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TOWARD A PRACTICAL ESTATE-TAX EXCLUSION FOR FAMILY-RUN BUSINESSES: ANALYSIS OF SECTION 2033A AND PROPOSAL FOR REFORM

Eric D. Chason*
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Editors' Synopsis: In a previous work appearing in this Journal, the authors proposed an approach to estate and gift taxation that encourages productive behavior by the recipients of wealth. In this Article, the authors analyze, in the context of their earlier work, the new estate-tax exclusion for closely held businesses (section 2033A) created by the Taxpayer Relief Act of 1997. The authors describe the features of a practical family-run business exclusion and conclude that section 2033A, in its present form, fails as a practical exclusion. The authors catalogue those elements of section 2033A that should be retained and propose reforms of those elements that should be eliminated or changed.

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In an earlier work, we analyzed the estate and gift taxation of closely held businesses.¹ In that article, we proposed that encouraging the work efforts of beneficiaries may be a justification for the estate and gift tax. Narrowing our focus to closely held businesses, we argued that this justification fails when beneficiaries work in family-run businesses. Thus, we concluded, the estate and gift tax should apply differently to

¹ Eric D. Chason & Robert T. Danforth, *The Proper Role of the Estate and Gift Taxation of Closely Held Businesses*, 32 REAL PROP. PROB. & TRUST J. 103 (1997).

interests in such businesses.²

In August of 1997, as part of the Taxpayer Relief Act of 1997 ("TRA 1997"),³ Congress changed the estate (but not gift)⁴ taxation of closely held businesses. Section 2033A⁵ of the Internal Revenue Code (the "Code") creates an exclusion for qualified family-owned business interests. Through the combined effects of the section 2033A exclusion and the section 2010 unified credit,⁶ qualifying estates may now pass up to \$1,300,000 in qualified family-owned business interests and other assets without payment of estate tax.

In this Article, we analyze section 2033A in the context of our previous work. Part II of this Article summarizes section 2033A⁷ and other elements of TRA 1997 that concern the taxation of closely held businesses. Part III summarizes our previous work. Part IV extends this work by describing how a practical exclusion for family-run businesses would operate. Part V analyzes section 2033A and concludes that, in its present form, it fails as a practical exclusion. Part V identifies those elements of section 2033A that should be retained and suggests a reform of those elements that should be eliminated or changed. Part VI summarizes our findings and reform proposals.

² For a more complete summary of our previous article, see *infra* Part III.

³ Pub. L. No. 105-34, 111 Stat. 788 (1997) [hereinafter TRA 1997].

⁴ Cf. *infra* Section V.G (arguing that an exclusion for family-run businesses should not apply to gifts).

⁵ For ease of citation, this article refers to TRA 1997 § 502(a), 111 Stat. 847 (1997) (codified at I.R.C. § 2033A) as section 2033A or I.R.C. § 2033A.

⁶ I.R.C. § 2010 (1994), *amended by* TRA 1997 § 501(a).

⁷ Any summary of section 2033A is by necessity an over-simplification. It is one of the longest and most complicated of the estate tax provisions and contains numerous and sometimes inscrutable cross-references. Its complexity alone is a sufficient basis to call for its reform. See *infra* note 66 and accompanying text (observing that complexity makes planning difficult and increases the costs of compliance). Several of our reform proposals would significantly simplify the statute. See, e.g., *infra* Section V.B (advocating repeal of the 50% liquidity test).

II. CLOSELY HELD BUSINESS PROVISIONS UNDER THE TAXPAYER RELIEF ACT OF 1997

A. The New Family-Owned Business Exclusion

1. *The Exclusion*

For decedents dying after December 31, 1997, section 2033A provides a "family-owned business exclusion" from the estate tax. Section 2033A potentially excludes from the decedent's gross estate value representing the decedent's interest in a "qualified family-owned business" ("QFOB"). The maximum exclusion equals the lesser of (1) the "adjusted value of the qualified family-owned business interests of the decedent otherwise includible in the estate"⁸ or (2) \$1,300,000 less the applicable exclusion amount.⁹ For decedents dying in 1998, the maximum QFOB exclusion will be \$675,000, because the applicable exclusion will be \$625,000.¹⁰ This maximum exclusion will decline in the years following 1998 as the applicable exclusion amount grows from \$625,000 to \$1,000,000 by 2006.¹¹ Thus, the maximum QFOB exclusion for decedents dying in 2006 and thereafter will be \$300,000.

2. *Qualified Family-Owned Business*

A QFOB must be a trade or business. Section 2033A does not define "trade or business," but the regulations under Code section 2032A

⁸ I.R.C. § 2033A(a)(1). For discussions of the "adjusted value" limitation, see *infra* notes 29-34 and accompanying text and Section V.E.

⁹ I.R.C. § 2033A(a)(2). Section 501(a) of TRA 97 amended section 2010 by changing the present \$600,000 estate-tax exemption equivalent to the "applicable exclusion amount," which is increased incrementally from \$600,000 to a maximum of \$1,000,000 for estates of decedents dying and gifts made during 2006 or later years. See generally Chason & Danforth, *supra* note 1, at 108 (discussing the \$600,000 exemption equivalent before TRA 1997).

¹⁰ See I.R.C. § 2010(c)(1997).

¹¹ See *id.*

elaborate on the meaning of the term.¹² Those regulations describe a trade or business as "an active business such as a manufacturing, mercantile, or service enterprise, or . . . the raising of agricultural or horticultural commodities, as distinguished from passive investment activities."¹³ Passive investment activities, such as renting real property, do not qualify as a trade or business.¹⁴

The interest in the trade or business may be either a sole proprietorship or an interest in an entity in which the decedent's family¹⁵ holds a sufficient percentage of the ownership interests. In general, the family ownership requirement for an entity¹⁶ is satisfied if the decedent's family owns fifty percent of the entity. Thirty-percent ownership by the decedent's family is sufficient if two families (including the decedent's family) own seventy percent, or three families own ninety percent, of the entity. Subject to several exclusions and limitations, an interest in a trade or business satisfying these ownership requirements is a QFOB interest.

¹² Although section 2033A does not expressly incorporate the section 2032A definition of a trade or business, the similarity between section 2033A and section 2032A invites analogy. Section 2032A permits an estate to value certain real property used for farming or in a trade or business at its use value, rather than at its fair market value (which would be based on highest and best use, as opposed to actual use). See Chason & Danforth, *supra* note 1, at 111-12. Section 2033A permits an exclusion rather than a valuation reduction; nevertheless, sections 2032A and 2033A are structurally similar, and section 2033A even defines several terms and concepts by reference to section 2032A. See, e.g., I.R.C. § 2033A(i); see also *infra* notes 40-44 and accompanying text (discussing the section 2032A material-participation test, which is incorporated into section 2033A by reference).

¹³ Treas. Reg. § 20.2032A-3(b)(1)(1997).

¹⁴ *Id.* In addition, the presence of an office with regular hours is insufficient to constitute a trade or business under section 2032A. *Id.* Furthermore, no activity not engaged in for profit is a trade or business under section 2032A. *Id.*

¹⁵ By decedent's "family," we mean to include the decedent. Cf. I.R.C. § 2033A(i)(2) (defining "member of the family" by reference to section 2032A(e)(2)).

¹⁶ Determining the percentage ownership in an entity is not a simple matter under section 2033A. Ownership in a corporation must be in both voting power and total ownership in the corporation. I.R.C. § 2033A(e)(3)(A)(i). Ownership in a partnership must be in the capital interest in the partnership. I.R.C. § 2033A(e)(3)(A)(ii). Ownership in tiered entities presents additional complications. The Code looks through each entity to determine whether every underlying trade or business satisfies the definition of a QFOB. I.R.C. § 2033A(e)(3)(B).

Section 2033A imposes several significant limitations on the definition of a QFOB. First, the principal place of business must be in the United States.¹⁷ Second, the stock or debt of the entity (or a controlled group that includes the entity) must not have been publicly traded anytime within three years of the decedent's death.¹⁸

Two other limitations curtail the use of section 2033A in transferring passive assets. In general, the entity may have no more than thirty-five percent of its adjusted ordinary income be personal holding company income for the year of the decedent's death.¹⁹ Personal holding company income typically means passive income such as dividends, interest, royalties, and rents.²⁰ Moreover, the value of the QFOB is reduced by the value of cash and marketable securities in excess of the needs for day-to-day working capital²¹ and by the value of other assets producing personal holding company income²² and foreign personal holding company income.²³ Thus, a QFOB interest may have no more than thirty-five percent of its income from passive assets, and, after accounting for working-capital needs, the value of passive assets reduces the value of the QFOB interest.

¹⁷ I.R.C. § 2033A(e)(2)(A).

¹⁸ I.R.C. § 2033A(e)(2)(B).

¹⁹ I.R.C. § 2033A(e)(2)(C).

²⁰ See generally I.R.C. § 543(a)(1994) (defining personal holding company income). Personal holding company income also includes amounts received under personal service contracts and income from trusts and estates.

²¹ The Conference Report indicates that day-to-day working capital is the historical average of the business's working capital needs. H.R. Conf. Rep. No. 105-220, at 379 (1997) (citing *Bardahl Mfg. Corp. v. Commissioner*, 24 T.C.M. 1030 (1965)). Accumulations for acquisitions are not part of day-to-day working capital. *Id.*

²² See *supra* note 20 and accompanying text (describing personal holding company income).

²³ See I.R.C. § 954(c)(1)(1994), amended by TRA 1997 § 1051. The relevant foreign personal holding company income is (1) net gain from the sale of an interest in a trust, partnership, REMIC, or property that produces no income, (2) net gain from commodities transactions, (3) net gain from currency transactions, (4) income equivalent to interest, (5) income from notional principal contracts, and (6) payments in lieu of dividends.

3. Qualifying Estates

Not all estates containing QFOB interests are entitled to the exclusion. In order to avail itself of the exclusion, the estate (as opposed to the business) must satisfy four other tests. First, the decedent must be a United States citizen or resident.²⁴ Second, the executor must make an election and file an agreement to pay future taxes.²⁵ Third, during at least five of the eight years before the decedent's death, the decedent or the decedent's family must have both owned the business interests and materially participated in the operation of the business.²⁶ Fourth, the value of the QFOB interests passing to qualified heirs²⁷ at death or by gift must, roughly speaking, exceed fifty percent of the decedent's gross estate.²⁸

The fifty-percent test is perhaps the most complex portion of this highly complicated statute.²⁹ Essentially, the fifty-percent test requires that the estate be somewhat illiquid. The test requires that the "adjusted value of the qualified family-owned business" plus the "amount of gifts of such interests" exceed fifty percent of the "adjusted gross estate."³⁰ Thus, the numerator, which is the adjusted amount of the interests passing to heirs, divided by the denominator, which is the adjusted gross estate, must exceed fifty-percent.

The base amount of the numerator is the value of the QFOB interests

²⁴ I.R.C. § 2033A(b)(1)(A).

²⁵ I.R.C. § 2033A(b)(1)(B); *see also* I.R.C. § 2033A(h) (describing the agreement by which each heir to the QFOB interests must agree to pay recapture taxes); *infra* Subsection II.A.5 (discussing recapture provisions).

²⁶ I.R.C. § 2033A(b)(1)(D).

²⁷ A qualified heir is either a member of the decedent's family or an active employee of the trade or business for 10 years prior to the decedent's death. I.R.C. § 2033A(i)(1)(A)-(B). The "decedent's family" includes any ancestor, spouse, lineal descendant, or spouse of a lineal descendant. I.R.C. § 2033A(i)(1)(A).

²⁸ I.R.C. § 2033A(b)(1)(C).

²⁹ *But cf.* I.R.C. § 2033A(f)(1)(A) (imposing a recapture tax if within 10 years after the decedent's death there is an 8-year period ending after the decedent's death during which the decedent's family did not materially participate in the trade or business for periods aggregating 3 or more years).

³⁰ I.R.C. § 2033A(b)(1)(C).

that are in the gross estate and acquired by any qualified heir³¹ plus the value of all gifts of the business that consumed part of the decedent's unified credit or escaped gift tax under the annual exclusion.³² This amount is then adjusted for debts of the decedent. It is reduced by deductions for all debts or mortgages under section 2053(a)(3) or (4), but increased by debts related to a residence, debts related to medical or educational purposes, and other debts that do not exceed \$10,000.³³ Additionally, this amount is adjusted for certain inter vivos gifts of the QFOB interests. It is reduced by the value of such gifts that the recipient failed to hold continuously until the decedent's death, such gifts that the decedent's spouse received, and such gifts that are included in the decedent's gross estate.³⁴ This process yields the numerator for the fifty-percent test.

The base amount of the denominator is the value of the gross estate. Section 2033A adds to this value the value of the gifts of the QFOB interests (as previously determined), transfers of QFOB interests to the decedent's spouse within ten years of death, and any other gifts of such interests (other than annual exclusion gifts) to members of the decedent's family within three years of death.³⁵ The provision reduces this amount by the value of all such gifts that are included in the gross estate and any deductions for debts or mortgages.³⁶ This process yields the denominator for the fifty percent test.

³¹ I.R.C. § 2033A(b)(2).

³² For a discussion of the unified credit and annual exclusion, see Chason & Danforth, *supra* note 1, at 108-09.

³³ I.R.C. § 2033A(d).

³⁴ Under section 2033A(b)(3)(A)(i), the starting point for determining the gifts included in the numerator is "the amount of [gifts of QFOB interests] from the decedent to members of the decedent's family [that are] taken into account under subsection 2001(b)(1)(B)." The latter provision concerns the decedent's "adjusted taxable gifts," which, by definition, excludes gifts that are includible in the decedent's gross estate. I.R.C. § 2001(b)(1994) (flush language). Thus, the reduction of the numerator by gifts includible in the decedent's estate as provided by section 2033A(b)(3)(B) is superfluous and, consequently, makes an inappropriate adjustment to the numerator under section 2033A(b)(1)(C). This apparent defect in the statute is the subject of a recently proposed technical correction. See H.R. 2645, 105th Cong. § 6(b)(2)(1997).

³⁵ I.R.C. § 2033A(c)(2)(A).

³⁶ I.R.C. § 2033A(c)(1).

4. Amount of QFOB Exclusion

Section 2033A limits the amount of the QFOB exclusion to a maximum of "the adjusted value of the qualified family-owned business interests of the decedent otherwise includible in the estate."³⁷ As discussed in greater detail below,³⁸ the "adjusted value" limitation reduces the size of the maximum available QFOB exclusion by most claims against the estate and debts of the estate that are deductible for estate tax purposes under section 2053(a). As a result of this limitation, the full value of the QFOB interests held by an estate may not be eligible for the exclusion, notwithstanding that the total value of the QFOB interest is less than the dollar limitation imposed by section 2033A(a)(2).³⁹

5. Recapture

The qualified heir who receives the QFOB interest must satisfy certain material-participation requirements to avoid recapture of the estate taxes attributable to the QFOB exclusion.⁴⁰ Section 2033A in general requires material participation by the qualified heir until ten years after the decedent's death.⁴¹ The section 2033A material-participation test triggers recapture if during any eight-year period ending after the decedent's death, material participation fails to occur for periods aggregating more than three years.⁴² While a qualified heir holds the property, the material-participation test is satisfied if either the heir or a member of the heir's family materially participates. While the decedent holds the property, the material-participation test is satisfied if either the decedent or a member of the decedent's family materially participates.⁴³

³⁷ I.R.C. § 2033A(a)(1).

³⁸ See *infra* notes 106-07 and accompanying text.

³⁹ See *supra* Subsection II.A.1 (discussing the provisions of section 2033A that limit the exclusion to \$1,300,000 reduced by the section 2010(c) applicable exclusion amount).

⁴⁰ For a discussion of the method for determining the amount of tax recaptured, see *infra* notes 47-50 and accompanying text.

⁴¹ I.R.C. § 2033A(f)(1). Material participation need not occur after the qualified heir's death if the qualified heir dies before the 10-year period expires.

⁴² I.R.C. § 2033A(f)(1)(A) (referring to the material-participation requirements of section 2032A(c)(6)(B)).

⁴³ I.R.C. § 2033A(b)(1)(D).

Failure to satisfy the material-participation test triggers the imposition of additional estate tax plus interest—essentially a recapture of the taxes attributable to the excluded QFOB property.⁴⁴ A disposition of the QFOB property by the qualified heir during the ten-year period following the decedent's death also triggers additional estate tax plus interest, unless the disposition is to a member of the qualified heir's family or constitutes a qualified conservation contribution under section 170(h).⁴⁵ Recapture is also triggered if the heir loses his or her United States citizenship or moves the principal place of business outside the United States.⁴⁶

Section 2033A bases the additional estate tax on the "adjusted tax difference attributable to the qualified family-owned business interest."⁴⁷ The statute does not define this term but directs that the "adjusted tax difference" is to be determined under principles similar to the rules of section 2032A(c)(2)(B).⁴⁸ Applying these principles yields an adjusted tax difference for purposes of recapture that would be a fraction of the estate tax savings attributable to section 2033A. The Committee Report indicates that the numerator of the fraction is the estate tax value of the interest triggering recapture, and the denominator is the estate tax value of all QFOB interests.⁴⁹ Upon a recapture event, the qualified heir owes the adjusted tax difference plus interest. This amount, however, is phased out incrementally between the sixth and tenth years after the decedent's death.⁵⁰

6. Summary

Section 2033A, along with the applicable exclusion amount under section 2010(c), excludes from qualifying estates up to \$1,300,000 of value represented by a family-owned business. To qualify for the exclusion, the business must satisfy one of two concentration-of-

⁴⁴ I.R.C. § 2033A(f)(2).

⁴⁵ I.R.C. § 2033A(f)(1)(B).

⁴⁶ I.R.C. § 2033A(f)(1)(C)-(D).

⁴⁷ I.R.C. § 2033A(f)(2)(A)(i).

⁴⁸ *Id.*

⁴⁹ H.R. CONF. REP. NO. 105-220, at 399 (1997).

⁵⁰ *See id.* at 400.

ownership tests: the business must be owned (1) fifty percent by the decedent's family or (2) thirty percent by the decedent's family, if ownership is sufficiently concentrated in one or two other families. Section 2033A either limits or denies the exclusion to businesses holding excessive passive assets. The exclusion is further limited to the amount of the QFOB interests reduced by certain estate tax deductible claims and debts. Even if an estate holds QFOB interests, the estate must meet other qualifications. In particular, the decedent or the decedent's family must have materially participated in the business before the decedent's death, and the interests must be roughly fifty percent of the estate. The heirs must continue to participate in the trade or business for ten years after the decedent's death.

B. Expansion of Estate-Tax Deferral

TRA 1997 substantially liberalized the interest payment rules of section 6166.⁵¹ Under prior law, a preferential four percent interest rate applied to a portion of the taxes deferred under section 6166 equal to the lesser of the total taxes deferred or the estate taxes attributable to the first \$1,000,000 of closely held business property.⁵² Under most circumstances, the maximum amount of taxes to which the preferential rate applied was \$153,000, which represented the tax on \$1,000,000, after taking into account the unified credit under section 2010. Section 503(a) of TRA 1997 changed the four percent rate to a two percent rate; the preferential rate now applies to the first \$1,000,000 of *taxable* closely held business property. In other words, the two percent rate applies to the tax on the first \$1,000,000 of closely held business property in excess of the amount sheltered by the unified credit and, if applicable, the QFOB exclusion. Based on the unified credit applicable to decedents dying in 1998,⁵³ the maximum amount of tax to which the special rate applies is

⁵¹ TRA 1997 § 503. For an overview of section 6166, see Chason & Danforth, *supra* note 1, at 112-15.

⁵² I.R.C. § 6601(j)(2)(1994), *amended by* TRA 1997 § 503(a).

⁵³ This calculation also reflects that the amount qualifying for the special interest rate in 1998 is \$1,000,000. The qualifying amount may be greater after 1998, because the \$1,000,000 figure is now indexed to inflation. See TRA 1997 § 501(e).

\$407,500.⁵⁴ The tradeoff for this more favorable rule is that interest payable on deferred taxes under section 6166 is no longer deductible for either income tax or estate tax purposes.⁵⁵ Assuming a marginal estate tax rate of 55%, the non-deductibility rule reduces the benefit of the favorable interest rate by a factor of 0.45, so that the new rate is roughly equivalent to a deductible interest rate of 4.44%.⁵⁶ Assuming an otherwise applicable interest rate of 8%,⁵⁷ the value of the benefit of the 4.44% rate is \$91,785.12.⁵⁸ For a taxable estate with a marginal estate tax rate of 55%, this savings corresponds to a \$166,882.04 reduction in the value of the estate for tax purposes.⁵⁹ Under prior law, the maximum benefit from the preferential interest rate was equivalent to excluding a

⁵⁴ A taxable estate of \$1,625,000, of which \$1,000,000 is attributable to a closely held business interest that satisfies the requirements of section 6166, would produce a tentative tax of \$609,550, reduced by the credit under section 2010 (which, in 1998, is \$202,050), and thus an estate tax of \$407,500. The full \$407,500 would be eligible for the preferred interest rate.

⁵⁵ I.R.C. § 2053(c)(1)(D) (1994), *amended by* TRA 1997 § 503(b). Under prior law, because the section 6166 interest obligation could be deducted for estate tax purposes only as the interest payments were made, to take advantage of the deduction an executor was required periodically to file revised estate tax returns, on which the interest paid would be deducted as an expense of administration under section 2053(a)(3). *See Chason & Danforth, supra* note 1, at 113-14 n.72. The new non-deductibility rule for section 6166 interest payments should simplify the administration of estates making section 6166 elections. The new rule probably will not, however, eliminate the need for revised estate tax returns entirely, because the estate may still want to deduct the additional fiduciary and professional fees incurred as a result of keeping the estate open during the section 6166 deferral period. *See Jonathan G. Blattmachr & Howard M. Zaritsky, Estate Planning After the Taxpayer Relief Act of 1997*, 87 J. TAX'N 133, 135 (1997).

⁵⁶ At a marginal rate of 55%, the value of a deduction is equal to 55% of the amount of the deduction. Accordingly, if interest is deductible, the deduction reduces the effective rate of the interest by a factor equal to the marginal tax rate. Thus, interest payable at a rate of 10% that is also deductible for estate tax purposes is equivalent to non-deductible interest payments at a rate of 4.5%. Based on this analysis, the 2% interest rate under revised section 6601(j) is equivalent to deductible interest incurred at a rate of 4.44% (0.0444 multiplied times 0.45 equals 0.02).

⁵⁷ The standard interest rate applicable to deferred estate taxes is the federal short-term rate plus 3%. I.R.C. § 6621(a)(1994).

⁵⁸ This number is the net present value of a \$407,500 loan bearing interest at 4.44%, assuming a discount rate of 8%, and assuming the longest possible deferral period under section 6166.

⁵⁹ This number is \$91,785.12 divided by 0.55.

\$70,489.74 portion of the closely held business from estate taxes.⁶⁰ Thus, the new interest payment rules are dramatically more beneficial to qualifying estates than prior law.⁶¹

III. A WORK-BASED THEORY OF THE ESTATE AND GIFT TAX

In our previous work, *The Proper Role of the Estate and Gift Taxation of Closely Held Businesses*,⁶² we described an economic rationale for imposing estate and gift taxes on wealth. We first identified the traditional rationales for imposing transfer taxes: generating revenues, supplementing the income tax, and promoting egalitarianism. We found all of these traditional rationales unworkable. The estate and gift tax fails to generate substantial revenue because it applies to so few taxpayers and because taxpayers can easily avoid it. Supplementing the income tax is unsatisfactory as well. Congress has lacked the will to use the estate and gift tax to bolster the progressivity of income taxation. Additionally, the estate and gift tax is unnecessary to cure the failure of the income tax to reach untaxed gains at a taxpayer's death; if this failure is a problem, its best solution is a direct one. Finally, promoting egalitarianism is an unworkable justification for the estate and gift tax. The estate tax and gift tax may promote one liberal goal: leveling wealth. Yet, it also promotes

⁶⁰ Chason & Danforth, *supra* note 1, at 114 & n.76.

⁶¹ The expansion of section 6166 under TRA 1997 is not directly relevant to a work-based model for taxing closely held businesses. Section 6166 ostensibly addresses liquidity concerns and does not directly remove any value from the estate, nor does it prevent the taxation of that value. Nevertheless, as observed earlier, the below-market rate of interest under section 6166 results in a de facto forgiveness of tax for qualifying estates. Chason & Danforth, *supra* note 1, at 114-15.

As observed in our earlier work, using the section 6166 preferential interest rate as a means of effecting estate tax relief is problematic, primarily because the section 6166 requirements focus on the problem of liquidity and not on factors relevant to tax relief, such as the presence or absence of material participation by the decedent's heirs. Chason & Danforth, *supra* note 1, at 114-15 n.79. Considering that Congress only recently liberalized the section 6166 interest payment rules, however, any attempt to persuade Congress to take away this tax benefit would probably fall on deaf ears. Nevertheless, in revising section 2033A -- specifically, in establishing the size of the section 2033A exclusion -- Congress should take into account the substantial tax benefit provided to most QFOB interests under the new section 6166 interest payment rules.

⁶² Chason & Danforth, *supra* note 1.

illiberal goals: encouraging excess consumption and discouraging thrift.

We developed an alternative justification for the estate and gift tax, based upon conventional wisdom, microeconomic theory, and empirical research. More than one hundred years ago, Andrew Carnegie observed that inherited wealth "deadens the talents and energies of the" heir and "tempts him to lead a less useful and worthy life than he otherwise would."⁶³ Microeconomic theory supports this hypothesis. Leisure is an economic good, which consumers purchase by not working and foregoing wages. Individuals tend to consume more goods (like leisure) when their wealth increases. Empirical research shows that heirs to substantial wealth tend to leave the work force. Interestingly, other research shows that heirs who do not leave the work force tend not to decrease their work efforts.⁶⁴ Thus, inherited wealth tends to affect labor supply only by decreasing participation in the labor market. The hypothesis is also supported by anecdotal evidence and conventional wisdom.

The estate and gift tax lessens the deterioration of work effort caused by gifts and inheritances. First, the estate and gift tax decreases the magnitude of gifts and inheritances. Second, and more subtly, the estate and gift tax makes gifts and inheritances less disruptive of work effort. As noted above, inheritances cause attrition in the labor force, but with respect to those who do not exit the labor force, inheritances tend not to affect the labor supply. Also, the likelihood of attrition increases with the size of the inheritance. Hence, only large inheritances substantially affect labor participation. The estate and gift tax system addresses this problem by prompting donors to transfer their wealth by a stream of lifetime gifts rather than all at death. This stream is less disruptive of participation in the labor market.

⁶³ Chason & Danforth, *supra* note 1, at 128 (quoting Andrew Carnegie, *The Advantages of Poverty*, in *THE GOSPEL OF WEALTH AND OTHER TIMELY ESSAYS* 43, 49-50 (1933)).

⁶⁴ As we discussed in greater detail in our earlier work, Chason & Danforth, *supra* note 1, at 132-35, large inheritances tend to cause heirs to exit the work force, while smaller inheritances do not. Furthermore, the recipients of smaller inheritances tend both not to exit the work force and not to reduce their work efforts (as measured by annual earnings).

If encouraging work efforts is the proper goal of estate and gift taxation, then taxing some closely held businesses may be improper. The estate and gift tax encourages work on the part of donees. If the donee receives an interest in a closely held business and will manage the business, then the donee needs no encouragement to work. Furthermore, applying the estate and gift tax discourages the production and accumulation of capital by reducing its value to its holder.⁶⁵ Thus, applying the estate and gift tax to some closely held businesses fails to further the goal of the tax but retains the harmful effects on capital associated with the tax.

IV. THE FRAMEWORK FOR A PRACTICAL EXCLUSION FOR FAMILY-RUN BUSINESSES

A. Introduction

As stated above, the estate and gift tax discourages the accumulation of all forms of capital, including interests in closely held businesses.⁶⁶ Previously, we assumed that the benefits of the estate and gift tax -- its encouragement of work effort -- outweigh the harmful effects of the estate and gift tax.⁶⁷ This general analysis does not apply to some closely held businesses. If the donee manages the business, then the tax is unnecessary to encourage work. Yet, it still discourages accumulation of the closely held business capital. Because the estate and gift tax has a different effect on these family-run businesses, perhaps the tax should apply differently to these interests.

B. Effects of Estate and Gift Taxes on Investing

Ideally, an exclusion for family-run businesses would restore the investments in family-run businesses that individuals have failed to make

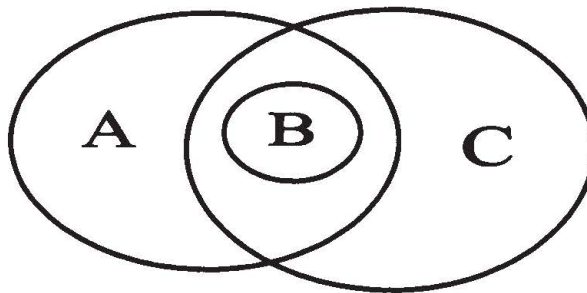
⁶⁵ The estate and gift tax reduces the value of capital because it burdens one of the holder's potential uses: giving it away. See Chason & Danforth, *supra* note 1, at 139-40 & n.195.

⁶⁶ See *id.*

⁶⁷ See Chason & Danforth, *supra* note 1, at 140-41.

because of the estate and gift tax. Such a restoration, however, would have a cost. Along with restoring discouraged investments in family-run businesses, an exclusion would necessarily prefer these investments over other investments. This preference would encourage investments in family-run businesses that individuals would not have made in the absence of the estate and gift tax.

Imagining the types of investments in a hypothetical world without the estate and gift tax is useful to this analysis. Suppose that *A* represents the level of investments in family-run businesses⁶⁸ in the absence of an estate and gift tax. Next, suppose that *B* represents the level of investments in family-run businesses in a world with an estate and gift tax that includes no family-run business exclusion.⁶⁹ Because the estate and gift tax only discourages investing in family-run businesses, *B* is necessarily a subset of *A*. Now, suppose *C* represents the investments in family-run



businesses under an estate and gift tax regime that includes a family-run business exclusion. Because *C* is an exclusion from tax it will necessarily include all of *B*.

⁶⁸ By "family-run businesses," we mean closely held businesses in which a successive generation will materially participate.

⁶⁹ *B* is not purely hypothetical. Roughly, it represents the level of investment in family-run businesses before TRA 1997.

C. A Practical Exclusion for Family-Run Businesses

Any exclusion will be imperfect in two ways. First, the exclusion will not restore all of the investments in family-run businesses that would have been made absent estate taxes. That is to say, *A* cannot be a subset of *C*. Any exclusion that would restore all of *A* would be too broad. A broad exclusion would encourage investments in family-run businesses for purely tax-motivated reasons by allowing taxpayers to convert assets into a family-run business with little cost. More importantly, a broad exclusion would exempt from the estate and gift tax assets (such as passive investments) that are not true family-run businesses. A family-run business is an inherently vague concept, which must be codified with reasonable certainty for the exclusion to be effective. This codification would have to be broad to restore all lost investments in family-run businesses, and the breadth would almost certainly cover assets that are not true family-run businesses.

Conversely, any practical exclusion would inadvertently encourage investments in family-run businesses that would not have been made in the absence of estate taxes. That is to say, *C* cannot be a subset of *A*. Any exclusion that would prevent all tax-motivated⁷⁰ investing would be too narrow. A narrow exclusion must limit the class of qualifying businesses and the value of the exclusion to prevent tax-motivated investing in family-run businesses. Yet, a narrow exclusion would be

⁷⁰ By tax motivated, we do not mean a conscious motivation to avoid taxes. Potential investors will decide whether to invest in family-run businesses by analyzing the returns such businesses would produce and by considering other issues, such as the associated lifestyle and the ability to pass their businesses on to their heirs. Investors would value these monetary and non-monetary returns to arrive at a net present value of the opportunity. Investors would then compare the value of this opportunity with the value of alternative opportunities and pursue the one with highest net present value. See STEPHEN A. ROSS ET AL., FUNDAMENTALS OF CORPORATE FINANCE at 229-32 (3d ed. 1993)(analyzing potential investments using net present values).

An estate tax exclusion makes family-run businesses comparatively more favorable than other investments. Presumably, investors consider negative cash flows associated with estate and gift taxes when choosing their investments. Cf. Chason & Danforth, *supra* note 1, at 139-40 & n.195 (discussing the value associated with the ability to transfer wealth). Relative to other investments, family-run businesses would have higher cash flows under an exclusion. The higher cash flows would make the opportunity more valuable, thus encouraging additional investments in family-run businesses.

unlikely to restore lost investments because the limitations would apply to all family-run businesses. Furthermore, a narrow exclusion may contain several complex requirements to ensure that only true family-run businesses qualify. Complexity, however, would create costs for taxpayers and the government and might also undermine the public's faith in the tax system.

Thus, creating an ideal estate and gift tax exclusion for family-run businesses is problematic. If the exclusion is too broad, it will encourage tax-motivated investments in family-run businesses and will allow favorable treatment for passive assets. If the exclusion is too narrow, it will not meaningfully restore the investments in family-run businesses that would not have been made because of estate taxes. Additionally, a narrow exclusion may also be complex and, therefore, costly to administer. Thus, no exclusion will be perfect. No exclusion will restore all investments lost to estate taxes (i.e., restore all of *A*), prevent all tax-motivated investing (i.e., keep *C* bounded by *A*), and not generate significant costs of compliance for the government and taxpayers.

Even though no exclusion will be perfect, an exclusion for family-run businesses may be practical. A practical exclusion would have three characteristics. First, it would minimize complexity. Second, it would clearly define an interest in a family-run business to ensure participation in the business by the beneficiaries and to prevent abuse. Third, it would set and limit the benefit of the exclusion.

A practical exclusion would minimize complexity. Complexity would make an exclusion expensive for the government and taxpayers to administer. Taxpayers would need more professional assistance in their planning, and the government would need to devote more resources to supervising taxpayer behavior. Complexity would also make it difficult for taxpayers to rely on the exclusion and thus decrease the likelihood that taxpayers would engage in the activity the exclusion was designed to promote. Taxpayers would be uncertain whether they would qualify under a complex exclusion. Naturally, they would not want to make investments that may fail to generate tax savings or that may create an

expensive controversy with the government.⁷¹

A clearly defined provision would encourage investment in family-run businesses and curtail the use of the exclusion for the transfer of other assets. The key element of defining a family-run business is participation by the heir.⁷² As we have previously argued, the estate and gift tax operates to encourage work efforts by heirs. Thus, the tax should apply differently if the heir operates the business. A secondary element of defining a family-run business is preventing the transfer of other assets to fall within the exclusion. Providing an exclusion for family-run businesses encourages individuals to use the exclusion to transfer other, often passive, assets. A practical exclusion, therefore, would define a family-run business as an active business. It would also exclude passive assets from special treatment.

A practical exclusion would provide an ascertainable and limited benefit. The benefit should be ascertainable so that taxpayers can rely on the value of the benefit. If the value of the benefit is not ascertainable, taxpayers will hesitate to invest in family-run businesses and to plan for the exclusion.⁷³ Additionally, the benefit should probably be limited. Although this is an empirical question, an unlimited benefit would probably encourage too much tax-motivated investing in family-run

⁷¹ Put in financial terms, complexity decreases the expected value of the exclusion. Suppose that p is the probability of success in planning for the exclusion, χ is the cost of planning for and administering the exclusion, and β is the benefit of the exclusion. Thus, the expected value of the exclusion is $p\beta - \chi$. Complexity decreases p (the probability of successful planning), increases χ (the cost of planning and administering), and thus decreases the expected value of the exclusion.

⁷² Cf. Chason & Danforth, *supra* note 1, at 141-43 (discussing the participation of heirs).

⁷³ A variable benefit increases risk. For example, the benefit under the present version of section 2033A depends upon the year in which the taxpayer dies. See *supra* Subsection II.A.1. The taxpayer may be able to estimate the expected benefit, but the expected benefit will not be certain.

The benefit from the exclusion is a return on the investment in the business and in the planning for the exclusion. Individuals typically require a higher return on investments that have a higher risk. See ROSS, *supra* note 65, at 256. Because a variable benefit makes the return riskier, taxpayers will require a greater return under a variable benefit than under a set benefit. As a corollary, a variable benefit will thus discourage some taxpayers from seeking the exclusion.

businesses.

D. Summary

The estate and gift tax discourages investments in family-run businesses. An exclusion might restore some of these investments, but the restoration would be imperfect and perhaps costly. An exclusion that restores all lost investments would encourage tax-motivated investments in family-run businesses and might also extend to passive assets. An exclusion that prevents all such abuses would not meaningfully restore lost investments in family-run businesses and might also be costly to administer. Even though no exclusion will be perfect, an exclusion may still be practical. A practical exclusion for family-run businesses would clearly define a family-run business, minimize complexity, and limit the benefits of the exclusion. As the next section discusses, section 2033A fails to satisfy this description of a practical exclusion.

V. TOWARD A PRACTICAL FAMILY-RUN BUSINESS EXCLUSION

A. Introduction

A practical estate-tax exclusion for family-run businesses would clearly define a family-run business to encourage beneficiaries' work efforts and to limit transfers of passive assets. It would minimize complexity. And, it would limit the benefits of the exclusion to an ascertainable amount that does not vary with unrelated factors.

Section 2033A, in significant part, fails this description of a practical exclusion, although some elements of the provision do comport with the description. This Part catalogues some major elements of section 2033A. Section B analyzes the tests for liquidity and concentration of ownership and concludes that the tests improperly deny the exclusion to some businesses that deserve it. Section C analyzes the restrictions on passive assets and concludes that section 2033A successfully and properly restricts the tax-free transfer of passive assets. Section D analyzes how section 2033A calculates the maximum size of the exclusion and concludes that this calculation distorts the benefit of the exclusion by

linking it to the applicable exclusion amount. Section E considers the manner in which debt reduces the size of the exclusion and concludes that section 2033A improperly reduces the exclusion by debts that may have no connection with the family-run business. Section F analyzes the material-participation requirements. Subsection F.1 concludes that these requirements properly require heirs to work in the business as a prerequisite to the exclusion. Subsection F.2 concludes that, although requiring pre-death participation distorts the benefit of the exclusion, retaining a pre-death participation requirement is probably necessary to prevent abusive planning techniques. Section G considers the absence of a QFOB exclusion for gifts and concludes that any extension of the exclusion to gifts would be too complex. Section H analyzes the basis rules for property subject to a section 2033A election and concludes that the present rules properly maintain the level of benefit of the exclusion. Section I summarizes these conclusions.

B. The Liquidity and Concentration-of-Ownership Tests

In defining family-run businesses, section 2033A wrongly focuses on the liquidity of the estate.⁷⁴ Section 2033A imposes two liquidity tests. First, no QFOB may have publicly traded debt or equity.⁷⁵ Congress probably thought that, if the QFOB interests were publicly traded, then the estate could readily dispose of them to pay estate taxes.⁷⁶ Second, the estate must meet a complicated fifty-percent liquidity test.⁷⁷ Roughly speaking, the fifty-percent liquidity test requires that the value of the QFOB equal at least fifty percent of the value of the estate. Congress probably thought that, if interests in the QFOB were a comparatively

⁷⁴ Technically, the liquidity tests are not part of the definition of a QFOB. Yet, by denying the exclusion to those estates that fail the tests, the tests are essentially part of the definition.

⁷⁵ See I.R.C. § 2033A(e)(2)(B).

⁷⁶ Perhaps the existence of publicly traded securities shows that the business is not truly family-owned. In any event, it is hard to imagine that a publicly traded company would meet many of the other requirements of section 2033A. As we later observe, *see infra* notes 86-88 and accompanying text, denying QFOB status to publicly traded companies, while wrongly premised on the question of liquidity, is probably harmless and may also serve to prevent some tax-motivated planning techniques.

⁷⁷ See *supra* Subsection II.A.3.

small part of the estate, then the estate could sell other assets to pay estate taxes attributable to the business.

The exclusion for interests in QFOBs should not contain the fifty-percent liquidity requirement. If liquidity is a problem for an estate, then Congress should address illiquidity rather than forgive the tax.⁷⁸ The Code already allows deferral of estate taxes under section 6166.⁷⁹ If section 6166 is insufficient to remedy present illiquidity problems, then Congress should expand it.⁸⁰ Liquidity should not preclude an estate from having an exclusion if encouraging work efforts by donees justifies the exclusion. That is, if the recipients of the closely held business will manage the business, then the exclusion should apply regardless of whether the estate is liquid.

Removing the fifty-percent liquidity requirement would also simplify section 2033A. The fifty-percent liquidity test creates much of the complexity of section 2033A.⁸¹ The calculation for the test relies on at least eleven independent variables.⁸² Abandoning this complicated calculation would have several positive benefits. It would decrease the costs of administering the exclusion and planning for the exclusion. It would restore more investments in family-run businesses. And, it would

⁷⁸ See Chason & Danforth, *supra* note 1, at 114-15 n.79.

⁷⁹ See *supra* Section II.B.

⁸⁰ By expanding section 6166, we do not mean that Congress should increase the indirect tax benefit associated with the preferential section 6166 interest rate. See *supra* note 61 (arguing that tax relief, if appropriate, should be provided directly, not indirectly through favorable interest rates). Rather, we mean that section 6166 could be expanded, for example, to cover a larger number of estates, to extend the due date of the first principal installment, or to reduce each principal installment by permitting a longer overall deferral period.

⁸¹ Cf. *supra* Subsection II.A.3 (discussing the liquidity test).

⁸² These variables are as follows: (1) the value of QFOB interests; (2) gifts of QFOB interests to family members taken into account under section 2001(b)(1)(B); (3) gifts of QFOB interests to family members that qualify for the gift tax annual exclusion; (4) other gifts of QFOB interests included in the gross estate; (5) the value of the gross estate; (6) deductions under sections 2053(a)(3) and (4); (7) gifts to the decedent's spouse within 10 years of death; (8) gifts of non-QFOB interests to family members within 3 years of death other than annual exclusion gifts; (9) indebtedness on a qualified residence; (10) indebtedness for medical and educational purposes; (11) indebtedness under \$10,000. I.R.C. § 2033A(b)-(d).

more completely further the goal of encouraging donees' work efforts. The main negative effect would be a loss of revenue. If Congress perceives that the revenue loss would be too high, however, it should limit the magnitude of the benefit rather than denying it to some estates on an arbitrary basis.

Section 2033A also includes a concentration-of-ownership test. To satisfy the test, ownership in the business must be sufficiently concentrated in one, two, or three families. The decedent's family will satisfy the test if it owns fifty percent of the QFOB. If the decedent's family fails to own fifty percent but owns at least thirty percent, the test is satisfied if two families (including the decedent's) collectively own seventy percent, or three families collectively own ninety percent.

Does requiring concentration of ownership further the work efforts of donees? That is, if the donee materially participates in the trade or business, should the degree of concentration of ownership determine the availability of the exclusion? If publicly traded stock were eligible for the QFOB exclusion, then not requiring concentration of ownership could encourage tax-motivated investments in an heir's employer. For example, if an individual's only child worked in a management position for a large corporation, the individual might be encouraged to invest a large amount in the child's employer to avoid estate taxes. This example seems a bit unlikely,⁸³ however, even in the absence of the requirement that was assumed away. Hence, the ownership test is probably unnecessary to achieve any meaningful goal under section 2033A.

Moreover, the percentage requirements based on multiple-family ownership could produce the odd result that one family's interest will qualify for the exclusion while the interest held by another family in the same business will not. Consider, for example, Corporation X, an active trade or business, which is owned thirty percent by A and members of A's family, twenty-five percent by B and members of B's family, and thirty-

⁸³ First, the individual would have to liquidate present investments, possibly generating capital gains taxation. Second, the individual would likely have an undiversified investment portfolio after the conversion. Third, the child would have to participate materially in the corporation, without a controlling interest, for an extended period after the individual's death. All of these factors argue against such odd planning.

five percent by *C* and members of *C*'s family; the remaining ten percent is owned by several key employees. Assuming that there is no overlap among the families and that the key employees are not related to *A*, *B*, or *C*, *A* and *C*'s estates will qualify for the exclusion,⁸⁴ but *B*'s estate will not.⁸⁵ Furthermore, because the definition of "family" does not include unrelated long-term employees,⁸⁶ *A* and *C* would be reluctant to agree to any additional distributions of stock to key employees, because to do so would both (1) cause *A* and *A*'s family to fail the thirty-percent test⁸⁷ and (2) cause both *A* and *C* and their families to fail the ninety-percent ownership test that applies to businesses owned by three families.⁸⁸

The concentration-of-ownership rules may also disqualify an estate for the exclusion as the result of some action beyond the decedent's control. For instance, if *A* in the previous example had made annual exclusion gifts of *X* stock to the spouse of one of *A*'s children, a subsequent divorce would disqualify the former spouse as a member of *A*'s family. The change in marital status would cause the percentage ownership of *A* and *A*'s family to fall below thirty percent, with the result that *A*'s estate would no longer be eligible for the exclusion.⁸⁹ Note that the divorce would also disqualify *C*'s estate for the exclusion, because the three families would thereafter own less than ninety percent of the business in the aggregate. Similarly, any transfer by *C* to a person who is not a member of *C*'s family (such as a stepchild of *C*'s child)⁹⁰ would disqualify both *A* and *C*'s estates for the exclusion.

Section 2033A also restricts the benefits of the exclusion to businesses

⁸⁴ This example assumes that *A* and *C*'s estates satisfy all of the other section 2033A requirements.

⁸⁵ See I.R.C. § 2033A(e)(1)(B)(ii)(providing that, in the case of multiple-family ownership, the decedent owner's estate will not qualify for the exclusion unless the decedent and the decedent's family own at least 30% of the business).

⁸⁶ I.R.C. § 2033A(i)(2)(incorporating section 2032A(e)(2) by reference). Cf. I.R.C. § 2033A(i)(1)(B)(defining "qualified heir" to include certain long-term employees).

⁸⁷ See *supra* note 85.

⁸⁸ I.R.C. § 2033A(e)(1)(B)(i)(III).

⁸⁹ See I.R.C. § 2032A(e)(2)(1994)(defining family member).

⁹⁰ See *id.* (including an adopted child, but not a stepchild, of a descendant as a family member).

that have no publicly traded debt or equity.⁹¹ Although this rule focuses improperly on the liquidity of the decedent's business interest, in most cases the rule will not disqualify an otherwise qualifying business.⁹² The rule may also curb the tax-motivated, though unlikely, planning technique described earlier, in which the decedent invests in the employer of the decedent's child.⁹³ Furthermore, unlike the fifty-percent liquidity test, the rule disqualifying publicly traded stock and debt does not unduly complicate the statute and, because it establishes a bright-line test, it should not significantly increase the costs of planning or compliance.

To summarize the conclusions of this Section, the fifty-percent liquidity test is impractical. It distorts the definition of a family-run business by requiring illiquidity, and it complicates planning and administration with its unwieldy formula. The concentration-of-ownership test is probably unnecessary, and it has the potential to unfairly deny the exclusion to some families and to distort the decisions owners make about the proper ownership structure of their businesses. The requirement that the business not be publicly traded distorts the definition of a family-run business as well, but this requirement is simple and probably harmless, and its retention may help to prevent certain tax-motivated planning.⁹⁴

C. Passive Assets and the Trade or Business Requirement

Section 2033A is not overly generous, as it prevents taxpayers from using QFOBs as vehicles for transferring passive assets. First, section 2033A disallows any exclusion for a business if more than thirty-five percent of the income of the business came from passive sources.⁹⁵ Second, section 2033A reduces the value of the QFOB by the value of passive assets not needed for working capital.⁹⁶ The thirty-five percent

⁹¹ See I.R.C. § 2033A(e)(2)(B).

⁹² Only rarely, for example, would a qualified heir of an interest in a publicly traded company be likely to satisfy the post-death material-participation requirement.

⁹³ See *supra* note 83 and accompanying text.

⁹⁴ See *supra* text accompanying note 83.

⁹⁵ See *supra* notes 19-20 and accompanying text.

⁹⁶ See *supra* notes 21-23 and accompanying text.

test is unnecessary because the statute already reduces the value of the business by its excess passive assets. For example, if forty percent of the income of a business is from passive assets, the appropriate response is to disqualify the passive assets, not to disqualify the entire business.⁹⁷ The thirty-five percent test is a trap for the unwary that is usually easy to avoid with careful planning⁹⁸ yet serves no purpose.

Section 2033A requires that a QFOB be a "trade or business." This requirement deters taxpayers from using the exclusion to transfer passive assets. The trade-or-business requirement thus comports with the goal of promoting the work efforts of donees. The recipient of passive assets will not engage in any meaningful work associated with the assets. Rather, the unfettered transfer of passive assets would allow the recipient to engage in a decreased work effort.⁹⁹ A practical exclusion should apply only to assets that will support meaningful work efforts by the recipient. A trade or business is an active business enterprise.¹⁰⁰ Thus, the trade-or-business requirement and the limitation on passive assets under section 2033A seem to accomplish the task of filtering out those assets that will not support meaningful work efforts.

Section 2033A has a predominately practical approach in limiting its benefit to active businesses only. First, it reduces the value of the business to the extent of any passive assets. Second, it requires the business to carry on a trade or business. These two elements are essential to a practical estate-tax exclusion for family-run businesses.

⁹⁷ Perhaps the 35% limitation on passive income could serve as a bright-line test, deeming any business holding that level of passive assets not to be an active trade or business. Rather than disqualify the entire business, however, a bright-line test should disqualify passive assets over a certain level.

⁹⁸ The business owner can usually create a separate entity to hold the passive assets.

⁹⁹ See Chason & Danforth, *supra* note 1, at 132-35 (describing how recipients of wealth tend to exit the labor force).

¹⁰⁰ See *supra* notes 12-14 and accompanying text (describing the trade-or-business requirement).

D. The Size of the Exclusion

Section 2033A determines the amount of the exclusion in a perverse manner. The maximum amount of the exclusion is \$1,300,000 less the applicable exclusion amount.¹⁰¹ The applicable exclusion amount, however, will increase from \$625,000 in 1998 to \$1,000,000 in 2006. Therefore, the maximum QFOB exclusion will decline by over fifty percent by 2006.¹⁰² Moreover, the operation of the five percent estate tax surcharge under section 2001(c)(2) eliminates the benefits of the QFOB exclusion for very large estates.¹⁰³

Explaining why Congress chose to reduce the benefit over time is difficult. Congress may have decided that business interests worth \$1,300,000 are the appropriate amount to exclude from estate taxes, but that a decedent should not be able to make any additional, nondeductible

¹⁰¹ See *supra* note 9 and accompanying text.

¹⁰² Furthermore, the decrease in the maximum QFOB exclusion is not properly coordinated with the increase in the applicable exclusion amount. This lack of coordination exists because the QFOB exclusion represents a tax benefit at the estate's highest marginal tax rates, while the applicable exclusion amount under section 2010 represents a benefit at the lowest marginal rates. A simple example illustrates the problem. Assume an estate consists solely of QFOB interests worth \$1,400,000. If the owner died in 1998, the applicable exclusion amount under section 2010(c) would be \$625,000, and the maximum QFOB exclusion would be \$675,000. The tax on the excess \$100,000 of value would be \$37,000. If the owner died in 2006, the applicable exclusion amount would be \$1,000,000, and the maximum QFOB exclusion would be \$300,000. Under these circumstances, however, the tax on the excess \$100,000 would be \$41,000. The difference in the two amounts of taxes is attributable to the loss of the QFOB exclusion benefit at the highest marginal rate, which is not fully offset by the increase in the applicable exclusion amount benefit at the lowest marginal rate. A technical correction bill has proposed a solution to this problem, but the cure appears to be worse than the disease: the bill would create a complicated system for determining the maximum QFOB exclusion, which would vary with the absolute size of the decedent's estate. See H.R. 2645, 105th Cong. § 6(b)(1)(1997).

¹⁰³ TRA 1997 modified section 2001(c)(2) to ensure that the 5% surcharge will offset the benefits of the applicable exclusion amount as that amount increases from 1998 to 2006. See I.R.C. § 2001(c)(2)(1994), amended by TRA 1997 § 501(a)(1)(D). The purpose of the surcharge is to cause large estates to be taxed at a flat rate of 55%. This offsets the advantages of both the lower marginal rates and the unified credit. The manner in which TRA 1997 amended section 2001(c)(2), however, ensures that the 5% surcharge will also offset any benefits of section 2033A.

transfers without generating taxes.¹⁰⁴ Yet, if interests in a family-run business represent unique assets, then any exclusion of their value should be in addition to the applicable exclusion amount. Thus, the maximum exclusion for QFOB interests should be a set amount that is indexed for inflation.¹⁰⁵

In the previous Part, we argued that the exclusion for family-run businesses should have a set and limited benefit. Section 2033A fails in this regard because its benefit is coordinated with the applicable exclusion amount and thus varies from year to year. Rather than have a benefit that is coordinated with the applicable exclusion amount, section 2033A should have a set benefit that is indexed to inflation. In addition, section 2001(c)(2) should be amended to ensure that the benefit is not reduced or eliminated for very large estates.

E. Treatment of Debt

The distinction between business and non-business debt is important in determining the size of the section 2033A exclusion. Business debt reduces the value of the business. The value of the business, in turn, establishes the maximum amount of the exclusion. This Section considers the propriety of further reducing the exclusion by certain non-business debt.

Section 2033A(a) limits the QFOB exclusion to the lesser of (1) the "adjusted value" of the QFOB interest or (2) the excess of \$1,300,000 over the applicable exclusion amount. Section 2033A(d) defines "adjusted value" as the estate tax value of the QFOB interest reduced by the amount of most of the decedent's debts, other than certain "qualified

¹⁰⁴ Congress may have used a decreasing exclusion to avoid future revenue loss. Indeed, by formulating section 2033A as it did, Congress could promote the legislation as a \$1,300,000 exclusion without losing the revenue that would be associated with a true exclusion of \$1,300,000.

¹⁰⁵ Alternatively, the exclusion could exclude a set amount and then a percentage of the value over that amount.

debts," such as mortgages on a residence.¹⁰⁶ Thus, the adjusted-value rule of section 2033A limits the amount that can be excluded to the value of the QFOB interest less the value of debts other than qualified debts. In effect, the adjusted-value rule attributes all debt, other than qualified debt, to the closely held business. As illustrated by the following example, the apparent purpose of this rule is to ensure that businesses operated as entities are treated in a similar manner as businesses operated as sole proprietorships.¹⁰⁷

Consider two taxpayers, *A* and *B*. Each is the sole owner of a trade or business that would satisfy the requirements of section 2033A. *A* operates his business as a sole proprietorship; *B* operates her business as a corporation. Each has made lifetime gifts equal to the applicable exclusion amount,¹⁰⁸ so that every asset of the estate other than those that are excluded under section 2033A will be subject to estate tax. Assume that each business comprises assets having a value of \$500,000. Each of *A* and *B* has non-business assets of \$150,000. *A* has a personal debt of \$110,000, which is deductible under section 2053(a)(4). *B*'s corporation has a corporate debt of \$100,000; the net value of *B*'s corporation (assets less liabilities) is therefore \$400,000. *B* has a personal debt of \$10,000, which is deductible under section 2053(a)(4).

¹⁰⁶ More specifically, section 2033A(d) defines the term "adjusted value" as the value for estate tax purposes (ignoring section 2033A) of the QFOB interest reduced by the excess of (1) amounts deductible as claims against the estate under section 2053(a)(3) or as indebtedness with respect to property included in the estate under section 2053(a)(4) over (2) certain types of indebtedness (referred to as "qualified debt" or "qualified indebtedness" in this discussion). Qualified indebtedness is indebtedness on a residence, the interest on which is deductible under section 163(h)(3), indebtedness incurred to pay certain educational and medical expenses, and other indebtedness not in excess of \$10,000. I.R.C. § 2033A(d).

¹⁰⁷ Another purpose of the rule may be to prevent an individual from borrowing money in anticipation of death to acquire a QFOB; in most cases, however, a business interest so acquired would fail to satisfy the pre-death material-participation requirement. See *supra* text accompanying note 26.

¹⁰⁸ This example also assumes that the lifetime gifts are not of such a type that they would cause the estate to fail to satisfy the 50% liquidity test under section 2033A(b)(1)(C). See *supra* Subsection II.A.3 (describing the liquidity test, which takes into account certain inter vivos transfers); see also *supra* notes 78-82 and accompanying text (advocating repeal of liquidity test).

In both *A* and *B*'s estates, the "adjusted value" of the QFOB interest will be \$400,000,¹⁰⁹ and the exclusion will therefore be limited to that amount. In each estate, the amount subject to estate tax will be \$140,000, calculated as follows:

	Taxpayer <i>A</i>	Taxpayer <i>B</i>
Business property	500,000	400,000
Non-business property	150,000	150,000
Assets includible in estate	650,000	550,000
Section 2033A exclusion	(400,000)	(400,000)
Section 2053(a)(4) deduction	(110,000)	(10,000)
Net estate	140,000	140,000

Thus, as a result of the adjusted-value limitation, both estates are entitled to the same exclusion, notwithstanding that the value of *B*'s business is \$100,000 less than the value of *A*'s business.

As this example illustrates, the adjusted-value limitation attributes all non-qualified debt to the QFOB, and the value of the QFOB is decreased accordingly. This rule is overly broad under certain circumstances. Suppose that *A* in the above example had incurred the \$110,000 debt in connection with acquiring rental real estate, which was his only non-QFOB asset. The real estate, worth \$150,000, secures the debt. Assuming that *A* dies in 1998, when the applicable exclusion amount (all of which has been consumed by *A*'s lifetime gifts) is \$625,000, the

¹⁰⁹ In *A*'s estate, this amount is determined by subtracting *A*'s non-qualified debt (\$100,000) from the value of the QFOB interest, disregarding section 2033A (\$500,000); in *B*'s estate, this amount is determined simply by reference to the value of the QFOB interest (\$400,000). See I.R.C. § 2033A(d). Note that this example assumes that *A* and *B* each have \$10,000 of qualified debt. See I.R.C. § 2033A(d)(2)(C). If all of *B*'s debt had been held by the corporation, the available exclusion would have been \$10,000 less. This would have increased *B*'s taxable estate by \$10,000.

\$140,000 portion of *A*'s estate that is subject to estate tax will generate a tax of \$52,100. If *A*'s executor wishes to avoid selling any of the QFOB interests, *A*'s executor must sell the rental real estate to pay estate taxes. After satisfying the secured debt, the remaining proceeds will be insufficient to satisfy the tax liability, which may force a partial liquidation of the QFOB interest. This problem does not occur in *B*'s estate, because non-qualified debt is not associated with the non-QFOB property. If the adjusted-value rule had not reduced the section 2033A exclusion in *A*'s estate, the amount of property subject to estate tax at *A*'s death would have been only \$40,000. This would have generated a tax of \$14,800; both the tax and the secured debt would have been covered by the value of the real estate. Under these circumstances, the adjusted-value limitation has improperly attributed all of *A*'s non-qualified debt to *A*'s business.

The adjusted-value limitation also produces disparate tax results depending on whether a taxpayer decides to finance business activities with borrowing or with existing resources. Suppose each of *C* and *D* (1) owns a corporation (a QFOB) with assets of \$400,000 and no debt, (2) has personal assets of \$200,000 and personal debt of \$10,000, and (3) wants to expand the corporation by \$150,000. *C* decides to borrow \$150,000, secured by her personal assets, and contributes the proceeds to her corporation. *D* contributes \$150,000 of her personal assets directly to her corporation, which then sells the assets to expand the business. Surprisingly, *C* and *D* are subjected to different estate tax treatments because of their different financing decisions. Both corporations have a value of \$550,000.¹¹⁰ Both decedents have a net estate of \$590,000.¹¹¹ Yet, the value of *C*'s QFOB interest is "adjusted" for the debt of \$150,000, whereas *D*'s interest is not adjusted. The QFOB exclusion for *C*'s estate will be \$400,000, whereas the exclusion for *D*'s estate will be \$550,000. This difference is improper because it results solely from different financing decisions.

¹¹⁰ The example assumes that the sale of assets by *D*'s corporation produced no capital gains.

¹¹¹ *C* has a \$550,000 corporation, \$200,000 in personal assets, and \$160,000 in debt (of which \$10,000 is qualified debt). *D* has a \$550,000 corporation, \$50,000 in personal assets, and \$10,000 in qualified debt.

One potential benefit of the adjusted-value rule is that it will prevent the owner of a business entity from liquidating before death and thereby obtaining a larger section 2033A exclusion.¹¹² If there were no adjusted-value limitation, the owner of a corporation could liquidate the corporation before death and potentially convert corporate debt (which reduces the value of the corporation) into personal debt.¹¹³ The risk that this transaction will occur, however, is slight. A business entity must typically satisfy the claims of all creditors before liquidating.¹¹⁴ Corporations often hold appreciated assets, and the shareholder¹¹⁵ and the corporation¹¹⁶ would realize capital gains upon liquidation. The limited liability and transfer tax valuation discounts associated with some business entities would further deter most tax-motivated liquidations.

A better adjusted-value rule would reduce the value of the QFOB only by debt directly attributable to the QFOB interest. The test for determining whether the debt was directly related could be whether the debt was secured by QFOB assets.¹¹⁷ To the extent that the debt was secured by non-business assets or was unsecured, the debt would not reduce the amount of the QFOB exclusion. This approach would have several advantages. First, it would treat loans secured by non-business assets as

¹¹² If a shareholder could accomplish this transaction, it might indicate that the business assets are no longer responsible for paying the debt. That is to say, the liquidation may shift responsibility for payment of the debt away from the business assets. Cf. *infra* notes 117-18 and accompanying text (proposing that debts be attributed to the assets by which they are secured).

¹¹³ To illustrate, consider *B* from an earlier example. See *supra* text accompanying notes 108-09. If *B* liquidated *B*'s corporation, after the liquidation, *B* would own QFOB assets of \$500,000, other assets of \$150,000, and deductible debt of \$110,000. Without the adjusted-value limitation, *B*'s estate would pay taxes on a net taxable estate of \$40,000, rather than \$140,000 (the result if the business had been kept in corporate form).

¹¹⁴ See, e.g., VA. CODE ANN. § 13.1-746 (Michie 1993) (establishing a procedure by which a Virginia corporation satisfies all known claims before liquidating).

¹¹⁵ See I.R.C. § 331(a)(1)(1994).

¹¹⁶ See I.R.C. § 336(a)(1994).

¹¹⁷ This rule does have the potential for giving a mild preference to proprietorships. Unsecured debt that is directly attributable to a proprietorship (for example, accounts payable) would not reduce the value of the proprietorship, whereas similar unsecured debt attributable to a corporation would reduce the value for purposes of the exclusion. If the proprietor discharged the debt with personal assets, however, this difference in treatment would be appropriate.

being equivalent to a contribution of additional property to the business. This would help to avoid the liquidity problem described earlier and would also ensure that a person who liquidates a non-business asset and adds the proceeds to the QFOB would be treated the same as the person who pledges non-business assets and contributes the loan proceeds to the QFOB. Second, this approach would provide a bright-line test for determining whether a loan is properly attributable to the business. If the loan is secured by business property, it reduces the value of the business in a real sense. Finally, this approach would simplify the adjusted-value limitation, by taking into account only debt secured by business property.¹¹⁸

By attributing most of the decedent's debt to the family-run business, section 2033A creates inconsistencies in setting the value of the exclusion. First, debt attributable to personal assets is deemed business debt under section 2033A. Second, the debt attribution rule creates different results based on how business owners finance business expansion. The best solution to this problem is to attribute debt to the business only when secured by business assets.

F. Material Participation

1. *Participation After Decedent's Death*

Requiring work effort by heirs after the decedent's death is central to a practical estate-tax exclusion for family-run businesses.¹¹⁹ As discussed in Part IV, participation by heirs should be part of the definition of a family-run business that qualifies for an estate-tax exclusion. Without this requirement, the heirs could sell their interest or passively operate the business and thereby fail to satisfy the goal of promoting productive activities.

¹¹⁸ One example of simplification is that the change would eliminate the difficult tracing requirement of section 2033A(d)(2)(B), which requires the taxpayer to establish that "the proceeds of . . . indebtedness were used for the payment of educational and medical expenses of the decedent, the decedent's spouse, or the decedent's dependents (within the meaning of section 152)."

¹¹⁹ See *supra* text accompanying note 72.

Section 2033A contains such a mechanism in its recapture provisions. If the heirs fail to participate materially in the trade or business, the estate taxes saved from the exclusion are subject to recapture. This requirement ensures that section 2033A principally benefits heirs who will work in their inherited business.

Material participation is a tax euphemism for work. Section 2033A defines material participation by reference to the material participation rules under section 2032A.¹²⁰ The regulations under section 2032A provide that "[a]ctual employment . . . on a substantially full-time basis (35 hours a week or more) or to any lesser extent necessary personally to manage fully the farm or business . . . constitutes material participation."¹²¹ This level of participation is sufficient under section 2032A, but is not necessary. At a minimum, a material participant will "regularly advise or consult with the other managing partner on the operation of the business."¹²² The participant must participate in a significant number of management decisions, inspect production activities regularly, and assume some financial responsibility for the business.¹²³ If an entity owns the business, section 2032A prescribes a somewhat formal arrangement for participation.¹²⁴ Nominal status as a manager, director, or fiduciary, without more, does not constitute material participation.¹²⁵

To avoid recapture of estate tax savings, qualified heirs¹²⁶ and their families must materially participate. With respect to an interest held by a qualified heir, material participation fails to occur if neither the qualified heir nor any member of the heir's family materially participates in the trade or business. Recapture occurs if there is insufficient material

¹²⁰ See I.R.C. § 2033A(f)(1)(A) (incorporating the material-participation test under section 2032A(c)(6)(B)).

¹²¹ Treas. Reg. § 20.2032A-3(e)(1)(1997).

¹²² See Treas. Reg. § 20.2032A-3(e)(2)(1997).

¹²³ See *id.*

¹²⁴ See Treas. Reg. § 20.2032A-3(f)(1)(1997).

¹²⁵ See Treas. Reg. § 20.2032A-3(f)(2)(1997).

¹²⁶ See I.R.C. §§ 2033A(i)(2); 2032A(e)(2)(1994) (describing qualified heirs as members of the decedent's family and certain long-term employees of the trade or business).

participation during the ten-year period following the decedent's death.¹²⁷

Ideally, the exclusion would require participation from every recipient of a QFOB interest rather than allowing a family member to participate on behalf of the participant. Instead, section 2033A does allow a family member to participate for the heir. If a decedent leaves an interest qualifying for the exclusion to, for example, three children, only one child must materially participate to avoid recapture.

Requiring participation by all heirs would be unworkable under the current structure of section 2033A. It would encourage business owners to give interests to likely nonparticipants during life—to avoid their being treated as "heirs"—and leave interests to likely participants at death. Requiring participation by all heirs might be workable if the exclusion varied directly with the number of heirs. That is, the provision could allow a decedent to exclude, for every heir, qualifying interests passing to the heir subject to some maximum limit. Such a rule, however, would need to trigger recapture upon any disposition to a family member. Otherwise, heirs who did not want to participate could sell their interests to a family member (*e.g.*, a sibling) who does participate, while generating a larger exclusion than if the decedent had simply left the entire interest to the participating heir. Additionally, such a rule would be unfair because it would favor estates of prolific decedents. Thus, although varying the benefit with the number of participating heirs might further the goal of promoting the heirs' work efforts, such a rule is probably politically impractical.

Hence the material-participation test under section 2033A (as adapted from section 2032A) works some compromises. To discourage unwieldy

¹²⁷ As discussed above, the decedent or the decedent's family must have materially participated in the business before the decedent's death for the estate to qualify for the exclusion. *See supra* note 26 and accompanying text. Additionally, whether or not taxes are recaptured depends upon pre-death and post-death participation. During any eight year period ending after the decedent's death, there may not be periods aggregating three years during which material participation fails to occur. Material participation fails to occur during the decedent's life if neither the decedent nor any member of the decedent's family materially participates. Material participation fails to occur after the decedent's death if neither the qualified heir nor any member of the qualified heir's family materially participates. *See* I.R.C. § 2032A(c)(6)(B)(1994).

planning, it allows any family member of an heir to participate on behalf of the heir. It also grants the same benefit, regardless of the number of participating heirs, to avoid unfair discrimination of estates with few heirs. Thus, these material-participation requirements comport with the structure of a practical exclusion proposed in Part IV.

2. *Participation Before Decedent's Death*

Requiring participation before the decedent's death is not directly related to the description of a family-run business proposed above. Following this description, a practical exclusion for family-run businesses requires participation by the heirs, and it also requires a limitation on the transfer of passive assets. The exclusion does not, however, mandate participation by the decedent or the decedent's family before the decedent's death. As explained in this Subsection, requiring pre-death material participation may distort the expected benefit of the exclusion,¹²⁸ which in turn increases planning costs. Nevertheless, as this Subsection further explains, requiring pre-death participation may be necessary to ensure that qualifying for the exclusion is not too easy, which would encourage excess investments.

Section 2033A in its present form requires material participation before the decedent's death. The decedent or the decedent's family must have participated in the business for five of eight years before the decedent's death.¹²⁹ Congress may have thought that requiring no pre-death participation would have made a family-run business too attractive for tax planning. That is, not requiring pre-death participation might encourage excess investment in family-run businesses.

As described above, this Article argues that section 2033A should not contain a liquidity test.¹³⁰ If the family-run business exclusion does not

¹²⁸ See *infra* note 135 and accompanying text (observing that the rule unfairly disqualifies estates of decedents who die prematurely).

¹²⁹ See I.R.C. § 2033A(b)(1)(D); see also *supra* note 127 (describing how the recapture provisions measure pre-death participation in addition to post-death participation).

¹³⁰ See *supra* Section V.B.

contain the liquidity test, then the pre-death material-participation requirement is probably necessary to prevent abuse. Suppose that the exclusion contained no liquidity test or pre-death participation requirement. Under such a rule, an individual could invest in a business¹³¹ that employs the individual's child, leave the business interest to the child, and obtain a tax benefit under the exclusion if the child continues to work in the business. The absence of a liquidity test increases the viability of this technique, because in order to obtain the benefits of the exclusion, the individual is not compelled to invest a substantial portion of his or her assets in the business. Retaining the pre-death material participation requirement would increase the stakes of the individual's investment, because the exclusion would be available only if the decedent had survived for at least five years and only if the child had continued to work for the employer during that period.¹³² This would, in turn, decrease the likelihood that the investment was for purely tax-avoidance purposes. Retaining the pre-death participation requirement thus makes qualifying for the exclusion more difficult, which should curb excess, tax-motivated investments in closely held businesses.

Preventing this technique and its undesired results would have costs. The exclusion should operate to restore investments in family-run businesses that were discouraged by reason of the estate tax.¹³³ The exclusion necessarily encourages both types of investments,¹³⁴ but requiring pre-death participation also discourages both types of investments. Requiring pre-death participation also distorts the expected benefit

¹³¹ The rule denying the exclusion for publicly traded business interests is a substantial impediment to this planning technique. *See supra* notes 91-93 and accompanying text (discussing the prohibition on extending the exclusion to publicly traded corporations and arguing that the prohibition should be retained). As a practical matter, if the child's employer is closely held, it will be difficult for the individual to acquire an interest in the employer, unless the child already holds a controlling interest.

¹³² *See* I.R.C. § 2033A(b)(1)(D); *see also supra* note 26 and accompanying text (noting that the pre-death material-participation requirement may be satisfied by a member of the decedent's family).

¹³³ *See supra* note 74 and accompanying text (describing restoration of discouraged investments as one reason to have a family-run business exclusion).

¹³⁴ Above, we identified two types of investments that the exclusion would encourage: investments that would have been made absent any estate or gift tax (restored investment) and investments that would not have been made absent any estate or gift tax (excess investment). *See supra* Section IV.B.

of the exclusion indirectly. If a new business owner dies within five years of making the investment, the estate will receive no benefit.¹³⁵ Yet, if the owner lives for five years and participates until death, the estate will receive a benefit. Thus, the benefit of the exclusion is tied to an external variable: the timing of the decedent's death.¹³⁶ This creates uncertainty, and as we earlier observed, uncertainty about the availability of the exclusion increases planning costs.¹³⁷

In summary, requiring pre-death participation is probably necessary to prevent abuse, especially if Congress abandons the liquidity test. Preventing this abuse, however, weakens the exclusion and is not without costs. First, requiring pre-death material participation will make the exclusion unavailable to some active businesses in which the heirs will participate. Second, tying the availability of the benefit to the time of the decedent's death distorts the expected benefit from the exclusion.

G. Application to Gifts

The estate and gift tax is a unified system, which taxes gratuitous transfers of wealth.¹³⁸ Transfers at death and during life are substantially similar, and should thus receive similar treatment under the estate and gift tax.¹³⁹ Yet, extending the section 2033A exclusion to gifts would generate considerable complexity. Thus, the family-run business exclusion should apply only to transfers at death.

Section 2033A applies only to transfers at death, and extending it to gifts would be virtually impossible. The liquidity test of section 2033A requires the estate to value all its assets and determine whether the family-owned business interests constitute fifty percent of the gross estate, once

¹³⁵ Compare this result with the result if the qualified heir dies before the expiration of the 10-year post-death material-participation period; in the latter case, the material participation requirement is forgiven. See I.R.C. §2033A(f)(1).

¹³⁶ Cf. *supra* Section V.D (arguing that the benefit should not be tied to the applicable exclusion amount).

¹³⁷ See *supra* note 71 and accompanying text.

¹³⁸ See Chason & Danforth, *supra* note 1, at 107-10.

¹³⁹ But cf. *id.* (discussing distinctions between the estate and gift taxes).

both amounts are adjusted for debts and prior gifts.¹⁴⁰ This process is not unduly cumbersome for the decedent's estate because the estate must value its assets in order to determine its estate tax liability. The gift tax does not, however, require such a comprehensive process of valuation. Rather, the gift tax requires the donor to value only the assets transferred and any prior taxable gifts.

Yet, the government could not extend the exclusion to gifts and abandon the liquidity test only for gifts. Abandoning the liquidity test for gift tax purposes while retaining it for estate tax purposes would allow business owners to avoid the test by making transfers during life. Applying the liquidity test to inter vivos transfers would, however, create an enormous administrative burden on the taxpayer and the government.¹⁴¹ Thus, the current version of section 2033A should not extend to gifts.

Even if the liquidity test were not part of section 2033A, the family-owned business exclusion should not apply to gifts. Section 2033A requires the recipient of a QFOB interest to participate in the business for ten years after the decedent's death.¹⁴² Extending the family-owned business exclusion to gifts would create enormous administrative burdens in measuring the material-participation test. For example, a donor who makes a series of small gifts to many children over several years would subject both his children and the government to a web of multiple material-participation tests, each one applying to only one specific gift.

The fact that the family-owned business exclusion does not (and should not) extend to gifts is not too troublesome. A business owner could give some interests in the family-run business during life, while retaining enough interests to take advantage of the exclusion at death. A business owner could also retain sufficient control over any gifts to ensure

¹⁴⁰ See *supra* notes 28-34 and accompanying text.

¹⁴¹ Some might argue that a taxpayer who is willing to take on this burden should be allowed to do so. Even so, the government still must monitor the taxpayer and determine whether the taxpayer has valued all assets properly.

¹⁴² See *supra* notes 40-42 and accompanying text.

inclusion in the estate.¹⁴³ Furthermore, but for the tax savings that gifts may produce,¹⁴⁴ most business owners would probably prefer making transfers at death rather than during life.

In the absence of administrative costs, the family-owned business exclusion should apply to gifts. But, administrative costs from extending the exclusion to gifts would be prohibitive. Section 2033A contains a liquidity test, which requires a valuation of all assets of the estate. Requiring a business owner to value all of his or her assets upon making a gift would generate exorbitant costs for the owner and the government. Even without the liquidity test, the ongoing material-participation requirements would be too costly for the government and taxpayers to administer. Because an extension to gifts would generate too much complexity, the family-owned business exclusion should apply only to transfers at death.

H. Income Tax Basis of Excluded Property

The basis of property acquired from a decedent is generally "the fair market value of the property at the date of the decedent's death."¹⁴⁵ Before TRA 1997,¹⁴⁶ section 1014 established two specific exceptions to this rule. One exception was for property subject to an alternate valuation date election under section 2032.¹⁴⁷ The other exception was for property subject to a special use valuation election under section 2032A.¹⁴⁸ In both cases the property receives a basis equal to the value reported for estate tax purposes.

¹⁴³ See I.R.C. § 2035 (1994), *amended by* TRA 1997 § 1310(a); I.R.C. §§ 2036-2038 (1994); *see also* Treas. Reg. § 25.2511-2 (stating that a gift will not generate taxes until the donor relinquishes dominion and control over the property).

¹⁴⁴ See Chason & Danforth, *supra* note 1, at 110 & n.50.

¹⁴⁵ I.R.C. § 1014(a)(1)(1994), *amended by* TRA 1997 § 508(b). Because the fair market value of property at a decedent's death usually exceeds the decedent's basis, the section 1014 adjustment is commonly referred to as the basis "step up."

¹⁴⁶ See *infra* note 151 and accompanying text (discussing new section 1014(a)(4)).

¹⁴⁷ See I.R.C. § 1014(a)(2)(1994); *see also* I.R.C. § 2032(1994) (permitting an estate under certain circumstances to elect to value estate assets as of 6 months after the decedent's death).

¹⁴⁸ I.R.C. § 1014(a)(3).

TRA 1997 did not expressly modify section 1014 to provide an exception for a QFOB interest excluded under section 2033A; based on the following analysis, it appears that this omission was intentional. Section 1014(a) refers to the "fair market value" of property received from a decedent at the date of the decedent's death. The reference to fair market value suggests that a section 2033A election should not affect the usual basis adjustment rule, because a section 2033A election does not affect the value of the property. Section 1014(a) establishes two specific exceptions to this general rule, both of which deny a date-of-death fair market value basis if estate taxes have been calculated based on some other value.¹⁴⁹ The existence of these exceptions and the fact that TRA 1997 did not expressly create an additional exception for QFOB interests suggest that the section 2033A exclusion was not intended to alter the normal fair market value basis rule for closely held business property.¹⁵⁰ Moreover, Congress expressly modified section 1014 with respect to the exclusion from estate taxes for certain real property subject to qualified

¹⁴⁹ See *supra* notes 147-48 and accompanying text (discussing section 1014(a)(2), (3)).

¹⁵⁰ The language of the section 1014 regulations lends some credibility to a contrary view, *i.e.*, that the basis step up should be denied for property excluded under section 2033A. Treasury Regulations section 1.1014-1(a)(1997) states that the purpose of section 1014 is "to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax." Treasury Regulations § 1.1014-2(b)(1)(1997) suggests that a condition for property to receive the benefits of section 1014 is that it be "includible in the decedent's gross estate." One could reasonably deduce from these provisions that section 2033A property should not receive a section 1014 basis adjustment at death because, as a result of the QFOB exclusion, the "value" of the property is disregarded for estate tax purposes and is not "includible" in the gross estate. See I.R.C. § 2033A(a) (stating that the "value of the gross estate *shall not include* . . . the adjusted value of the qualified family-owned business interests," subject to a maximum dollar exclusion amount (emphasis added)); I.R.C. § 2033A(b)(2) (stating that "qualified family-owned business interests . . . are the interests which . . . are *included* in determining the value of the gross estate (*without regard to this section*)" (emphasis added)). Another reasonable interpretation, however, is that the references in the regulations to "value" for estate tax purposes and to "inclusion" in the gross estate are merely shorthand for implementing the general statutory rule that the basis for property received from a decedent be adjusted to its fair market value as of the date of death. This interpretation comports with a literal reading of section 1014(a). Thus, it is probably the better view.

conservation easements, which was added by TRA 1997.¹⁵¹ The Department of Treasury has announced informally that it will take the position that a section 2033A election does not prevent a basis adjustment under section 1014.¹⁵² Accordingly, under current law, an election to exclude property under section 2033A apparently does not prevent a basis step up under section 1014(a).

As observed earlier in this Article, encouraging productive behavior by the recipients of wealth justifies an estate tax exclusion for closely held businesses in which the recipients materially participate. Because the post-death basis of property determines future income tax liability, basis rules indirectly affect the value of the QFOB exclusion. Denying a section 1014 basis adjustment for estates that take advantage of the exclusion would penalize those estates by reducing the value of their exclusions. If Congress wishes to reduce the value of the exclusion it should do so directly by limiting the amount of the exclusion and should not do so indirectly by denying a basis adjustment for those estates that elect section 2033A treatment. Moreover, if property subject to the exclusion did not receive a basis equal to fair market value at the decedent's death, then the benefit of the exclusion would vary with the basis of the business property: the exclusion would be more beneficial to estates with high basis property than to estates with low basis property if excluded assets received a carryover basis. A failure to grant a basis step up to excluded property would thus distort the benefit of the exclusion on a basis unrelated to its purpose.¹⁵³ Denying a section 1014 basis adjustment for QFOB interests would further disadvantage the recipients of those interests by creating liquidity problems associated with the property

¹⁵¹ TRA 1997 § 508(b), 111 Stat. 860 (1997) (codified at I.R.C. § 1014(a)(4)) (denying the basis step up for such excluded property).

¹⁵² See *Treasury Official Clarifies Family-Owned Business Estate Tax Exclusion*, Tax Day(CCH) (Sept. 26, 1997)(reporting speech by Beth Kaufman, attorney-advisor with the Department of Treasury's Office of Legislative Counsel).

¹⁵³ We do not mean to endorse the basis step up rule of section 1014(a) as a general proposition. See Chason & Danforth, *supra* note 1, at 123-25. Rather, we mean that its general application (whether or not proper) should remain with respect to any family-run business exclusion, and that it would be improper for the benefit to be denied to QFOB interests while granted to other assets owned by the decedent.

having built-in capital gains.¹⁵⁴ Accordingly, Congress acted properly when it chose not to modify section 1014 with respect to assets excluded under section 2033A. To avoid any question about its intent, however, Congress should make this result explicit through a technical amendment to section 2033A.

Although there are arguments to the contrary, we find none persuasive. One argument in favor of the current system of adjusting the basis of property at death is that the stepped-up basis is "paid for" by the estate tax on the appreciation.¹⁵⁵ A logical corollary to this argument would be to deny the basis step up if the appreciation is not subject to estate taxes. The fallacy of this argument is that the premise is not applied consistently—the basis step up is not always "paid for" by estate taxes, because the step up occurs even for those estates that pay no estate taxes due to the section 2010 unified credit or the section 2056 estate tax marital deduction. Denying a basis adjustment in the case of a section 2033A election would create an unjustifiable inconsistency: smaller closely held businesses (those whose estate tax burden is fully sheltered by the section 2010 unified credit) and those businesses passing at death to surviving spouses would receive the benefit of the section 1014 basis adjustment, while other business interests (those for which the section 2033A election was made) would not.

Another argument in favor of denying a basis step up for section 2033A interests is based on an analogy to section 2032A. As noted

¹⁵⁴ A rule requiring the recipients of QFOB interests to take the decedent's basis would also introduce further complexity into a statute that is already intolerably complex. For example, the decedent's basis would presumably need to be allocated among all of the QFOB assets, notwithstanding that a portion of those assets did not qualify for the section 2033A exclusion due to the dollar limitation of section 2033A(a). To the extent that all of the QFOB assets were not excluded under section 2033A(a), a portion of the assets would likely be subject to estate taxes, which would necessitate a basis adjustment for the estate taxes payable. See Chason & Danforth, *supra* note 1, at 124 & nn.121-23 (observing that this adjustment is necessary to make the consequences of carryover basis consistent with the tax results of selling appreciated property before death). Moreover, a carryover basis rule would require that an adjustment to basis be made in the event that estate taxes are recaptured under section 2033A(f). Cf. *infra* note 157 (discussing the basis adjustment rules in the event of recapture under section 2032A).

¹⁵⁵ See Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 364 (1993)(observing that this view is subject to logical inconsistencies and other problems).

earlier, section 2033A is modeled to a significant degree on section 2032A.¹⁵⁶ Under section 1014(a)(3), if an estate makes a special use election, the income tax basis for the property is determined by its value under section 2032A.¹⁵⁷ One could argue, therefore, that there should similarly be no basis adjustment for property excluded under section 2033A. This argument fails to take into account, however, an important distinction between the two provisions. Section 2032A, unlike section 2033A, reflects the judgment of Congress that special use property should be treated as having a value less than its fair market value, because of the use to which the property was put during the deceased owner's lifetime and because the heirs of the property commit to maintaining that use during a significant post-mortem period. If the property is accurately valued based on its qualified use, then there is no reason to give it an income tax basis that is higher than that value. On the other hand, section 2033A reflects the judgment of Congress that the value represented by closely held businesses should not be subject to estate taxes, not that those businesses have less value than other assets. It would be unfair to penalize such interests by imposing on them a basis less than their value, when the same is not done for other assets of the estate.

I. Summary

Section 2033A, in its present form, fails as a practical exclusion for family-run businesses. Its liquidity tests extend the exclusion only to illiquid estates, thereby denying the benefit to certain active businesses that should qualify for the exclusion because they will be run by the heirs. Its benefit decreases yearly as the applicable exclusion amount increases. This lack of an ascertainable benefit makes it difficult for business owners (and potential business owners) to ascertain the benefit of the exclusion.

¹⁵⁶ See *supra* note 12 and accompanying text.

¹⁵⁷ Under section 1016(c), if an additional estate tax is recaptured under section 2032A(c)(1) due to a disposition of the special use property or a cessation of its qualified use, the qualified heir of the special use property may elect to adjust the basis of the property to its fair market value as of the decedent's death. The cost of this adjustment is that the qualified heir must pay interest on the estate taxes that were, in effect, deferred during the period in which the special use election was in effect. I.R.C. § 1016(c)(5)(B)(1994).

Finally, section 2033A requires material participation before the decedent's death, preventing abusive transactions but discouraging potential investors in family-run businesses from relying on the exclusion.

Section 2033A does have some practical elements. It requires the heirs of a family-run business to participate in the business. It reduces complexity by not applying the exclusion to gifts. And, it does not distort the benefit of the exclusion by requiring a carryover basis for excluded assets. These features of present section 2033A should be retained in any future version.

VI. CONCLUSION AND PROPOSALS FOR REFORM

Section 2033A, in its current state, is too complicated because of the fifty-percent liquidity test. In addition, the liquidity test needlessly denies the benefit of the exclusion to true family-run businesses. The problems with section 2033A extend beyond its needless requirement that a qualifying estate must be illiquid. For example, the benefit of the exclusion decreases over time as the unified credit increases.

Even with its enormous complexity, however, section 2033A contains the core elements of a practical exclusion for family-run businesses. It grants an exclusion only for a trade or business. It requires the beneficiaries to participate in the trade or business after the decedent's death. And, it reduces the value of the business to the extent the business holds passive assets beyond needs for working capital.

By eliminating or modifying certain provisions and retaining others, Congress could create a workable exclusion. Based upon the analysis in this Article, we offer the following suggestions:

(1) Congress should eliminate the fifty-percent liquidity test. The liquidity test is the most complicated part of the statute. Moreover, it too narrowly restricts the benefits under section 2033A.

(2) Congress should eliminate the concentration-of-ownership test. This test does not serve any meaningful goal of section 2033A, and its retention would unfairly deny the exclusion to some family-run busi-

nesses. Moreover, retaining the test would distort business owners' decisions about how best to structure business ownership.

(3) The requirement that the business not be publicly traded may distort the definition of a family-run business in certain cases, but retaining this requirement is probably harmless. Indeed, the requirement may be necessary to prevent abuse if section 2033A is liberalized.

(4) Congress should provide a fixed benefit that is indexed to inflation. In its present form, the benefit under section 2033A depends upon the size of the applicable exclusion amount. Because interests in a family-run business represent unique assets, the exclusion should be in addition to the applicable exclusion amount. Thus, a fixed amount (perhaps \$500,000 to \$1,000,000) indexed to inflation would be appropriate. Congress should amend section 2001(c)(2) so that the benefit of the exclusion is not denied to large estates.

(5) Congress should amend the adjusted-value rule of section 2033A(d) to provide for a reduction in the amount of the exclusion only for debt secured by QFOB property. This change would provide a bright-line test for identifying debt that is properly attributable to the business, and it would eliminate the disparate treatment of taxpayers who choose different methods of financing business expansion.

(6) Congress should probably retain the pre-death material-participation requirement. The requirement distorts the expected benefit of the exclusion by tying its availability to the timing of the decedent's death. Nonetheless, the pre-death material-participation requirement is probably necessary to prevent abusive transactions.

(7) Congress should retain the trade or business requirement, the post-death material-participation test, and the exclusion for passive assets. These three features sufficiently limit the section 2033A exclusion to true businesses in which a successive generation will participate.

(8) Congress should retain the rule denying the QFOB exclusion to lifetime transfers. Extending the exclusion to gifts would generate inordinate complexity and associated costs for both taxpayers and the government.

(9) Congress should retain the section 1014(a) basis adjustment rule for section 2033A property, but should modify section 2033A to make its intent clear. Adjusting the basis for section 2033A property under section 1014(a) would ensure that the estate-tax benefits of section 2033A are not undermined by any income-tax detriments.

To conclude, section 2033A in its present form is too complicated and is unworkable. Most importantly, it needlessly requires that the estate be illiquid before granting a benefit, and it provides a haphazard benefit that depends upon the size of the applicable exclusion amount. Although section 2033A has certain features that should be retained, Congress should revisit section 2033A, simplify it, and improve it in the manner suggested in the Article.