INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

March 24, 2004

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CASE-MIS No.: TAM-153049-03, CC:PSI:B09

Territory Manager
Field Compliance, SB/SE, Territory 3

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference: December 12, 2003

LEGEND:

Decedent =

Date 1 =
State =
Property 1 =
Property 2 =
Daughter =

ISSUE: Whether the election made by Decedent's estate to deduct the value of Decedent's qualified family-owned business interests under § 2057 is valid.

CONCLUSIONS: Although the value of Decedent's qualified family-owned business interests exceeded 50 percent of the adjusted gross estate, the estate's election to deduct Decedent's qualified family-owned business interests is invalid and no deduction may be claimed because the estate did not deduct sufficient property to satisfy the

threshold requirements of § 2057(b)(1)(C) and because the qualified heirs did not consent to the recapture tax provisions under § 2057(f) with respect to Property 2.

FACTS:

Decedent died on Date 1. At his death, Decedent owned an interest as a proprietor in an agricultural business that included farmland located in State, Property 1 and Property 2, and a bank account. Pursuant to the terms of Decedent's will, Property 2 was devised to Daughter, however, shortly after Decedent's death and during the administration of his estate, Property 2 was sold to unrelated third parties. The executrix of Decedent's estate timely filed the estate's Form 706 United States Estate (and Generation-Skipping Transfer) Tax Return ("estate tax return"). On Schedule T of the estate tax return, the estate elected the application of § 2057 and listed Property 1 and the bank account as qualified family-owned business interests. Based on the information contained on the estate tax return as filed, the adjusted value of Property 1 and the bank account exceeded 50 percent of Decedent's adjusted gross estate and, therefore, the estate appeared to qualify for the § 2057 deduction.

The Internal Revenue Service examined the estate tax return and determined that the estate failed to include the amount of Decedent's other gifts made within 3 years of his death in determining the value of Decedent's adjusted gross estate. When the amount of Decedent's other gifts are taken into account, the adjusted value of Property 1 and the bank account do not exceed 50 percent of the adjusted gross estate and, therefore, § 2057 does not apply to Decedent's estate. When the Service informed Decedent's estate that it did not qualify for the § 2057 deduction, the estate argued that Property 2 should be included in the computation to determine whether the adjusted value of Decedent's qualified family-owned business interests (plus the amount of the gifts of such interests) exceeds 50 percent of the adjusted gross estate.

LAW AND ANALYSIS:

Section 2057(a)(1) provides that for purposes of the tax imposed by § 2001, in the case of an estate of a decedent to which this section applies, 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 that are described in § 2057(b)(2). Section 2057(a)(2) provides that the maximum deduction allowed by § 2057 shall not exceed $675,000.

Section 2057(b)(1) provides, generally, that § 2057 shall apply to an estate if: (A) the decedent was (at the date of the decedent's death) a citizen or resident of the United States; (B) the executor elects the application of § 2057 and files the agreement referred to in § 2057(h); (C) the sum of the adjusted value of the qualified family-owned business interests described in § 2057(b)(2), plus the amount of the gifts of such interests determined under § 2057(b)(3), exceeds 50 percent of the adjusted gross

estate; and (D) during the 8-year period ending on the date of the decedent's death there have been periods aggregating 5 years or more during which such interests were owned by the decedent or a member of the decedent's family, and there was material participation (within the meaning of § 2032A(e)(6)) by the decedent or a member of the decedent's family in the operation of the business to which such interests relate.

Section 2057(b)(2) provides that the qualified family-owned business interests described in § 2057(b) are the interests that are included in determining the value of the gross estate and are acquired by any qualified heir from, or passed to any qualified heir from, the decedent (within the meaning of § 2032A(e)(9)).

Section 2057(b)(3) provides that the amount of the gifts of qualified family-owned business interests determined under § 2057(b) is the sum of the amount of such gifts from the decedent to members of the decedent's family taken into account under § 2001(b)(1)(B), plus the amount of such gifts otherwise excluded under § 2503(b), to the extent such interests are continuously held by members of the decedent's family (other than the decedent's spouse) between the date of the gift and the date of the decedent's death.

Section 2057(c) provides that for purposes of § 2057, the term "adjusted gross estate" means the value of the gross estate reduced by any amount deductible under § 2053(a)(3) or (4), and increased by the excess of: (i) the sum of the amount of gifts determined under § 2057(b)(3), plus (ii) the amount (if more than de minimis) of other transfers from the decedent to the decedent's spouse within 10 years of the date of the decedent's death, plus (iii) the amount of other gifts (not included under (i) or (ii)) from the decedent within 3 years of the date of the decedent's death, other than gifts to members of the decedent's family otherwise excluded under § 2503(b), over the sum of the amounts described in § 2057(c)(2)(A)(i), (ii), and (iii) that are otherwise includible in the gross estate.

Section 2057(e) provides, generally, that for purposes of § 2057, the term "qualified family-owned business interest" means an interest as a proprietor in a trade or business carried on as a proprietorship, or an interest in an entity carrying on a trade or business, if certain ownership percentages are met.

Section 2057(f)(1)(B) provides, generally, that an additional estate tax is imposed if, within 10 years after the date of the decedent's death and before the date of the qualified heir's death the qualified heir disposes of any portion of a qualified family-owned business interest (other than by a disposition to a member of the qualified heir's family or through a qualified conservation contribution under § 170(h)).

Section 2057(h) provides that the agreement referred to in this subsection is a written agreement signed by each person in being who has an interest (whether or not in

possession) in any property designated in such agreement consenting to the application of § 2057(f) with respect to such property.

Section 2057(i)(1)(A) provides that for purposes of § 2057, the term "qualified heir" has the meaning given to such term by § 2032A(e)(1).

Section 2057(i)(2) provides that for purposes of § 2057, the term "member of the family" has the meaning given to such term by § 2032A(e)(2).

Section 2032A(e)(1) provides, in part, that for purposes of § 2032A, the term "qualified heir" means, with respect to any property, a member of the decedent's family who acquired such property (or to whom such property passed) from the decedent.

Section 2032A(e)(2) provides, in part, that for purposes of § 2032A, the term "member of the family" means, with respect to any individual, only: (A) an ancestor of such individual; (B) the spouse of such individual; (C) a lineal descendant of such individual, of such individual's spouse, or of a parent of such individual; or (D) the spouse of any lineal descendant described in § 2032A(e)(2)(C).

Section 2057(i)(3)(H) provides that for purposes of § 2057, rules similar to the rule contained in § 2032A(d)(1) shall apply.

Section 2032A(d)(1) provides that the election under § 2032A shall be made on the return of the tax imposed by § 2001. Such election shall be made in such manner as the Secretary shall by regulations prescribe. Such an election, once made, shall be irrevocable.

Section 20.2032A-8(a)(2) of the Estate Tax Regulations provides, in part, that an election under § 2032A need not include all real property included in an estate that is eligible for special use valuation, but sufficient property to satisfy the threshold requirements of § 2032A(b)(1)(B) must be specially valued under the election.
The Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 6007(b), repealed the § 2033A[1] qualified family-owned business exclusion and replaced it with an estate tax deduction under § 2057, effective for estates of decedents dying after December 31, 1997. The Senate Report that accompanies the Taxpayer Relief Act of 1997 indicates that § 2033A was added to the Internal Revenue Code to reduce estate taxes for qualified family-owned businesses, preserve family farms and

[1] Section 2033A was enacted by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 502, and provided an estate tax exclusion for certain qualified family-owned business interests. The Internal Revenue Service Restructuring and Reform Act of 1998 redesignated § 2033A as § 2057. Section 2057 is virtually identical to § 2033A, with the exception of several clarifications and corrections made to facilitate the conversion of the exclusion into a deduction.

other family-owned businesses, and prevent the liquidation of these enterprises to pay estate taxes. S. Rep. No. 105-33 at 40.

In order for § 2057 to apply to an estate, several requirements must be satisfied. One of these requirements is that under § 2057(b)(1)(C), the value of the qualified family-owned business interests described in § 2057(b)(2), with certain adjustments, must be greater than 50 percent of a decedent's adjusted gross estate. Under § 2057(b)(2), the qualified family-owned business interests described in § 2057(b) are the interests that are included in determining the value of the gross estate and are acquired by a qualified heir from or passed to a qualified heir from the decedent.

In this case, Property 2 is an interest included in determining the value of the gross estate because Decedent owned Property 2 at the time of his death. In addition, pursuant to Decedent's will, Property 2 was acquired by Daughter, a qualified heir, from Decedent. Therefore, Property 2 is a qualified family-owned business interest described in § 2057(b)(2). When the value of Property 2 is considered, the adjusted value of Decedent's qualified family-owned business interests exceeds 50 percent of the adjusted gross estate.

Section 2057(i)(3)(H) provides, however, that rules similar to the rules contained in § 2032A(d)(1) and (3) apply for purposes of § 2057. The rules in § 2032A(d)(1) and (3) pertain to the election that must be made and the agreement that must be filed to qualify for the special valuation of property used as a farm or in a trade or business. Under § 20.2032A-8(a)(2), the election under § 2032A need not include all real property included in an estate that is eligible for special use valuation, but sufficient property to satisfy the threshold requirements of § 2032A(b)(1)(B) must be specially valued under the election. If rules similar to those under § 2032A(d) apply to § 2057, it follows that the estate must deduct sufficient property to satisfy the threshold requirements of § 2057(b)(1)(C).

Furthermore, the election alone is not sufficient to obtain the benefits of § 2057. Without the recapture agreement, the election is neither valid nor effective. Under § 2057(h), the agreement required under § 2057(b)(1)(B) must be executed by all parties who have any interest in the property designated in the agreement. In the case of a qualified heir, the agreement must express consent to personal liability for the additional tax imposed under § 2057(f) in the event of certain early dispositions of property, the failure to satisfy the material participation requirements, the qualified heir's loss of United States citizenship, or the principal place of business of a trade or business of the qualified family-owned business interest ceases to be located in the United States. The recapture of tax benefits under § 2057(f) is a limitation designed to ensure continued use of qualified family-owned business interests as a family business. Without the recapture agreement, it is not clear that qualified heirs are on notice of and

may be subject to the recapture tax provisions. See also Estate of Gunland v. Commissioner, 88 T.C. 1453 (1987).

In this case, the value of Decedent's qualified family-owned business interests exceeded the 50 percent requirement of § 2057(b)(1)(C). The estate, however, sought to deduct the value of the qualifying property (Property 1 and the bank account) that did not exceed 50 percent of the value of the adjusted gross estate. In addition, the estate did not list Property 2 as a qualified family-owned business interest on Schedule T of the estate tax return, and therefore, the qualified heirs did not agree to the recapture provisions of § 2057(f) with respect to such property. Therefore, the estate's election to deduct Decedent's qualified family-owned business interests under § 2057 is invalid and no deduction may be claimed under § 2057.

CAVEAT(S):

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