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Person To Contact:  
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Telephone Number:

Refer Reply To:  
CC:PSI:B04 – PLR-142946-10  
Date: April 6, 2011

Re:

Legend:

- Decedent =
- Child 1 =
- Child 2 =
- Child 3 =
- Child 4 =
- Grandchild =
- 1
- Grandchild =
- 2
- Grandchild =
- 3
- Grandchild =
- 4
- Grandchild =
- 5
- Grandchild =
- 6
- Grandchild =
- 7
- Grandchild =
- 8
- Trust 1 =
- Trust 2 =
- Trust 3 =
- Date 1 =
- Partnership =
- Date 2 =
- Spouse 1 =

Spouse 2 =  
 Spouse 3 =  
 Spouse 4 =  
 Partner 1 =  
 Partner 2 =  
 Partner 3 =  
 Partner 4 =  
 Partner 5 =  
 Partner 6 =  
 Partner 7 =  
 Partner 8 =  
 Partner 9 =  
 Partner 10 =  
y =  
 State =  
 Year 12 =  
 Year 18 =  
 Year 19 =  
 Date 2 =  
 Date 3 =  
y =  
 Year 1 =

Dear \_\_\_\_\_ :

This letter responds to the letter dated October 13, 2010, and subsequent correspondence, submitted by your authorized representative, requesting rulings under § 2032A of the Internal Revenue Code with respect to the proposed transfer of farmland held in trust for a qualified heir to a limited liability company (LLC) and the subsequent lease of that farmland by the LLC to a partnership.

The facts and representations submitted are summarized as follows:

Prior to his death, Decedent, a United States citizen, owned and farmed land, Farm, located in State, United States. On Date 1, Decedent entered into a lease, Lease, with a general partnership, Partnership, in which Decedent agreed to lease Farm for the Year 12 through Year 19 crop years to Partnership. In exchange, Partnership agreed to pay Decedent \$y. During the lease term, Partnership conducted farming operations on Farm. It is represented that during this period, Decedent actively and materially participated in the farming operation on Farm. Decedent died in Year 18 of the lease.

Decedent died on Date 2, survived by four children, Child 1, Child 2, Child 3, and Child 4. Child 1 and his spouse, Spouse 1, have two children, Grandchild 1 and Grandchild 2. Child 2 and his spouse, Spouse 2, have three children, Grandchild 3, Grandchild 4, and Grandchild 5. Child 3 and his spouse, Spouse 3, have three children, Grandchild 6, Grandchild 7, and Grandchild 8. Child 4 is married to Spouse 4.

Under Item VII of Decedent's will, Decedent bequeathed the residue of his estate to his children outright, in substantially equal shares, to be divided among them as they agree, or in the absence of such agreement, as his executor may determine. The residue of Decedent's estate included Farm. Item VII further provides that if any child does not survive Decedent, then Decedent bequeaths that deceased child's share of the residue to a separate trust for the then living children of the deceased child, Decedent's grandchildren. Under Item VII(A), the trustee of each separate trust shall pay the beneficiary grandchildren as much of the net income of the trust, as the trustee, in the trustee's discretion, deems advisable for the education, support, maintenance, and health of those grandchildren. Any income not distributed shall be added to principal. Item VII(B) provides that the trustee, in the trustee's discretion, may distribute principal for the education, support, maintenance, and health of each beneficiary grandchild. Under Item VII(C), one-half of the assets of each separate trust will be distributed to the beneficiary grandchildren in shares as equal as the trustee can attain. Each share will be distributed to a beneficiary grandchild upon reaching age 21, or, if a grandchild dies before reaching that age, to the then living descendants of the deceased grandchild. The remaining assets of each separate trust will be distributed in equal shares to the beneficiary grandchildren. Each share will be distributed to a beneficiary grandchild upon reaching age 25, or, if a grandchild dies before reaching that age, to the then living descendants of the deceased grandchild.

On Date 3, Child 1, Child 2, and Child 3 each disclaimed a portion of his undivided interest in Farm bequeathed to him under Decedent's will. Specifically, Child 1 disclaimed one-half of his interest; Child 2 disclaimed one-half of his interest, and Child 3 disclaimed nine-tenths of his interest. Pursuant to Item VII of Decedent's will, Child 1's disclaimed interest passed to Trust 1, a trust benefiting Child 1's children, Grandchild 1 and Grandchild 2. Child 2's disclaimed interest passed to Trust 2, a trust benefiting Child 2's children, Grandchild 3 through Grandchild 5. Child 3's disclaimed interest passed to Trust 3, a trust benefiting Child 3's children, Grandchild 6 through Grandchild 8. Accordingly, after the disclaimers, each grandchild held a beneficial interest in Farm, indirectly through the trusts. Grandchild 6 and Grandchild 7 were over age 25 on Decedent's date of death and, under Item VII(C) of the will, they are entitled to receive their interests in Farm outright. It is represented that those interests will be distributed to Grandchild 6 and Grandchild 7 upon receipt of this letter. Therefore, the undivided interests in Farm are currently held as follows: Child 1 holds a 1/8<sup>th</sup> interest; Child 2 holds a 1/8<sup>th</sup> interest; Child 3 holds a 1/40<sup>th</sup> interest; Child 4 holds a 1/4<sup>th</sup> interest; Trust 1 holds a 1/8<sup>th</sup> interest; Trust 2 holds a 1/8<sup>th</sup> interest, and Trust 3 holds a

9/40<sup>th</sup> interest. In the event a trust distributes any interest in Farm to a beneficiary during the 10-year recapture period under § 2032A(c), such beneficiary will enter into an agreement to be fully liable for any amount of additional estate tax under that section. Upon the receipt of this letter, Grandchild 6 and Grandchild 7 will each receive a distribution from Trust 3 equal to a 3/40<sup>th</sup> interest in Farm. Trust 3 will hold the remaining 3/40<sup>th</sup> interest in trust for Grandchild 8. This ruling request pertains to Trust 3.

The executor of Decedent's estate, Estate, filed a timely United States Estate (and Generation-Skipping Transfer) Tax Return and elected to value Farm under § 2032A. Child 1 through Child 4 each executed an Agreement to Special Valuation under Section 2032A in Schedule A-1 of Decedents' Form 706 be personally liable for any amount of additional estate tax that may be due under § 2032A(c). It is represented that the leasing arrangement with Partnership continued in effect after Decedent's death.

Following the receipt of this letter ruling and the distribution of the undivided interests in Farm from Trust 3 to Grandchild 6 and Grandchild 7, Child 1 through Child 4, Grandchild 6, Grandchild 7, and Trust 1 through Trust 3 propose to transfer their undivided interests in Farm to newly-formed limited liability companies, LLC 1 through LLC 4, in exchange for proportionate interests in the LLCs. Specifically, Child 1 and Trust 1 will transfer their undivided interests in Farm to LLC 1 in exchange for proportionate interests in LLC 1. Child 2 and Trust 2 will transfer their undivided interest in Farm to LLC 2 in exchange for proportionate interests in LLC 2. Child 3, Grandchild 6, Grandchild 7, and Trust 3 will transfer their undivided interest in Farm to LLC 3 in exchange for proportionate interests in LLC 3. Child 4 will transfer her undivided interest in Farm to LLC 4 in exchange for a 100 percent interest in LLC 4.

Article 10 of the proposed LLC 3 Operating Agreement provides that the managers have the authority to manage the business and affairs of the company. Article 2 provides that the purpose of the company is to engage in the ownership, leasing, and farming of Farm. Article 8 prohibits the transfer of any member's LLC interests for 10 years, except to members of that qualified heirs family as defined in § 2032A(e)(2). Article 4 provides that each member will execute an agreement as a member of the LLC to be personally liable for any additional estate tax which may result due to the application of § 2032A(c). It is represented that LLC 3 will enter into an agreement to be fully liable for any amount of additional estate tax that may be due under § 2032A(c). The proposed LLC 1, 2, and 4 Operating Agreements contain similar terms.

Partnership was formed in Year 1. At the time Decedent entered into Lease and currently, there were and are v corporate partners, Partner 1 through Partner 10. Each partner owns a v percent interest in Partnership. The shareholders of Partners 1 and 9

are Child 1 and Spouse 1. The shareholders of Partners 2 and 7 are Child 2 and Spouse 2. The shareholders of Partners 3 and 8 are Child 3 and Spouse 3. The shareholders of Partners 4 and 6 are Child 4 and Spouse 4. The shareholders of Partner 5 are Estate, Child 1, Child 2, and Child 3. The shareholders of Partner 10 are Child 1, Child 2, Child 3, and Grandchild 1.

Each LLC proposes to enter into a leasing agreement with Partnership. Specifically, LLC 1 will enter into Lease 1 with Partnership. LLC 2 will enter into Lease 2 with Partnership. LLC 3 will enter into Lease 3 with Partnership. LLC 4 will enter into Lease 4 with Partnership. Pursuant to the terms of each proposed lease, each LLC will lease its undivided interest in Farm to Partnership for agricultural purposes, specifically to be used as a farm for farming purposes. Partnership will agree to pay each LLC a sum certain per annum or a certain percentage share of the crops grown per annum. The decision to pay either a fixed cash rent or to pay rent based on a percentage of crops grown on Farm shall be made solely by Partnership. The term of each lease will be fixed by the parties subsequent to receiving this letter.

Trust 3 has requested the following rulings:

1. Trust 3's transfer of Trust 3's undivided interest in Farm to LLC 3 in exchange for a proportionate interest in LLC 3, as proposed, will not be treated as a disposition of the trust beneficiary's interest in Farm resulting in additional estate tax under § 2032A(c)(1)(A).
2. LLC 3's proposed leasing arrangement with Partnership will not be treated as a cessation of the qualified use of the trust beneficiary's interest in Farm and, accordingly, will not result in additional estate tax under § 2032A(c)(1)(B).

## LAW AND ANALYSIS

### Ruling #1:

Section 2032A(a)(1) provides that, if the decedent was (at the time of his death) a citizen or resident of the United States, and the executor elects the application of § 2032A and files the agreement referred to in § 2032A(d)(2), then, for purposes of chapter 11, the value of the qualified real property shall be its value for the use under which it qualifies, under § 2032A(b), as qualified real property.

Section 2032A(b)(1) provides that, for purposes of § 2032A, the term "qualified real property" means real property located in the United States which was acquired from or passed from the decedent to a qualified heir of the decedent and which, on the date of the decedent's death, was being used for a qualified use by the decedent or a

member of the decedent's family, but only if the percentage requirements under subsections (A) through (D) are met.

Section 2032A(b)(2) provides that, for purposes of § 2032A, the term "qualified use" means the devotion of the property to any of the following: (A) use as a farm for farming purposes, or (B) use in a trade or business other than the trade or business of farming.

Section 2032A(c)(1)(A) provides that if, within 10 years after the decedent's death and before the death of the qualified heir, the qualified heir disposes of any interest in qualified real property (other than by a disposition to a member of his family), then an additional estate tax will be imposed. Under § 2032A(c)(5), the qualified heir is personally liable for the additional estate tax imposed under § 2032A(c)(1).

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

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

Section 2032A(e)(9) provides, in part, that property shall be considered to have been acquired from, or to have passed from, the decedent if such property is acquired by any person from the estate or from a trust (to the extent such property is includible in the gross estate of the decedent).

Under § 2032A(g), an interest in a discretionary trust all the beneficiaries of which are qualified heirs shall be treated as a present interest.

Section 20.2032A-3(b)(1), which applies to pre-death ownership by a decedent, provides that real property valued under § 2032A may be owned directly or may be owned indirectly through ownership of an interest in a corporation, partnership, or a trust. Where the ownership is indirect, however, the decedent's interest in the business, must, in addition to meeting the tests for qualification under § 2032A, qualify under the tests of § 6166(b)(1) as an interest in a closely-held business on the date of the decedent's death and for sufficient other time.

As stated above, the requirements under § 20.2032A-3(b)(1) address only pre-death ownership by a decedent. Although no regulations have ever been issued

applying this rule to qualified heirs, the legislative history indicates that Congress intended this rule to apply to qualified heirs as well.

It is intended, however, that the Treasury Department will provide by regulations that the disposition of qualified property by tax-free transfer to a corporation pursuant to section 351 or to a partnership pursuant to section 721 is not to result in application of the recapture tax if the qualified heir retains the same equitable interest in the property, if the corporation or partnership would, with respect to the *qualified heir*, be considered a closely held business within the meaning of section 6166 and if the corporation or partnership consents to personal liability for the recapture if it disposes of the real property or ceases to use the property for qualified purposes during the period in which recapture may occur. (Emphasis added).

H.R. REP. NO. 94-1380, n.3 at 25 (1976).

In this case, Grandchild 8, Decedent's grandchild, is a member of Decedent's family as defined under § 2032A(e)(2). Under Decedent's will, an interest in Farm passed from Decedent to Grandchild 8 as a beneficiary of Trust 3. Therefore, Grandchild 8 is a "qualified heir" for purposes of § 2032A(e)(1), (e)(2), and (g).

Grandchild 8 holds an interest in Farm indirectly through Trust 3. Trust 3 proposes to transfer Trust 3's undivided interest in Farm to LLC 3. In exchange, Trust 3 will receive an ownership interest in the LLC proportionate to the transferred interest in Farm. Accordingly, Trust 3 will indirectly own Farm through the LLC. The proposed LLC 3 Operating Agreement provides that Trust 3 will execute an agreement as a member of the LLC to be fully liable for any additional estate tax which may result due to the application of § 2032A(c). Further, it is represented that LLC 3 will enter into an agreement to be fully liable for any amount of additional estate tax that may be due under § 2032A(c). Based upon the facts submitted and representations made, and assuming LLC 3 satisfies the requirements of § 6166(b)(1) as a closely-held business, we conclude that Trust 3's transfer of Trust 3's undivided interest in Farm to LLC 3 in exchange for a proportionate interest in the LLC, as proposed, will not be treated as a disposition of the trust beneficiary's interest in Farm resulting in additional estate tax under § 2032A(c)(1)(A).

#### Ruling #2:

Section 2032A(c)(1)(B) provides, that if, within 10 years after the decedent's death and before the death of the qualified heir, the qualified heir ceases to use for the qualified use the qualified real property which was acquired (or passed) from the decedent, then an additional estate tax will be imposed.

The requirements for determining whether there has been a cessation in use under § 2032A(c)(1)(B) are found in § 2032A(c)(6). Section 2032A(c)(6)(A) provides that for purposes of § 2032A(c)(1)(B), real property shall cease to be used for other qualified use if (A) such property ceases to be used for the qualified use set forth in subparagraph (A) of § 2032A(b)(2) under which the property qualified under § 2032A(b).

The legislative history underlying the 1981 amendments to § 2032A suggests by negative implication that the qualified use requirement of § 2032A(b)(1) is satisfied if the income from rental of the property is substantially dependent upon production. See S. REP. NO. 97-144 at 133 (1981). Specifically, the Senate Report states that “during any period when the decedent leases the real property to a nonfamily member for use in a qualified use pursuant to a lease under which the rental is not substantially dependent upon production, the qualified use requirement is not satisfied.” This requirement has been construed by the courts to apply to qualified heirs as well. See *Estate of Gavin v. United States*, 113 F.3d 802 (8<sup>th</sup> Cir. 1997).

Income from a leasing arrangement in which the lessee has the option to pay the lessor rent either in the form of a sum certain or a certain percentage of the crop share is substantially dependent upon production. See *Estate of Gavin, supra*, and *Schuneman v. United States*, 783 F.2d 694 (7<sup>th</sup> Cir. 1986). In *Estate of Gavin*, under the decedent’s will, the farm property passed to decedent’s grandchildren and children. Some of the qualified heirs leased the farm to decedent’s son, another qualified heir. The lease provided for either an annual rent of \$10,000 or a 50 percent crop share, at the son’s option. The court found that the son’s ability to choose whether to pay fixed cash rent or a 50 percent share put the other qualified heirs at risk, because in a bad year the son would likely pay the fifty-fifty split rather than the fixed payments. The court held that the leasing arrangement did not result in a cessation of use under § 2032A(b)(6) and, therefore, the qualified heirs were not subject to additional estate tax under § 2032A(c).

In *Schuneman*, the decedent owned a farm; and, prior to her death, she leased the farm to a third party. The lessee agreed to conduct farming operations on the farm. Under the leasing arrangement, the rental amount was based upon crop production and crop prices. The court concluded that the lease arrangement created financial risk for the decedent and held that the farm was used in a qualified use at the time of her death.

Pursuant to Lease 3, LLC 3 will lease Trust 3’s interest in Farm to Partnership for agricultural purposes, specifically to be used as a farm for farming purposes. Farming is a qualified use under § 2032A(b)(2)(A). Under Lease 3, Partnership will agree to pay the LLC either a sum certain per annum or a certain percentage of the share of crops grown per annum. The decision to pay either fixed cash rent or to pay rent based on a percentage of crops grown on Farm shall be made solely by Partnership. Lease 3 is substantially similar to the lease in *Estate of Gavin, supra*. We conclude that the rental



payments under Lease 3 will be substantially dependent upon production. Based on the facts submitted and representations made, we conclude that LLC 3's proposed leasing arrangement with Partnership will not be treated as a cessation of the qualified use of the trust beneficiary's interest in Farm for purposes of § 2032A(c)(6)(A) and, accordingly, will not be subject to an additional estate tax under § 2032A(c)(1)(B).

The rulings contained in this letter are based upon information and representations submitted by the taxpayers and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as specifically ruled herein, we express no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code. Specifically, we are not ruling on the application of § 2032A to the election on Decedent's Form 706 made by the executor of Decedent's estate. Further, we are not ruling on whether the trust beneficiary materially participates in farming on Farm for purposes of § 2032A(c)(6)(B)(ii). Whether the required material participation by the qualified heir or a member of his family occurred is a factual determination. Section 6.02 of Rev. Proc. 2011-1 I.R.B. 1, 14 provides that the Service ordinarily does not issue letter rulings in certain areas because of the factual nature of the problem involved.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with a power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Associate Chief Counsel  
(Passthroughs and Special Industries)

By: \_\_\_\_\_

Lorraine E. Gardner, Senior Counsel  
Branch 4  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures

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Copy of this letter