The Colorado Lawyer
February 1998
Vol. 27, No. 2 [Page 57]

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Specialty Law Columns
Estate and Trust Forum
Making Sense of the New Family-Owned Business Exclusion
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Effective January 1, 1998, new Internal Revenue Code ("Code") § 2033A, enacted as part of the Taxpayer Relief Act of 1997,[1] allows certain decedent's estates to exclude from the taxable estate a portion of the value of a qualifying family-owned business interest ("QFOBI"). Section 2033A requires a confusing multiplicity of considerations and calculations in order to determine the availability of the exclusion to any given estate. The optimistic might suggest that this is beneficial as additional job security for the tax practitioner, but the pessimistic rejoinder would be that § 2033A is an additional opportunity for malpractice on the part of the uninformed.

The new exclusion under § 2033A borrows heavily from existing Code §§ 2032A (Special Use Valuation) and 6166 (Extension of Time for Payment of Estate Tax Where Estate Consists Largely of Interest in Closely Held Business). The new exclusion may be used in addition to §§ 2032A, 6166, and the unified credit. The exclusion is from the estate tax only; there is no comparable gift tax exclusion.

This article provides a general explanation of the new § 2033A by addressing the following issues: (1) the value of the exclusion; (2) the definition of a QFOBI; (3) which estates qualify for the exclusion; (4) the recapture rules; and (5) planning opportunities that exist.

The Value of the Exclusion

The exclusion is a shrinking tax break that will decline annually between 1998 and 2006 in an inverse relationship to the increase in the unified credit. The exclusion from a "qualified" gross estate is calculated as the lesser of (1) the adjusted value of the qualified family-owned business interest or (2) the declining "exclusion limitation." The exclusion limitation is $675,000 in 1998, but is reduced every year thereafter, as the estate tax unified credit exemption equivalent is slowly increased to $1 million in 2006. The total allowable combined exclusion in 1998 is $1.3 million. Because the exemption equivalent is $625,000 in 1998, that leaves $675,000 for the family-owned business exclusion.

The original scheme involved reducing the 2033A exclusion each year by subtracting the current exemption equivalent from $1.3 million. However, the inverse relationship of these two components over time, coupled with the progressive estate tax rate structure, would have resulted in certain estates with excludable QFOBIs paying more tax in later years of the phase-in period. Similarly sized estates taking full advantage of the QFOBI exclusion in both 1998 and 2006, at a 55 percent estate tax rate, would pay more tax in 2006 than in 1998.

Proposed technical corrections would amend the formula to equalize the tax advantage throughout the phase-in period. The exclusion will still be reduced each year, but not by the same flat amount as originally enacted. While the new formula is more favorable to the taxpayer, it adds an additional layer of complexity.

Definition of a QFOBI

A QFOBI is any interest in a trade or business, regardless of the form in which it is held. While not defined in that statute, the committee reports indicate that it must be an "active" interest.[2] Section 6166, and the regulations and rulings construing it, should be applicable in determining the qualification of a trade or business.[3] The principal place of business must be in the United States.

The QFOBI may be a proprietorship or an interest in an entity (such as a corporation, partnership, or LLC). The decedent's interest in an entity will qualify if any of the following apply:

1) 50 percent of such entity is owned directly or indirectly by the decedent and members of the decedent's family;

2) 70 percent is so owned by members of two families; or

3) 90 percent is so owned by members of three families.

If the entity is held by more than one family, the decedent and members of the decedent's family must own at least 30 percent of the trade or business.

Section 2033A follows the § 2032A definition for members of the family,[4] thus including:

1) the decedent's spouse;

2) the decedent's ancestors;

3) the lineal descendants of the decedent, of the decedent's spouse, or of the decedent's parents; and

4) the spouses of any such lineal descendants.

Special rules apply to ownership of entities. With regard to corporations, the decedent and members of the decedent's family are required to own the requisite percentage of the total combined voting power of all classes of stock entitled to vote AND the requisite percentage of the total value of all shares of all classes of stock of the corporation. With regard to partnerships, the decedent and members of the decedent's family are required to own the requisite percentage of the capital interest of the partnership.

Look-through rules apply to "tiered entities" (a trade or business that owns an interest in another trade or business). The value of any QFOBI held by an entity is treated as being proportionately owned by or for the entity's partners, shareholders, or beneficiaries in the case of a trust. A person is treated as a beneficiary of a trust for entity ownership purposes only if he or she has a present interest in the trust.[5]

The following examples, while not comprehensive, are illustrative of the entity ownership rules:

1) Decedent (D) and members of D's family own 60 percent of an LLP. The LLP owns 33.33 percent of an LLC. The LLC otherwise meets QFOBI qualifications. The other 66.66 percent of the LLC is not owned by members of D's family. D's interest in the LLP would not be a QFOBI because D and members of D's family own only 20 percent of the QFOBI (60 percent X 33.33 percent = 20 percent).

2) Same facts as 1, except the other 66.66 percent of the LLC is owned by members of D's family. Therefore, D's interest in the LLP would be a QFOBI (D = 20 percent; D's family = 66.66 percent. 20 percent + 66.66 percent = 86.66 percent).

3) Same facts as 1, but D and members of D's family own 98 percent of the LLP. Thus, it *might* qualify as a QFOBI because the total interest owned by D and D's family equals 32.6 percent (98 percent X 33.33 percent), thus meeting the minimum 30 percent requirement where ownership is by more than one family. The other 66.66 percent of the LLC must be owned in appropriate proportions by D or members of D's family or by one or two other families. If owned by D or a member of D's family, they must own 17.4 percent for a total of 50 percent. If one other family also owns an interest, the other family must own at least 37.4 percent for a total of 70 percent. If two other families own an interest, they must own at least 57.4 percent for a total of 90 percent.

Limitations

A trade or business will not qualify as a QFOBI if the trade or business's stock or securities were publicly traded within three years of a decedent's death, or more than 35 percent of the adjusted gross income was personal holding company income under Code § 543 (except for banks or domestic building and loan associations).

The adjusted value of a QFOBI is reduced to the extent the business holds either (1) passive assets or (2) excess cash or excess marketable securities.

"Section 2033A requires a confusing multiplicity of considerations and calculations in order to determine the availability of the exclusion to any given estate."

Examples of prohibited "passive assets" include those that:

1) produce dividends, rents, royalties, annuities; and passive income described in Code § 543(a);

2) are an interest in a trust, partnership, or REMIC;

3) produce no income as described in Code § 954(c)(1)(B)(ii);

4) give rise to income from commodities and foreign currency transactions;

5) produce income equivalent to interest under Code § 954(c)(1)(E); and

6) produce income from notional principal contracts or payments in lieu of dividends under Code § 954(c)(1) (F) and (G).

In the case of dealers in property, income from such transactions is not deemed passive.

Cash or marketable securities may be included in the QFOBI only to the extent necessary to provide for the "reasonably expected day-to-day working capital needs of such trade or business."[6] Accumulations of cash for capital acquisitions would not be considered "working capital."

Estates that Qualify For the Exclusion

The decedent must have been a U.S. citizen or resident at the time of death, and the aggregate value of the decedent's QFOBIs that pass to "qualified heirs" combined with qualifying gifts to family members must exceed 50 percent of the decedent's "adjusted gross estate." This calculation is known as the "50 percent liquidity test."

The term "qualified heirs" includes the Code § 2032A definition of members of the decedent's family described above, as well as any individual who has been an "active employee" (not defined) of the trade or business for at least ten years prior to the decedent's death. QFOBIs acquired by any noncitizen

qualified heir will not qualify unless held in a "qualified trust" similar to a qualified domestic trust ("QDOT") under Code § 2056A(a). QDOTs must be organized under U.S. or state law, and one trustee must be a U.S. citizen or corporation. Possible alternatives may be provided for in regulations.

50 Percent Liquidity Test

The 50 percent liquidity test is § 2033A's heart of darkness; therein lie most of the calculation complexities and planning problems. The general idea is that more than 50 percent of the decedent's adjusted gross estate must consist of QFOBI. However, the QFOBI includable in the decedent's estate is aggregated with qualifying gifts to family members and reduced by certain estate indebtedness. This numerator is compared to a denominator consisting of the decedent's gross estate with similar adjustments. The calculation is made as follows.

The ***NUMERATOR*** equals:

1) QFOBIs includable in the decedent's gross estate that pass to qualified heirs;

PLUS

2) all lifetime transfers of QFOBIs made by the decedent to members of the decedent's family (other than the decedent's spouse), but only if such interests have been continuously held by the decedent's family and were not otherwise includable in the decedent's estate (valued at the date of transfer), including gifts excluded under Code § 2503(b);

LESS

3) certain indebtedness of the estate deductible under Code § 2053(a)(3) and (4) (Debts of the Decedent, Mortgages and Liens), except:

a) the decedent's qualified residence indebtedness as defined under Code § 163(h);

b) debt incurred to pay educational or medical expenses of the decedent, the decedent's spouse, or the decedent's dependents; and

c) other indebtedness of up to $10,000.

The ***DENOMINATOR*** equals:

1) the decedent's gross estate;

LESS

2) certain indebtedness of the estate deductible under Code § 2053(a)(3) and (4);

PLUS

3) the following transfers (to the extent not already included in the decedent's estate):

a) all lifetime transfers of QFOBIs made by the decedent to members of the decedent's family (other than the decedent's spouse), but only if such interests have been continuously held by the decedent's family (valued at the date of transfer), including gifts excluded under § 2503(b);

b) other transfers (unless *de minimis*) to the decedent's spouse made within ten years of the decedent's death (value at the date of transfer); AND

c) any other transfers to members of the decedent's family, excluded under Code § 2503(b).

QFOBIs in more than one trade or business are aggregated for purposes of applying the 50 percent liquidity test.

When calculating the 50 percent liquidity test, it is important to know when to value the interest. All gifts of QFOBIs made to members of the decedent's family are valued at the date of such transfer. Other transfers from the decedent to the decedent's spouse within ten years of the decedent's death are valued at the date of such transfer. Other gifts within three years of death (included in the denominator), except § 2503(b) gifts to family members, are apparently valued at the date of death.

Participation Requirements

The decedent, or members of the decedent's family, must have owned and materially participated in the trade or business at least five of the eight years preceding the decedent's death.[7] Note that a ten-year active employee may be a qualified heir, but may not satisfy the participation requirements.

Code § 2032A and regulations thereunder determine material participation. The Conference Report says that the principal factors to consider include physical work and participation in management decisions. If the decedent was an owner, he or she should have been paying self-employment tax. Merely being a shareholder, partner, officer, or director does not prove material participation.[8]

Election and Agreement

Finally, the executor must elect application of Code § 2033A and file a required agreement with the federal estate tax return. Again, § 2032A rules will apply and require each person with an interest in the property to agree to the extent of the person's interest in the property to pay a recapture tax, when and if applicable. An open question is whether co-owners of property who are not subject to recapture must sign the agreement. The statute indicates that they should.[9]

The Recapture Rules

An additional tax, together with interest assessed on the basis of the very expensive rates under Code § 6621, will be imposed if any of the following recapture events occurs within ten years of death AND before the qualified heir's death:

1) the qualified heir ceases to materially participate, provided, however, that a qualified heir who is a surviving spouse need only show "active management";[10]

2) the qualified heir disposes of any portion of the QFOBI other than by a disposition to a member of the qualified heir's family or through a conservation contribution under Code § 170(h);

3) the principal place of a trade or business of the QFOBI ceases to be located in the United States; or

4) the qualified heir loses U.S. citizenship (unless the qualified heir places the QFOBI assets in a qualified trust similar to a QDOT under Code § 2056A).

Each qualified heir is personally liable for a proportionate share of the recapture tax. The recapture tax is phased out over a ten-year period, but equals 100 percent of the exclusion for the first six years. A two-

year grace period is allowed to the qualified heir to begin material participation after the decedent's death, but this extends the recapture period.

Planning Opportunities

Basis and Discounting

QFOBIs passing from a decedent to a qualified heir should receive a stepped-up basis despite their exclusion from the taxable estate.[11] Therefore, the planner should be cautious about aggressively discounting QFOBIs. Discounts that reduce the value of the QFOBIs for estate tax purposes below the allowable exclusion level will result in an unnecessarily low basis in the hands of the qualified heirs. A related, but unanswered, question is whether the requirement to aggregate the value of includable QFOBIs and previously gifted QFOBIs in the numerator of the 50 percent liquidity test may affect the ability to apply a minority discount to the QFOBIs includable in the estate. Additionally, avoid discounting the QFOBI to such an extent that it fails the 50 percent liquidity test.

Gifting Strategies

Gifting strategies to take advantage of Code § 2033A will involve arranging values between the numerator and the denominator of the 50 percent liquidity test. The numerator needs to be increased, while the denominator needs to be decreased.

1. Regarding gifts between spouses, remember that each spouse has a full exclusion under Code § 2033A. The family-owned business exclusion can be wasted, like the unified credit, without proper planning. Consider dividing QFOBI between spouses so that each may qualify their respective shares for exclusion. However, transferring QFOBI between spouses will be more difficult than transferring property between spouses to maximize use of both spouses' unified credit. If gifts of QFOBIs between spouses reduce each spouse's QFOBIs too far, one or both could fail the 50 percent liquidity test and end up wasting some or all of the exclusion. Fluctuations in the value of the QFOBIs, as well as the other assets in the estate, between the date of transfer and the date of death also will impact the 50 percent liquidity test.

2. If a client is close to the 50 percent liquidity test, consider making excludable gifts to family members of non-QFOBI assets. This will help reduce the denominator.

3. Keep excellent records. Valuations required under the 50 percent liquidity test often are based on date of transfer value. This includes valuations for unreported, excludable gifts made many years in the past. Consider the effect that previous discounting may have had on the calculation. Counsel also will, apparently, need to support the qualification of the entity as a QFOBI when the gift was made, even if many years or decades before.

Review the Estate Planning Documents

Marital deduction formula clauses must be reviewed to assure that all available "exclusions" are taken into account. Many older wills refer only to taking the "unified credit" or "credits" into account.

Provide for qualified heirs to receive QFOBIs under the will or trust instrument. If an interest passes to a bypass trust, there may be a qualification issue if all trust beneficiaries are not qualified heirs. Depending on the terms of the bypass trust, it may qualify to take distribution of the unified credit exemption equivalent amount, but may not be a qualified heir for QFOBI purposes. A trust should qualify if there is only a remote possibility that a nonqualified heir would take an interest in the property (such as a remainder to charity if all lineal descendants fail to survive).[12]

Borrow Against the Personal Residence

Pay off business liabilities and borrow against the personal residence. If the personal residence debt qualifies for an interest deduction under Code § 163(h), it will be excluded from the liabilities of the estate that reduce the numerator (thus increasing the numerator).

Conclusion

Code § 2033A will take some getting used to. The practical application of the new exclusion remains to be seen. Most commentators believe it will apply to very few estates. In considering its impact on clients' estates, counsel should consider the two primary qualification requirements: (1) whether the asset is a qualified family-owned business, and (2) if so, whether the decedent's estate will satisfy the 50 percent liquidity test.

NOTES

1. Taxpayer Relief Act of 1997, § 502(a).

2. Taxpayer Relief Bill of 1997 Conference Report and Statement of Managers (H.R. 2014).

3. I.R.C. § 2033A references generally to § 2032A. Section 2032A incorporates references and definitions from § 6166.

4. IRC § 2033A(i)(2).

5. IRC § 2033A(e)(3)(c).

6. IRC § 2033A(e)(2)(D)(i).

7. IRC § 2033A(b)(1)(D).

8. Treas. Reg. 20.2032A-3(e)(1).

9. IRC §§ 2033A(b)(1)(B) and 2033A(h).

10. IRC § 2032A(b)(5), incorporated through § 2033A(i)(3)(B).

11. IRC § 1014 was not amended with regard to § 2033A. Note, however, that a new § 1014 (a)(4) was added to provide carryover basis treatment for the new conservation easement exclusion under § 2031(c).

12. Treas. Reg. 20.2032A-8(a)(2) requires that where there are successive interests in property, such as remainders, all persons receiving interests must be qualified heirs. This regulation has been held invalid by the Tax Court in *Estate of Davis*, 86 T.C. 1156 (1986); *Estate of Clinard*, 86 T.C. 1180 (1986); and *Estate of Pliske*, T.C.M. 1986-311. In these three cases, only a remote possibility existed that the specially valued property would eventually pass to charity.