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THE FAMILY-OWNED BUSINESS EXCLUSION: HOW USEFUL IS IT?

— by Neil E. Harl[*]

One of the centerpieces of the Taxpayer Relief Act of 1997 was the family-owned business exclusion, or FOBE.[1] The various requirements of FOBE were discussed in the August 8, 1997, issue of the Digest.[2] Although there was political pressure to repeal the transfer tax system (federal estate and gift tax), Congress opted instead to retain the system but to lessen the impact on those owning interests in farms and small businesses for deaths after 1997.[3]

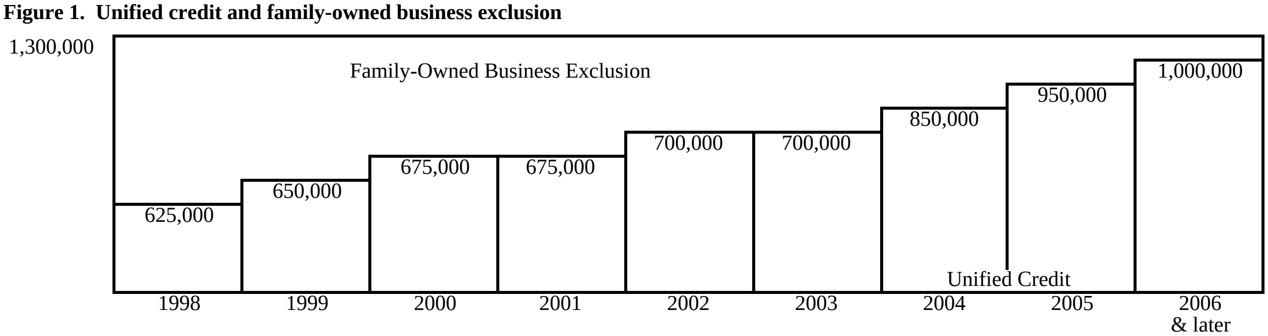
The major concern now is how FOBE can be used advantageously in planning farm and ranch estates.

Size of FOBE

Although reference has been made to $1.3 million, FOBE is actually a declining amount for each year, 1998 through 2006.[4] The FOBE amount is $1.3 million minus the "applicable exclusion amount" from the unified credit[5] as shown in Figure 1.

Thus, the FOBE amount will be $675,000 for deaths in 1998 and will decline to $300,000 for deaths in 2006 and thereafter.[6]

Figure 1. Unified credit and family-owned business exclusion



Implications for leasing

One of the more puzzling aspects of FOBE is what constitutes a "business" for purposes of the exclusion. This has important implications for how farm and ranch operations are structured.

No "qualified use" test. Although FOBE draws heavily on special use valuation for statutory provisions,[7] the drafters of FOBE failed to include the so-called "qualified use" test from special use valuation.[8] That test emerged in IRS regulations[9] four years after enactment of special use valuation based upon language in the statute requiring farm property, to be eligible for special use valuation, to be devoted to "use as a farm for farming purposes or use in a trade or business of farming."[10] That test requires, in the pre-death period, that the decedent or a member of the decedent's family be "at risk" in an operation.[11] In the pre-death period, the qualified use test allows rental of land to a family member as tenant under a cash rent lease.[12]

In the after death period, a two-year "grace period" excuses the estate and the qualified heirs from meeting the qualified use test for up to two years after death.[13] Thereafter, each qualified heir must be "at risk" and personally meet the qualified use test except, since 1988, surviving spouses have been permitted to cash rent lease to a member of the surviving spouse's family[14] and, since 1997, lineal descendants of the decedent have been permitted to cash rent to a member of the lineal descendant's family.[15]

"Passive asset" test. Although FOBE does not incorporate the "qualified use" test, it does make use of the two-year grace period from special use valuation[16] (which only applied, in the context of special use valuation, to the qualified use test).[17] FOBE, like special use valuation, also

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requires the existence of a "trade or business."[18] But FOBE does not define "business" or "trade or business."

FOBE does, however, classify some assets as passive assets which are not eligible for the family-owned business exclusion.[19] Thus, the following categories of assets are not included in the value of a qualified business— (1) assets producing interest, dividends, rents, royalties, annuities and personal holding company income; (2) assets that are interests in a trust, partnership or real estate mortgage investment conduit (REMIC); (3) assets producing no income; (4) assets giving rise to income from commodity transactions or foreign currency gains; (5) assets producing income equivalent to interest; and (6) assets producing income from "notional principal contracts" or payments in lieu of dividends.[20] In the context of farm and ranch operations, the major question is the meaning of "rents."

The term "rents" is not defined in the FOBE statute. However, the statute refers to the personal holding company definition of the term[21] In that provision, the term "rents" is defined as—

> "...compensation, however designated, for the use of, or right to use, property...."[22]

In the leading case on that definition involving the leasing of farm property, the courts held that a crop share lease with strong involvement in decision making by a farm management firm produced business income, not "rents," and the personal holding company tax did not apply.[23] There is no question that cash rents are deemed "rents" for this purpose and it is likely that non-material participation crop and livestock share leases also produce "rents" for this purpose.

Planning guidance. What this adds up to is that assets which are cash rented in the pre-death period by the decedent, even if to a member of the decedent's family as tenant, are ineligible for FOBE. The same outcome can be expected from assets cash rented by the decedent to an entity owned by family members of the decedent. The same result seems likely for assets leased under a non-material participation share lease in the pre-death period even if leased to a member of the decedent's family or to an entity owned by members of the decedent's family. It is noted that individuals who are in retirement rarely lease under any arrangement other than a cash rent lease or a non-material participation share lease. Leasing under a material participation share lease, which would assure eligibility for FOBE, would result in imposition of self-employment tax and, between age 65 and 69, loss of social security benefits.[24]

How to use FOBE

If FOBE is repaired sufficiently to make it a useful concept,[25] the question is how to make the most effective use of the provision.

• One attractive strategy would be to die in 1998 (when FOBE is at a maximum of $675,000), creating a FOBE trust as a generation skipping vehicle with the maximum term allowable by the local Rule Against Perpetuities. Keep in mind that the property involved in FOBE is excluded from the gross estate.[26] Therefore, it makes a great deal of sense to keep the assets involved outside the gross estate for the longest possible time. It is important to note that a "direct skip" is defined as a transfer "subject to a tax imposed by Chapter 11 (estate tax) or Chapter 12 (gift tax) of an interest in property to a skip person."[27]

This strategy is particularly attractive if a question exists whether the business will be eligible for FOBE at the death of the surviving spouse or next generation heirs and where the death of the survivor is expected to occur after 2005 when FOBE has dropped to $300,000.

Planners should assure, in the post-death recapture period, that the material participation test[28] will be met, that the assets do not become "passive assets" and cease being part of a qualified trade or business and that the assets are not transferred to non-family transferees.[29]

• A similar strategy would be to create a FOBE trust with features of a non-marital or bypass trust with income payable to the surviving spouse and, possibly, others.

• Inasmuch as the FOBE assets are excluded from the gross estate, it would generally be imprudent to leave the property in a marital or QTIP trust for inclusion in the estate of the surviving spouse (unless it is virtually certain that the property involved would be eligible for FOBE at the death of the surviving spouse).

• Inasmuch as substantial uncertainty exists over leasing assets (under cash rent or non-material participation share leases), it seems wise for those wanting to use the concept to plan for a single entity approach to structuring the farm or ranch business or to limit leasing to a material participation share lease.

In conclusion

FOBE clearly needs repair work before it will be a useful planning concept. Hopefully, Congress will respond yet this year to move toward amending the statute to eliminate the more serious shortcomings.

FOOTNOTES

1 Pub. L. 105-34, Sec. 502(a), 105th Cong., 1st Sess. (1997). See Harl, "The Family-Owned Business Exclusion: In Need of Repairs," 76 *Tax Notes* 1219 (1997).

2 Harl, "Taxpayer Relief Act of 1997 (H.R. 2014), Summary of Selected Provisions," 8 *Agric. L. Dig.* 113, 114 (1997).

3 TRA-97, Pub. L. 105-34, Sec. 502(c), 105th Cong., 1st Sess. (1997).

4 I.R.C. § 2033A(a)(2).

5 I.R.C. § 2010(c).

6 I.R.C. §§ 2010(c), 2033A(a)(2).

7 I.R.C. § 2032A.

8 See I.R.C. § 2032A(b)(2).

9 Treas. Reg. § 20.2032A-3(b)(1) (1980).

10 I.R.C. § 2032A(b)(2).

11 See I.R.C. § 2032A(b)(1)(C)(i), (b)(2).

[12] See I.R.C. § 2032A(b)(1)(C)(i); Treas. Reg. § 20.2032A-3(b)(1); see, e.g., Ltr. Rul. 8147100, Aug. 27, 1981 (cash rent lease to partnership comprised of decedent's sons as partners acceptable for special use valuation).

[13] I.R.C. § 2032A(c)(7)(A).

[14] I.R.C. § 2032A(b)(5)(A).

[15] I.R.C. § 2032A(c)(7).

[16] I.R.C. § 2033A(i)(3)(G).

[17] See I.R.C. § 2032A(c)(7)(A).

[18] I.R.C. § 2033A(e)(1).

[19] See I.R.C. § 2033A(e)(2)(D)(ii).

[20] *Id.*

[21] I.R.C. § 2033A(e)(2)(D)(ii).

[22] I.R.C. § 543(b)(3).

[23] Webster Corp. v. Comm'r, 25 T.C. 55 (1955), *acq.*, 1960-2 C.B. 7, *aff'd*, 240 F.2d 164 (2d Cir. 1957).

[24] See I.R.C. § 1402.

[25] See Harl, *supra* n. 1; Harl, *supra* n. 2.

[26] I.R.C. § 2033A.

[27] I.R.C. § 2612(c)(1).

[28] I.R.C. § 2033A(f)(1)(A).

[29] I.R.C. § 2033A(f)(1)(B).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

<u>GENERAL</u>-*ALM* § 13.03.*

CLAIMS. The debtor's Chapter 13 plan provided for payment over the life of the plan of a claim secured by a tractor-trailer used in the debtor's truck hauling business. The issue involved was the value of the truck for purposes of the claim and plan payments. The debtor argued that the truck was to be valued according to the amount of proceeds resulting from a foreclosure sale, less the costs of the sale. The creditor sought a fair market value of the truck for replacement purposes. The court held that, because the truck remained in the possession of the debtor for the production of income, the truck was to be valued as an operating business asset, using the replacement value. **Associates Commercial Corp. v. Rash, 117 S. Ct. 1879 (1997), *rev'g*, 90 F.3d 1036 (5th Cir. 1996), *rev'g en banc*, 31 F.3d 325 (5th Cir. 1994), *rev'g unrep. D. Ct. dec. aff'g*, 149 B.R. 430 (Bankr. E.D. Tex. 1993)**.

<u>FEDERAL TAXATION</u>-*ALM* § 13.03[7].*

PREFERENTIAL TRANSFERS. The debtor had made several payments of employment taxes to the IRS within 90 days before filing the Chapter 11 petition. The payments were not designated by the debtor and the IRS applied the payments to non-trust fund taxes owed by the debtor. The debtor sought to avoid and recover the payments as preferential under Section 547(b). The court found that the debtor was insolvent during the 90 day pre-petition period, the payments were made for the benefit of the IRS, and the IRS received more than it would have if the debtor filed for Chapter 7 before the payments were made. The court held, however, that the debtor had a beneficial interest in the payments only to the extent the payment represented the debtor's share of the social security tax on the wages paid. In addition, the court held that the payments were not made for an antecedent debt but were made for taxes due after the payments were made (an employer's social security taxes are due at the end of the employment quarter); therefore, the payments were not preferential under Section 547(b). After reconsideration, the Bankruptcy Court held that the payments made after the date for which penalties would be assessed were payments made for an antecedent debt and were recoverable as preferential transfers. The IRS also argued that the late payments were excepted from the preferential transfer rules in that the payments were made in the ordinary course of business. The court held that the debtor had a history of making timely payments; therefore, the late payments were not made in the ordinary course of business. ***In re* Pullman Const. Industries, Inc., 210 B.R. 302 (N.D. Ill. 1997), *aff'g*, 190 B.R. 618 (Bankr. N.D. Ill. 1996), *aff'g in part and rev'g in part on reconsideration*, 186 B.R. 88 (Bankr. N.D. Ill. 1995)**.

CONTRACTS

BREACH OF WARRANTY. The plaintiff was a wheat farmer who purchased winter wheat seed from the defendant. The defendant's agents orally represented that the seed was certified and the delivery tickets also stated that the seed was certified. The defendant had tested the seed for germination and knew that the seed's germination rate was insufficient to qualify as certified seed. Each delivery ticket carried terms of disclaimer of all warranties except to the extent of the purchase price of the seed, but the disclaimer was not discussed or negotiated by the parties. The seed did not germinate properly and the plaintiff lost the entire crop planted with the seed provided by the defendant. The court held that the disclaimers were ineffective to limit the defendant's liability for breach of warranty because the disclaimers did not specifically set forth the aspects of the seed which were not warranted and because the disclaimers were not negotiated by the parties. The court also held that the disclaimers were unconscionable because the defect of the seed was known by the defendant and was not discoverable by the plaintiff until the seed was used. The court also held that the disclaimers were unenforceable because they failed of an essential purpose in that the disclaimers deprived the plaintiff of the substantive value of the seed as represented as certified. The court noted that the oral and written representations of the defendant that the seed was certified were express warranties which were shown to be breached. The plaintiff has also claimed that the defendant