

# Family Owned Business-Exclusion or Illusion

by Gideon Rothschild

The Taxpayer Relief Act of 1997 includes a new federal estate tax exclusion for the value of a decedent's interest in one or more family owned businesses effective for estates of decedents dying after December 31, 1997. The tax benefits offered by the new exclusion are less than what many hoped for and the requirements of Section 2033A of the Internal Revenue Code are quite complex and difficult to meet.

If an estate qualifies, there is excluded from the decedent's gross estate the lesser of (i) the adjusted value of the decedent's qualified family-owned business ("QFOB") interests or (ii) the excess of \$1,300,000 over the "applicable exclusion amount" (previously referred to as the unified credit equivalent) in effect with respect to the decedent's estate (currently \$625,000). Although the intent was apparently to provide for an exclusion on top of the unified credit amount, as the unified credit amount increases between the years 1998 to 2006, the QFOB exclusion will decrease proportionately. For example, assume a decedent dies in 1998 with a gross estate of \$2.0 million consisting entirely of a qualified family-owned business. If the decedent's estate makes an election under Section 2033A, the QFOB exclusion will be \$675,000. This represents the excess of \$1.3 million over \$625,000, the applicable exclusion amount available in 1998. In 2006, when the applicable exclusion amount is fully phased in will be \$1,000,000, the QFOB exclusion will decrease to \$300,000. Thus, the QFOB exclusion will have decreasing significance over the next eight years. This anomaly would have been corrected in the proposed 1997 Technical Corrections bill.

Under the proposal, if the Code Sec. 2033A election is made, the estate tax would be calculated allowing a maximum \$675,000 QFOB exclusion and an applicable exclusion amount of \$625,000 for a total of \$1.3 million, regardless of the year in which the decedent dies. If the QFOB interest is less than \$675,000, the applicable exclusion amount would be increased up to the applicable exclusion amount available for the year of death.

For example, assuming the decedent dies in 2005 when the applicable exclusion amount would otherwise be \$800,000 and the QFOB value is \$600,000, the applicable exclusion amount would be limited to \$700,000 (\$1,300,000-\$600,000). The proposal would not affect the potential recapture amount since such recapture would be limited to the amount in excess of the liability had the election not been made (i.e., in this example, the potential for recapture would be the tax on \$500,000).

This article will examine the requirements to qualify for the exclusion, some planning considerations to make optimum use of it and some of the remaining uncertainties relating to the exclusion.

## 1. Basic Qualifications for Eligibility

The requirements for claiming the QFOB exclusion are based in large part upon the qualifications for special use valuation under Section 2032A of the Code. The eligibility requirements may be summarized as follows:

(a) *The decedent must have been a U.S. citizen or resident at the time of death.*

(b) *The business interest in question must qualify as a "qualified family-owned business interest".*

Although the statute refers to a "qualifying business interest" as a trade or business, the term specifically excludes any interest where the principal place of business is not located in the United States. It further excludes (i) any interest in a trade or business if more than 35% of the adjusted ordinary gross income of the business for the taxable year of the decedent's death consists of personal holding company income, (ii) any assets of the trade or business which produce certain passive income and (iii) cash or marketable securities in excess of the reasonably expected working capital needs of the business. While the special use valuation rules only apply to land, the family owned business exclusion applies to all assets actively used in a family business.

(c) *The adjusted value of the qualified family-owned business interests must exceed 50 percent of the adjusted gross estate.*

The decedent's estate qualifies for special treatment under the QFOB exclusion only if the aggregate value of the decedent's qualified family-owned business interests that are passed to qualified heirs exceeds 50% of the decedent's adjusted gross estate. The 50% test is calculated using a ratio, the numerator of which is determined by aggregating all qualified family-owned business interests that are includable in the decedent's gross estate and are passed from the decedent to a qualified heir, plus any lifetime transfers of such interests by the decedent to members of the decedent's family (other than the decedent's spouse), provided such interests were held continuously by members of the family, reduced by indebtedness of the estate except for qualified residence mortgage debt, indebtedness incurred for educational or medical expenses and other debt up to \$10,000. The denominator is equal to the decedent's gross estate reduced by the same adjustment for indebtedness and increased by (i) the amount of all lifetime transfers of qualified business interests that were made by the decedent to members of the decedent's family (other than the decedent's spouse), provided such interests were held continuously by members of the decedent's family, (ii) transfers of assets (other than qualified business interests) to the decedent's spouse made within 10 years of death, and (iii) any other transfers made by the decedent within 3 years of death (except nontaxable transfers to members of the decedent's family). These adjustments for lifetime transfers are intended to prevent tax motivated transfers of property other than qualified business interests to meet the 50% requirement.

*(d) During at least five out of eight years ending prior to the decedent's retirement, disability or death, the decedent or the decedent's family members must have owned and "materially participated" in the operation of the business interests.*

A result of the material participation requirement is that in order to qualify for the QFOB exclusion, a business must have been in existence for at least five years prior to the decedent's death. If, for example, a business has only been operating for four years prior to the decedent's death, the material participation requirement cannot be met.

*(e) The business interests must pass to one or more "qualified heirs" as defined under Section 2032A(e) (9).*

Under Section 2033A, a qualified heir includes any individual who was actively employed by the business for at least 10 years prior to the date of the decedent's death. If the qualified heir is not a U.S. citizen, any qualified family-owned business interest acquired by that heir must be held in a trust similar to a qualified domestic trust under Section 2056A of the Code.

*(f) The executor must elect to qualify under Section 2033A and every person who has an interest in the property must agree to repayment of the tax benefits if a recapture event occurs.*

The tax benefits of Section 2033A are subject to recapture if, within 10 years of the decedent's death, any of the following events occur:

(i) neither the qualified heir nor a member of his family meets the material participation requirements for five out of any eight year period following death;

(ii) the qualified heir disposes of his or her interest to someone other than to a member of the qualified heir's family;

(iii) the principal place of business ceases to be located in the United States; or

(iv) the qualified heir loses U.S. citizenship, unless the interest is transferred to a qualified domestic trust.

The portion of the reduction in estate taxes that is recaptured is dependent upon the number of years that the qualified heir (or member of the qualified heir's family) materially participated in the business after the decedent's death. The material participation tests are derived from the rules set forth in Section 2032A(c) (6)(B). If the qualified heir materially participated in the business for less than six years after the decedent's death, 100% of the reduction in estate taxes attributable to that heir's interest is recaptured. If the recapture event occurs in the seventh year, 80% is recaptured. The applicable percentage decreases to 60% in the eighth year, 40% in the ninth year and 20% in the tenth year.

## 2. Planning Considerations

### (a) *Spousal Transfers*

A lifetime transfer of a part of the business to the taxpayer's spouse may enable both the taxpayer and the spouse to make better use of the QFOB exclusion. For example, assume husband owns all outstanding stock in a qualified family-owned business worth \$3.0 million and other assets worth \$1.0 million. If husband dies in 2006, the QFOB exclusion will be the maximum amount of \$300,000. If, instead, husband transfers 50% of his interest in the business to wife during his lifetime, upon his death in 2006, his estate would still be entitled to a QFOB exclusion of \$300,000. However, wife's estate will also have the benefit of a QFOB exclusion of \$300,000 on her death if the value of the QFOB interest meets the 50% test in her estate.

It should be noted that before making lifetime transfers of QFOB interests to a spouse the effect on the 50% of the adjusted gross estate computation must be taken into account since transfers of QFOB interests to a spouse are not included under Section 2033A(b)(3) and all spousal gifts made within 10 years prior to death are included as the adjusted gross estate denominator.

### (b) *Effect of Annual Exclusion Gifts*

Since annual exclusion gifts of QFOB interests to descendants will increase the numerator of the fraction to determine if the 50% test is met, no detrimental impact is realized for such gifts. Furthermore, since annual exclusion gifts of other property to family members made within 3 years of death are excluded from the denominator, such gifts may in fact be helpful towards meeting the test.

### (c) *Interplay with Section 2032A*

The Conference Report seems to make it clear that if the estate meets the respective requirements, both Sections 2032A and 2033A can be availed of.

### (d) *Disposition of Qualified Business Interest to a Trust*

Where a qualified business interest passes to a trust for the benefit of a qualified heir, the issue arises as to whether it will be deemed to be passing to a qualified heir and thus qualify for the QFOB exclusion. The answer to this question is not clear. In general, Section 2033A(i)(3) states that rules similar to those in Section 2032A will apply. Section 2032A(g) governs whether an interest passing in trust will be treated as passing to a qualified heir for the purposes of the special use valuation. However, in referring to specific provisions of Section 2032A which apply to Section 2033A, Section 2033A(i) does not include Section 2032A(g). Thus, it is not certain that the rules under Section 2032A(g) can be relied upon for guidance on this issue. However, there is no clear reason for not using the same approach in both sections, especially given the significant overlap in the manner in which the two sections are applied.

If Code Sec. 2032A(g) does apply, then a QFOB interest held by a trust in which all of the beneficiaries of the trust are qualified heirs, will qualify for the exclusion.<sup>(1)</sup> The Tax Court has ruled that a nonqualified heir may be a trust beneficiary without disqualifying the property for the purposes of the special use valuation as long as he or she only holds a remote interest in the trust.<sup>(2)</sup> Thus, assuming that reliance on Section 2032A is proper, it seems that it should be possible to create a trust to hold qualified business interests which would be eligible for the QFOB exclusion. For example, a credit shelter trust could be formed for the benefit of a surviving spouse which would qualify for the QFOB exclusion, where the remainder passes to the decedent's issue or if no issue survive, to charity. Since the surviving spouse and the decedent's issue would all be qualified heirs, the fact that there is a remote possibility that the charity (which is not a qualified heir) would receive a distribution from the trust should not preclude qualification for the QFOB exclusion.

Where a trust for qualified heirs holds QFOB interests, it is not clear how the post-death material participation requirement may be met. If we refer to the Regulations for Section 2032A such participation may be met in one or more of four situations. First, the qualified heir may be appointed as trustee of the trust. Second, the qualified heir could contract with the trustee of the trust holding the QFOB interest to

manage or participate in the management of the property for the trust. Third, the trust may grant management authority to the qualified heir. Finally, the qualified heir may be employed by the business in a position requiring his or her material participation.<sup>(3)</sup>

There are several advantages to allocating a QFOB interest to a trust rather than leaving the interest outright to a qualified heir. For example, if a qualified interest is left outright to the decedent's surviving spouse, estate tax on the QFOB interest is deferred until the death of the surviving spouse as a result of the marital deduction. Upon the death of the surviving spouse, assuming the spouse leaves the interest to a qualified heir, the QFOB exclusion may be available to his or her estate. However, the QFOB exclusion in the first spouse's estate will have been wasted. If instead the decedent leaves the QFOB interest in trust for the surviving spouse, no tax on the QFOB interest will be payable on the first death. Assuming no QTIP election is made with respect to the trust, the QFOB interest will not be subject to estate tax on the death of the surviving spouse. In addition, the QFOB exclusion will be available to avoid estate tax on other qualified business interests includable in the surviving spouse's estate, rather than having to use the survivor's exclusion to shelter from tax the interest received from the first spouse to die.

#### *(e) Uncertainties*

One issue that remains open with respect to Section 2033A is whether the benefit is an "exclusion" or a "deduction". The distinction is important in determining the effect on the basis of the business interest for capital gains tax purposes. Section 1014(a) provides that the basis of property acquired from a decedent is stepped up to the fair market value of the property as of the decedent's date of death. However, where, for example, property is received from a decedent as a result of a joint tenancy, Section 1014(b)(9) provides that a basis step-up is allowed only if the property is included in the decedent's gross estate. Since the QFOB exclusion is characterized as an *exclusion* from the gross estate (and not a credit), it is not clear whether a qualified heir who acquires the family-owned business interest through a joint tenancy will be entitled to a step up in basis. The same concern applies where an heir receives the entire business interest under a will. However, unlike §2032A, where there is an exception to the step up provisions of §1014, no provision for such an exception was made in the case of Section 2033A. Another distinction from Section 2032A is that the QFOB interest is included in the gross estate amount at its full value unlike Section 2032A property. Clarifying legislation may be needed.

Another open issue with respect to the QFOB exclusion involves the generation-skipping transfer ("GST") tax. The term "transferor" is defined for GST tax purposes as "the individual with respect to whom property was most recently subject to Federal estate or gift tax." Reg. § 26.2652-1(a)(1). Under Treas. Reg. § 26.2652-1(a)(2), a transfer is subject to federal estate tax if the value of the property is includable in the decedent's gross estate as determined under Section 2031 or 2103. If a qualified family-owned business interest is eligible for the QFOB exclusion, it is excluded from the decedent's gross estate and not subject to estate tax. Therefore, it would seem that the decedent would not be the transferor with respect to this interest for GST tax purposes. Again, the proposed Technical Corrections would clarify that the deduction is not available for GST tax purposes and the decedent would be treated as the transferor.

#### *(f) Drafting Considerations*

From a drafting perspective the new exclusion may require a modification of the traditional formula clauses used in marital deduction planning. It is unclear whether Section 2033A, as drafted, is intended to exclude specific property from the estate or, instead, simply the dollar value of such interest. Some commentators believe that Section 2033A does not exclude specific property from the gross estate but rather a pecuniary amount since the statutory language refers to an exclusion of "the value" of the business interest. Accordingly, either a pecuniary or fractional formula can be used to allocate the business interest to the marital bequest while funding the credit shelter trust with \$1.3 million. If this analysis is correct the interest would obtain a step-up in basis and there would be no GST benefit gained by the exclusion.

It is important to consider the effect of the QFOB exclusion in drafting a trust which may hold qualified family-owned business interests. For example, a preresiduary credit shelter trust should provide that the value excluded under Section 2033A should pass to the credit shelter trust, thereby causing the trust to be funded with up to \$1.3 Million. The credit shelter formula should be drafted to include the maximum amount that can pass free from estate tax not only due to the unified credit but also taking into account all other tax credits, deductions and exclusions.

If a trust will be funded with a QFOB interest it may be advisable to include a savings clause directing and authorizing the trustee to administer such interest in accordance with Section 2033A and any Regulations thereto. It may also be advisable to authorize the executor to make the 2033A election and include an exculpatory provision to protect the executor from a beneficiary's claim with regard to the exercise of such election. Since the funding of the credit shelter trust to the maximum \$1.3 Million is dependent on making the election, it is conceivable that some beneficiaries might receive less if the election is not made. That is, the credit shelter trust will only be funded with the unified credit amount and the balance might go to the marital bequest. To avoid such value shifting it may be advisable to provide for a specific bequest for the QFOB interest. A simple provision might read:

"I give and bequeath to [name of qualified heir] such portion of any qualified family-owned business interest as is excludable under Section 2033A of the Internal Revenue Code."

### **3. Conclusion**

The new provision for the QFOB exclusion is unusually restrictive and contains many complex requirements. There are also numerous pitfalls which require the recapture of any estate tax savings. Furthermore, the exclusion will have less and less impact over the next number of years. However, despite these drawbacks, the QFOB exclusion should be considered in planning the estate of an owner of a qualified family-owned business.

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<sup>1</sup>See Treas. Reg. 20.2032A-8(a)(2).

<sup>2</sup> See *Davis Estate v. Commissioner*, 86 T.C. 1156 (1986); *Estate of Clinard*, 86 T.C. 1180 (1986); *Estate of Pilske*, 51 T.C.M. 1543 (1986).

<sup>3</sup> See Treas. Reg. § 20.2032A-3(f)(1).

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