INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-143856-03, CC:PSI:B04

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Decedent =
Company =
a =
b =
c =
d =
Date 1 =
Trust =

ISSUE:

Whether promissory notes that were issued by a family-owned business constitute a qualified family-owned business interest (QFOBI) that is deductible by an estate under section 2057 of the Internal Revenue Code?

CONCLUSION:

The promissory notes do not constitute a QFOBI under section 2057.

FACTS:

Decedent died on Date 1. As of Date 1, Decedent owned a shares of Class A voting common stock in Company, a company engaged in the active business of b. Decedent's a shares of voting common stock comprised a% (more than 50%) of the outstanding voting common stock. The a shares owned by the decedent were valued at $c dollars as of Date 1. Decedent owned none of the outstanding nonvoting common stock in Company.

In addition, prior to his death, Decedent had made cash loans to Company. At the time of his death, Trust, a revocable inter vivos trust created by Decedent, owned five promissory notes issued by Company evidencing this indebtedness. The principal amount and accrued interest due on the five notes as of Date 1 totaled $d.

On the Federal Estate Tax Return (Form 706) filed by the estate, the executor included the value of the Company stock owned by Decedent on Schedule B. On Schedule G, the executor included a total of $d reflecting the five Company promissory notes owned by Trust. On Schedule T (Qualified Family–Owned Business Interest Deduction) the executor deducted, under section 2057, the value of the a shares of Company stock. The executor also deducted a total of $d reflecting the principal amount and accrued interest due on the five Company notes.

LAW AND ANALYSIS:

Section 2057(a)(1) provides that the value of the taxable estate shall be determined by deducting from the value of the gross estate the adjusted value of the qualified family-owned business interests of the decedent.

Section 2057(e)(1) provides, in part, that the term "qualified family-owned business interest" means: (A) an interest as a proprietor in a trade or business carried on as a proprietorship, or (B) "an interest in an entity carrying on a trade or business," if at least 50 percent of the entity is owned (directly or indirectly) by the decedent and members of the decedent's family.

Section 2057(e)(2)(D)(i) provides that a qualified family-owned business interest does not include that portion of “an interest in a trade or business” that is attributable to cash or marketable securities in excess of the reasonably expected day-to-day working capital needs of such trade or business.

The estate contends that the five Company notes owned by Trust constitute an “interest in” an entity carrying on a trade or business for purposes of section 2057(e)(1). First, the taxpayer argues that there is no indication in the statute that an “interest in an entity” must be an ownership interest. The statute specifically references an “ownership interest” in the entity in applying the rules for determining whether sufficient family ownership of the entity exists to qualify the decedent’s interest in the entity for a deduction. See, e.g., section 2057(e)(3). However, there is no reference to an “ownership interest” in section 2057(e)(1), which section defines the nature of the interest that is deductible. Thus, in the absence of any specific exclusion, an entity’s debt should constitute an interest in the entity for purposes of section 2057.

The estate also argues that the estate’s position is consistent with the purpose of section 2057, to alleviate the need to sell family-owned business interests to pay the estate tax liability generated by the inclusion of the business in the gross estate. The lack of liquid assets to pay the estate tax is presented to the same extent whether a decedent owns equity interests or holds the Company’s debt obligations.

Finally, the estate argues that if Decedent received stock in company in exchange for his cash contribution, the stock interest would qualify for the deduction. The result should be the same where the decedent elected to receive a debt interest in exchange for cash.

However, we believe that the term “interest in an entity,” as used in section 2057(e)(1)(B) contemplates only an equity or ownership interest in the entity. Initially, we note that section 2057(e)(1)(A) limits the interest that is deductible under the statute, in the case of a proprietorship, to only “an interest as a proprietor;” that is, an ownership or equity interest. Logically, this same limitation applies to interests covered in section 2057(e)(1)(B). Further, in common usage, an “interest in” an entity would normally reference an ownership interest such as a stock interest or partnership interest, etc. See, e.g., Black’s Law Dictionary, 7th ed. (“A legal share in something; all or part of a legal or equitable claim to a right in property.”) There is no indication that the statute intended that ownership of promissory notes should be treated as an interest <u>in</u> the business. A loan made to a corporation is materially different from a cash contribution in exchange for stock. The holder of the promissory note of a corporation is a creditor of the entity, and does not have any “interest in” the entity, as that term is commonly used.

Furthermore, as noted above, section 2057(e)(2)(D)(i) provides that a “qualified family-owned business interest” does not include that portion of an interest that is attributable to cash or marketable securities in excess of the reasonably expected day-to-day working capital needs of the trade or business. The use of the term “interest” in this section clearly comprehends an ownership interest in the entity to which a proportionate part of the underlying assets owned by the entity can be attributed. On the other hand, a debt instrument represents a liability of the entity and assets held by the entity are not readily attributable to the liabilities of the entity (unless perhaps, the indebtedness is secured by a particular asset.) Thus, the limitation contained in section 2057(e)(2)(D)(i) indicates that Congress contemplated that only ownership interests that reflect a percentage interest in the underlying entity assets would constitute interests in the trade or business eligible for the section 2057 deduction.

Logically, as referenced in section 2057, what constitutes an “interest in” a trade or business should be the same whether the term is used in the provision describing the interest that is deductible, or in the provision describing the requisite degree of family ownership. Otherwise, we would reach the anomalous result that a promissory note owned by a family member would constitute a deductible interest in the entity, notwithstanding that a promissory note, even if owned by a family member, is completely ignored when considering whether the family ownership percentage requirements are satisfied. Rather, we believe that what constitutes an interest in an entity should be the same with respect to all aspects of the statute. That is, the interests that are counted in determining whether sufficient family ownership is present, are the same interests that, if held by the decedent, are deductible.

Accordingly, we conclude that the five Company promissory notes are not deductible under section 2057.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) provides that it may not be used or cited as precedent.