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MEETING THE "50 PERCENT" TEST FOR THE FOBE

— by Neil E. Harl*

Without much doubt, the most complex, convoluted and confusing provision in the family-owned business exclusion (FOBE)[1] is the pre-death requirement that the adjusted value of qualified family-owned business interests (plus pre-death gifts of family-owned business interests within the family) must exceed 50 percent of the decedent's adjusted gross estate[2] (with various modifications).[3] The calculation involves a fraction with both the numerator and the denominator posing formidable problems of interpretation.[4]

Calculating the Numerator

The process of calculating the numerator is somewhat clearer if approached on a step-by-step basis—

Step One: Determine the value of all qualified family-owned business interests that would be includible in the decedent's gross estate were it not for FOBE and that are passed from the decedent to a qualified heir.[5]

Example: The decedent, Elmer Jones, died owning 700 shares of stock in, ABC Farm, Inc. The fair market value of the stock owned by the decedent is $1,800,000. The 700 shares are set to pass by will to Jones' son, Allen, outright (Mrs. Jones had predeceased Elmer).

The result of Step One calculations is $1,800,000.

Step Two: Add to the Step One result lifetime transfers of qualified business interests that had been made by the decedent to members of the decedent's family (other than the decedent's spouse) if the interests have been owned continuously by members of the decedent's family and that are not includible in the decedent's estate.[6]

Example: Elmer Jones in 1990 had given 300 shares of the stock in ABC Farm, Inc., to his son, Allen. The total amount of the gift was $90,000 with $10,000 of that amount covered by the federal gift tax annual exclusion. The taxable gift amount was, therefore, $80,000.

Because the statute specifies[7] that any gift of a "qualified family-owned business interest" is the sum of taxable gifts[8] and the annual exclusion amount, the result of Step Two is $80,000 + $10,000 = $90,000.

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Step Three: Add the results of Step One and Step Two.

Example: In the case of the Elmer Jones Estate, the sum is $1,800,000 + $90,000 = $1,890,000.

Step Four: Calculate all indebtedness of the estate.

Example: Elmer Jones left a secured mortgage on his residence of $65,000, an unpaid credit card bill of $8,500, unpaid medical bills of $22,000, an executive line of credit at a local bank with a balance owing at death of $95,000 and estate settlement costs of $170,000. The grand total of all indebtedness is $360,500.

Step Five: Subtract the qualified residence interest from the indebtedness of the estate.[9]

Example: The "qualified residence interest"[10] totals $65,000 in the Jones estate.

The result is $360,500 - $65,000 = $295,500.

Step Six: Subtract the indebtedness the proceeds of which were used to pay the educational and medical expenses of the decedent, the decedent's spouse or the decedent's dependents.[11]

Example: The medical expense portion of the indebtedness was all for Elmer Jones' last illness, and totaled $22,000.

The result is $295,500 - $22,000 = $273,500.

Step Seven: Subtract any other indebtedness "...to the extent such indebtedness does not exceed $10,000."[12]

Example: In the Jones Estate, the only indebtedness meeting that criterion is the unpaid credit card bill of $8,500.

The result is $273,500 - $8,500 = $265,000.

Step Eight: Subtract the remaining indebtedness (from Step Seven) from the Step Three amount (qualified family-owned business interests plus interests transferred to the family and owned continuously).[13]

Example: For the Jones Estate, the Step Three amount is $1,890,000 and the Step Seven amount is $265,000.

The result is $1,890,000 - $265,000 = $1,625,000. This figure, $1,625,000, is the numerator in the fraction

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for determining whether qualified family-owned business interests total more than 50 percent of the decedent's adjusted gross estate.[14]

Calculating the Denominator

The calculation of the denominator is, like that of the numerator, made clearer by approaching the task on a step-by-step basis—

Step One: Determine the fair market value of the decedent's gross estate, calculated as though the business interests were not excluded from the gross estate[15] under the FOBE.

Example: Elmer Jones left, in addition to 700 shares of stock in ABC Farm, Inc., valued at $1,800,000, mutual fund shares totaling $732,000, certificates of deposit totaling $108,000 and bank accounts with balances as of the date of death of $110,000.

The result of Step One for the Jones estate is $2,750,000.

Step Two: Calculate the indebtedness of the estate and subtract from the gross estate.[16]

Example: For the Jones Estate, the indebtedness (from Step Four of the numerator calculation) is $360,500.

The result is $2,750,000 - $360,500 = $2,389,500.

Step Three: Identify any lifetime transfers of qualified business interests made by the decedent to members of the decedent's family (other than the decedent's spouse) if the interests have been held continuously by members of the decedent's family and add that amount to the gross estate less allowable deductions from Step Two.[17]

Example: In the case of Elmer Jones, he had made a gift of 300 shares of stock in ABC Farm, Inc., to his son, Allen, in 1990, valued at $90,000 with $10,000 of that amount covered by the federal gift tax annual exclusion, leaving an amount of $80,000 (see Step Two of the numerator calculation).

The result is $2,389,500 + $80,000 = $2,469,500.

Step Four: Identify any transfers from the decedent to the decedent's spouse (if other than de minimis) made within 10-years of the date of the decedent's death and add that amount to the gross estate less allowable deductions and plus lifetime transfers to members of the family (from Step Three).[18]

Example: Elmer Jones had made no transfers to his spouse prior to his death. She had inherited a sizable amount from her Mother's estate which was left in a bypass trust except for the unified credit amount which was left to Elmer outright and is reflected in his mutual fund balance at his death.

The result is $2,469,500 - 0 = $2,469,500.

Step Five: Identify any other gifts within three years of death other than to members of the family.[19]

Example: Elmer Jones had made no other gifts within three years of his death.

The result is $2,469,500 - 0 = $2,469,500.

Step Six: Determine whether any of the gifts from Step Three, Four and Five, are included in the gross estate.[20] If so, the included amount must be added back in.

Example: None of the family gifts (notably the 300 shares of stock in ABC Farm., Inc. given by son, Allen) is included in Elmer Jones' gross estate.

The result is that the adjusted gross estate is $2,469,500.

Step Seven: Determine whether the "adjusted value of the qualified family-owned business interests" (as augmented by family gifts) (Step Eight of the numerator calculations) exceeds 50 percent of the adjusted gross estate (Step Six of the denominator calculations).[21]

Example: In the Jones Estate the calculations are as follows—

$$\frac{Numerator(StepEight)}{Denominator(StepSix)} = \frac{\$1,625,00}{\$2,469,500} = 65.8\%$$

Therefore in this example, the "more than 50 percent" test has been met.[22]

Conclusion

In some instances, it will be obvious that the "50 percent" test[23] can or cannot be met. In close cases, a careful and detailed calculation will be necessary in order to establish whether the estate is eligible to elect the FOBE.

FOOTNOTES

1 See generally 5 Harl, *Agricultural Law* § 43.04 (1997); Harl, *Agricultural Law Manual* § 5.02[7] (1997). See also Harl, "The Family-Owned Business Exclusion: In Need of Repairs," 76 *Tax Notes* 1219 (1997); Harl, "The Family-Owned Business Exclusion: How Useful Is it?" 8 *Agric. L. Dig.* 137 (1997).

2 I.R.C. § 2033A(b)(l)(C).

3 See I.R.C. § 2033A(d), (d).

4 See Harl and McEowen, "The Family-Owned Business Exclusion," Tax Management Portfolio. TM ___ (forth-coming).

5 I.R.C. §§ 2033A(b)(1)(C)(i), 2033A(b)(2)(A).

6 I.R.C. §§ 2033A(b)(1)(C)(ii), 2033A(b)(3).

7 I.R.C. § 2033A(b)(3).

8 I.R.C. § 2001(b)(1)(B).

9 I.R.C. § 2033A(d)(1)(A).

10 I.R.C. §§ 163(h)(3), 2033A(d)(2)(A).

11 I.R.C. §§ 2033A(d)(2)(B), 152.

12 I.R.C. § 2033A(d)(2)(C).

13 I.R.C. § 2033A(d).

14 I.R.C. § 2033A(b)(1)(C).

***Agricultural Law Manual (ALM). For information about ordering the *Manual*, see the last page of this issue.**

[15] I.R.C. § 2033A(a).

[16] I.R.C. § 2033A(c)(1).

[17] I.R.C. §§ 2033A(c)(2)(A)(i), 2033A(b)(3).

[18] I.R.C. § 2033A(c)(2)(A)(ii).

[19] I.R.C. § 2033A(c)(2)(A)(iii).

[20] I.R.C. § 2033A(c)(2)(B).

[21] I.R.C. § 2033A(b)(1)(C).

[22] I.R.C. § 2033A(b)(1).

[23] See I.R.C. § 2033A(b)(1)(C).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

ADVERSE POSSESSION

ADVERSE POSSESSION. The previous owner of the disputed land owned all 640 acres and sold several one acre parcels to third parties. In 1962, the plaintiff purchased the previous owner's rights in all 640 acres and built a fence around the entire parcel and a fence through the middle of the entire parcel. The plaintiff used almost all of the land for grazing and crop production from the date of purchase through the time of trial. The defendant negotiated an oil and gas drilling lease with the plaintiff. The lease included a provision to allow the defendant to negotiate leases with the title owners of the one-acre parcels but not to the detriment of the plaintiff's title. The plaintiff claimed title to the entire 640 acres under adverse possession. The plaintiff sued for slander of title after the defendant entered into leases with the title owners of the one-acre parcels, arguing that the plaintiff had title to the entire 640 acres. The plaintiff obtained a jury verdict which found that the plaintiff had title by adverse possession for over 25 years. The court found that the plaintiff had purchased several of the parcels from the title owners, but held that, because title by adverse possession had already occurred prior to the purchases, the purchases did not defeat the plaintiff's claim by adverse possession. **Santa Fe Energy Operating Partners v. Carrillo, 948 S.W.2d 780 (Tex. Ct. App. 1997)**.

ANIMALS

HORSES. The plaintiff was injured while riding a horse owned by the defendants. The plaintiff had ridden the horse before with dressage tack. The day of the accident, the horse was equipped with hunter-jumper tack and the plaintiff claimed that the defendants were at fault for allowing the plaintiff to ride the horse when equipped with unfamiliar tack. A jury awarded the plaintiff damages of $250,000. The defendants had claimed the defense of assumption of risk which was rejected by the trial court which allowed the case to go to the jury. The appellate court reversed, holding that, as a matter of law, the plaintiff has assumed the known risks of riding the horse. The appellate court found that the plaintiff was an experienced horse rider, was aware of the equipment on the horse, and was aware of the inherent risks of horseriding. **Young v. Brandt, 485 S.E.2d 519 (Ga. Ct. App. 1997)**.

The plaintiff was a nine year old who was invited to the defendants' home by the child of the defendants for play. The defendants' child started training with a lunge line a horse on the property and asked the plaintiff to help. The plaintiff was kicked by the horse while trying to help the defendants' child control the horse. The plaintiff sued for negligence and the defendants countered that the Nebraska Recreation Liability Act, Neb. Rev. Stat. § 37-1001 et seq., barred any liability for the accident. The trial court ruled that the Act did apply and dismissed the case. The appellate court reversed, holding that a nine year old child invited to the defendants' house by their child was not a member of the public to which the Act applied. The court noted that the purpose of the Act was to encourage the open use of rural lands for the general public and did not apply to residential and family situations such as the accident involved here. **Brown v. Wilson, 567 N.W.2d 124 (Neb. 1997)**.

BANKRUPTCY

CHAPTER 12-*ALM* § 13.03.*

DISMISSAL. The debtors had filed two previous Chapter 12 cases and all three cases were filed on the eve of a foreclosure sale of the debtors' farm. In the first case the debtors and the farm mortgage holder entered into a court-approved stipulation that, if the debtors defaulted on any plan payments on the bank's claim, the bank would be allowed to foreclose against the farm without interference of a subsequent bankruptcy filing. The debtors defaulted on the plan payments in the first two cases, causing dismissal of the cases, and filed a new Chapter 12 case when the bank sought to foreclose. The bank filed a motion to dismiss the current case for cause because (1) the filing of the second and third cases violated the agreement and (2) the debtors could not propose a feasible plan. The court dismissed the debtors' case for cause because (1) the filing of the second and third cases violated the court-ordered stipulation, (2) the three cases were filed primarily to stop the foreclosure sales, and (3) the debtors' plans were not feasible, given that the debtors had delayed the foreclosure for over four years and still could not meet their projected income and expenses. The court held that the third plan had unreasonable projections of income and expense, based on the performance of the farm during the bankruptcy cases. ***In re* Wald, 211 B.R. 359 (Bankr. D. N.D. 1997)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

DISCHARGE. The debtor had filed three previous Chapter 13 cases and sought to discharge taxes due more