T.C. Memo. 2007-107

For purposes of the qualified family-owned business interest (QFOBI) deduction's 50% liquidity test, the term "interest in an entity" carrying on a trade or business, as it applies to corporations and partnerships, is limited to equity ownership interests and does not include debt instruments such as loans made by the decedent to the family-owned business.

Summary

The Tax Court in *Farnam v. Commissioner* addressed whether promissory notes, representing loans made by the decedents to their family-owned corporation, constituted "interests" in the corporation for purposes of meeting the 50-percent liquidity test required to qualify for the qualified family-owned business interest (QFOBI) deduction under Section 2057 of the Internal Revenue Code. The court held that the term "interest" as used in Section 2057(e)(1)(B) is limited to equity ownership interests, such as stock or partnership capital interests, and does not encompass debt instruments. Therefore, the decedents' loan notes were not considered qualified family-owned business interests, and the estates did not meet the 50% liquidity test.

Facts

Duane and Lois Farnam owned and managed Farnam Genuine Parts, Inc. (FGP). Over many years, the Farnams and related family entities lent funds to FGP, receiving promissory notes (FGP notes) in return. These notes were unsecured and subordinate to outside creditors. The Farnams formed limited partnerships (Duane LP and Lois LP) and contributed their ownership interests in buildings and some FGP notes to these partnerships, which then leased buildings to FGP. Upon their deaths, the Farnam estates included the FGP stock and notes in their gross estates and claimed QFOBI deductions. The IRS disallowed the deductions, arguing that the FGP notes should not be treated as qualified family-owned business interests for the 50% liquidity test.

Procedural History

The estates of Duane and Lois Farnam filed Federal estate tax returns claiming QFOBI deductions. The IRS issued notices of deficiency, disallowing the claimed deductions. The estates petitioned the Tax Court for redetermination. The case was submitted fully stipulated to the Tax Court under Rule 122.

Issue(s)

1. Whether, for purposes of the liquidity test of section 2057(b)(1)(C), loans made by decedents to their family-owned corporation, evidenced by promissory notes, are to be treated as "interests" in the corporation and thus qualify as qualified family-owned business interests (QFOBIs).

Holding

1. No, loans made by the decedents to their family-owned corporation, represented by the FGP notes, are not considered “interests” in the corporation for the QFOBI liquidity test. Therefore, the FGP notes do not qualify as QFOBIs for the purpose of the 50% liquidity test under section 2057(b)(1)(C) because the term “interest in an entity” under section 2057(e)(1)(B) is limited to equity ownership interests.

Court’s Reasoning

The Tax Court focused on the statutory language of Section 2057. The court noted that while Section 2057(e)(1)(B) refers broadly to “an interest in an entity,” other parts of Section 2057 use language that connotes equity ownership. Specifically, Section 2057(e)(1)(A) defines QFOBI for sole proprietorships as “an interest as a proprietor,” explicitly limiting it to equity. Furthermore, Section 2057(e)(3)(A) provides rules for determining ownership in corporations and partnerships based on holding “stock” or “capital interest.” The court reasoned that the absence of explicit limitation in 2057(e)(1)(B) does not imply a broader meaning to include debt. Instead, the court interpreted “interest in an entity” in 2057(e)(1)(B) to be contextually limited by the immediately following clauses, which emphasize family “ownership” and are calculated based on stock or capital interests. The court stated, “As we read the statute, the ‘interest in an entity’ language of section 2057(e)(1)(B) encompasses, or embraces, or is limited to, only the type of interests (i.e., to equity ownership interests) that is described in the rest of the very same sentence (i.e., in the immediately following clauses of section 2057(e)(1)(B)).” The court acknowledged the legislative history and arguments regarding the purpose of Section 2057 to protect family businesses but ultimately found the statutory language and structure to be more persuasive in limiting “interest” to equity ownership. The court distinguished Section 6166, which explicitly uses terms like “interest as a proprietor,” “interest as a partner,” and “stock” to define interests in closely held businesses for estate tax deferral, but did not find this distinction compelling enough to broaden the definition of “interest” in Section 2057 beyond equity.

Practical Implications

Farnam v. Commissioner clarifies that for the QFOBI deduction liquidity test, family business owners cannot count loans they have made to their businesses as part of their qualifying business interests. This decision narrows the scope of what constitutes a QFOBI for the 50% liquidity test, particularly impacting family businesses financed partly through shareholder loans. Estate planners must advise clients that to maximize the QFOBI deduction, a greater portion of the family business’s value within the estate should be in the form of equity rather than debt. This case highlights the importance of structuring family business ownership to meet the specific requirements of tax benefits like the QFOBI deduction and underscores that tax deductions are narrowly construed. Future cases involving the QFOBI deduction will likely adhere to this interpretation, focusing on equity ownership when assessing the liquidity test for corporations and partnerships.