference committee report as follows—

“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.”¹⁷

With no statutory provision, however, a question is raised whether language in the conference committee report alone is a sufficient basis to sell assets in the course of business without recapture.¹⁸

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.”¹⁹

In conclusion

For the family-owned business deduction to be minimally workable, amending legislation is needed. Unfortunately, the chances for such amending legislation are dim.

FOOTNOTES

¹ See Harl, “The Family-Owned Business Exclusion: In Need of Repairs,” 76 *Tax Notes* 1219 (1997); Harl, “A New Face for FOBD?” 9 *Agric. L. Dig.* 73 (1998). See also Harl and McEowen, *The Family-Owned Business Deduction—Section 2057, Tax Management Portfolio*, TM 829 (2001).

² See I.R.C. § 2057(j), added by EGTRRA of 2001, Pub. L. 107-17, Sec. 521(d).

³ I.R.C. § 2057(f)(1). See generally 5 Harl, *Agricultural Law* § 44.03[3] (2001); Harl, *Agricultural Law Manual* § 5.04[7][c] (2001).

⁴ I.R.C. § 2057(f)(2)(C)(i), (b)(2).

⁵ I.R.C. § 2057(f)(2)(C)(i).

⁶ I.R.C. § 2057(b)(2)(A).

⁷ I.R.C. § 2057(b)(2)(B).

⁸ I.R.C. § 2057(b)(1)(C).

⁹ I.R.C. § 2057.

¹⁰ I.R.C. § 2057(f)(2)(A)(ii).

¹¹ Cf. I.R.C. § 2032A(c)(4).

¹² I.R.C. § 2032A(c)(4).

¹³ Rev. Rul. 81-308, 1981-2 C.B. 176.

¹⁴ See note 2 *supra*.

¹⁵ I.R.C. § 2057.

¹⁶ I.R.C. § 2057(f)(1)(B).

¹⁷ Rep’t 105-220, Conference Committee Report of the Taxpayer Relief Bill 400, 105th Cong., 1st Sess. (1997).

¹⁸ The Joint Committee on Taxation apparently believed the conference committee report language was sufficient. See Letter from Kenneth Kies, Chief of Staff, Joint Committee on Taxation, to Sen. Charles Grassley, dated November 3, 1997 (response to question 1).

¹⁹ H.R. 4640, Sec. 1, 105th Cong., 2d Sess. (1998) (the proposed legislation is flawed in the reference to I.R.C. § 2057(c)).

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