Federal Tax Issues

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The New Family-Owned Business Exclusion

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Tax simplification this is not. In many respects new Internal Revenue Code Section 2033A , "Family-owned Business Exclusion," added by the Taxpayer Relief Act of 1997, is so convoluted that it raises doubts as to whether the benefit it imparts to taxpayers is worth the effort to comply with its requirements. In addition to its almost overwhelming complexity, this provision creates a shrinking benefit that decreases as the new unified credit increases on an annual basis.

This form of estate tax relief for closely held business owners has been on lawmaker's "to-do" list since former Senator Robert Dole first introduced a similar relief measure at the beginning of his presidential campaign in 1995. Unfortunately, the enacted provision's \$1,300,000 exclusion in conjunction with the unified credit pales in comparison to the \$2,500,000 exclusion in addition to the unified credit as originally proposed by Dole.

The Relief

New I.R.C. Section 2033A allows the executor of an estate of a closely held business owner to exclude \$1,300,000 in value of a closely held business from the estate for purposes of computing the federal estate tax. The \$1.3 million exclusion, however, is computed in conjunction with the utilization of the unified credit.

For example, if a decedent dies with a \$2 million interest in a qualified family-owned business in 1998, when the unified credit exemption amount is \$625,000, decedent's executor can elect to exclude \$675,000 in value of the \$2 million interest from taxation in D's estate. Similarly, if decedent dies in 2006 instead, when the unified credit exemption amount is \$1,000,000, decedent's executor can elect to exclude only \$300,000 in value of the business interest (which has most likely appreciated in value). Consequently, the degree of tax relief provided for over the long term is eroded.

The Qualifications

New I.R.C. Section 2033A is modeled closely after the older I.R.C. Section 2032A, "Special Use Valuation," provision extending estate tax relief for real property devoted to farming or closely held business use. In order to take advantage of Section 2033A the estate must meet the following four requirements:

1. the decedent must be a U.S. citizen or resident at death,
2. the executor must make a Section 2033A election and file a recapture agreement signed by each person receiving a "qualified family-owned business interest,"
3. the aggregate value of decedent's qualified family-owned business interests that are passed to "qualified heirs" must exceed 50% of the decedent's adjusted gross estate, and
4. the decedent or members of his or her family must have met certain tests of "material participation" in operating the family-owned business for a certain period of time before the decedent's death.

The concept of material participation is important not only for the decedent to qualify for the exclusion, but also for the surviving family members to avoid possible recapture of estate taxes related to the exclusion for a ten year period after the decedent's death.

Qualified Family-Owned Business Interest

The first and foremost issue to resolve in determining eligibility for estate tax relief under Section 2033A is whether or not the business interest included in the decedent's estate is a "qualified family-owned business interest" for purposes of Section 2033A. This term is defined as any interest in a trade or business with a principal place of business in the United States. In addition, if the family-owned business interest is not a proprietorship but rather an interest in an entity, then the decedent's family must own at least 30% of the entity and the entity must be owned at least:

- 50% by one family,
- 70% by two families, or
- 90% by three families.

A business interest will not be a "qualified family-owned business interest" for purposes of Section 2033A if:

1. the principal place of business is not in the United States,
2. any interest in the business was publicly traded within three years of the decedent's death, or

3. more than 35% of the adjusted ordinary gross income from the business for the year of the decedent's death was personal holding company income.

Further, the value of any "qualified family-owned business interest" is reduced to the extent the business holds cash, marketable securities, or other passive assets in excess of the reasonably expected day-to-day working capital needs for the trade or business. Although Section 2033A does not elaborate on the process of determining the reasonably expected day-to-day working capital needs for the trade or business, the Senate Conference Report explaining this provision indicates that an analysis similar to that used in *Bardahl Mfg. Corp.*, 24 T.C.M. 1030 (1965) should be used. *Bardahl Mfg. Corp.*, was a landmark case concerning the computation of accumulated earnings for purposes of imposing the accumulated earnings tax on corporations taxed under Subchapter C.

Finally, certain other passive assets such as assets that produce portfolio income (dividends, interest, etc.), or assets producing income equivalent to portfolio income are not to be considered in determining the value of a "qualified family-owned business interest."

The 50% Test

The business owner's estate will qualify for relief under Section 2033A only if the aggregate value of the qualified family-owned business interests that are passed to qualified heirs, including lifetime gifts of qualified family-owned business interests valued as of the date of original transfer, exceeds 50% of the decedent's adjusted gross estate.

The 50% test is calculated through the use of a fraction the numerator of which is computed by adding the value of all qualified family-owned business interests passing to a qualified heir included in the decedent's gross estate, plus any lifetime gifts of such interests to members of the decedent's family (other than the decedent's spouse) as long as such interests have been continuously held by members of the decedent's family and are not already included in the gross estate. Certain liabilities of the estate are allowed as a deduction in computing this numerator.

The denominator represents the decedent's gross estate reduced by any liabilities and increased by the following transfers:

1. gifts included in the numerator above, plus
2. gifts, that are not *de minimis* in nature, made to the decedent's spouse within ten years of death, plus
3. any other gifts made within three years of the decedent's death (excluding annual exclusion gifts to family members).

A qualified heir is determined with reference to Section 2032A(e) as any individual who was actively employed by the trade or business for at least ten years prior to the decedent's date as well as members of the decedent's family.

Material Participation

There are material participation requirements that must be met as measured both before the decedent's death and after the decedent's death. Before death, the decedent or a member of his or her family must have owned and materially participated in the operation of the trade or business for at least five of the eight years preceding death. The term, "material participation," is specifically defined in Section 2032A and Treasury Regulation Section 20.2032A-3, and generally requires some form of full management of the trade or business, regardless of hours worked, as long as necessary functions are performed.

After death, a material participation requirement must be met by the qualified heir or any member of his or her family in order to avoid a "recapture tax." A recapture tax will be imposed if the qualified heir (or his or her family member) does not materially participate in the trade or business for at least five of any eight-year period within ten years following the decedent's death.

Recapture Tax

Any tax benefit that arises as the result of an election made under Section 2033A may be recaptured if within ten years of the decedent's death and before the qualified heir's death one of the following occurs:

1. the qualified heir fails to meet the material participation requirements,
2. the qualified heir disposes of his or her interest in the family-owned business,
3. the principal place of business leaves the United States, or
4. the qualified heir loses U.S. citizenship.

The amount of reduction in estate taxes attributable to Section 2033A that is recaptured is based upon when the recapture event occurs in relation to the decedent's death. If the recapture event occurs within the first six years after the decedent's death 100% of the reduction in estate taxes attributable to the heir's interest is recaptured. If the recapture event occurs in years seven, eight, nine, and ten the applicable recapture percentages are 80%, 60%, 40%, and 20%, respectively. The threat of recapture tax liability disappears after year ten.

Conclusion

Analyzing the eligibility of an estate to qualify for Section 2033A relief is not an easy undertaking. The aforementioned discussion of this complicated provision represents a cursory overview of the subject matter. A more detailed review of Section 2033A should be conducted when applying this provision to specific factual circumstances.

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