YOUR FAMILY-OWNED BUSINESS MAY SAVE ESTATE TAXES

Estate taxes can be a very burdensome expense. They can run as high as 55% of the value of a decedent's estate, and they are generally due within 9 months after the decedent dies. This burden often falls particularly hard on the heirs of a small business owner, who may be forced to sell the business simply to pay the estate taxes.

The Taxpayer Relief Act of 1997, which became effective on August 7, 1997, included a provision by which Congress intended to reduce the estate taxes attributable to many small family-owned businesses. This provision is known as the Qualified Family-Owned Business Deduction (which I will refer to simply as the deduction).

As is often the case, however, due to the complexity of the Internal Revenue Code (IRC), the 1997 Act created some inconsistencies between provisions of the new Act and existing provisions of the IRC. Congress has attempted eliminate those inconsistencies by the IRS Restructuring and Reform Act, which took effect on July 22, 1998. This article will discuss the deduction as enacted in 1997 and corrected in 1998.

The deduction takes effect after December 31, 1997. It enables certain heirs of a person who died owning a qualified family business interest to exclude up to $1,300,000 from estate taxes that would otherwise be attributable to the value of the business.

Three key elements must be satisfied to get the deduction. First, the business must meet the definition of a "qualified family-owned business." Second, the "adjusted value" of the business must exceed 50% of the decedent's "adjusted gross estate." Third, the decedent's "qualified heirs" must operate the business for a sufficient time period after the decedent's death. We will examine these requirements below.

What is a qualified family-owned business?

A qualified family-owned business includes a sole proprietorship as well as an entity such as a corporation, partnership, or limited liability company that conducts a trade or business. If the business is an entity rather than a sole proprietorship, the decedent and his or her family members must own any of the following: (1) at least 50% of the entity; (2) at least 30% of an entity in which members of two families own 70%; or (3) at least 30% of an entity in which members of three families own 90%.

Certain businesses are excluded from the definition of a "qualified" business. These are (1) a business whose principal place of business is outside the United States; (2) a business whose stock was readily tradable on an established securities market (such as the NASDAQ) or secondary market within three years of the decedent's death; (3) the portion of a trade or business that is attributable to cash or marketable securities that exceed the reasonably expected day-to-day working capital needs of the business; or (4) a business in which more than 35% of the adjusted ordinary gross income for the year of the decedent's death was passive income. Passive income is income from sources such as interest, dividends, certain royalties, and certain rental income.

What is the decedent’s "adjusted gross estate"?

Basically, the adjusted gross estate is the fair market value of the assets the decedent owned, minus the debts the decedent owed. This figure is calculated as of the date of decedent’s death.

Who are the decedent’s "qualified heirs," and what is the time period during which they must operate the business?

The term "qualified heir" denotes the group of individuals who are eligible to inherit a qualified family-owned business for purposes of the deduction. These persons include the decedent’s "family" (spouse, children, parents, siblings, and children’s spouses) and anyone who was actively employed in the business for at least ten years preceding the date of the decedent’s death.

As noted above, Congress enacted the deduction so that the heirs of small business owners would not need to sell the family business simply to pay estate taxes. Therefore, Congress requires that those heirs operate the business for some time period after the former owner dies. Specifically, during the ten-year period following the decedent’s death, a qualified heir or a member of the qualified heir's family must operate the business for more than three years in any eight-year period. Otherwise, the qualified heirs who inherited the business will be obliged to repay the estate taxes, plus interest, that had been avoided through the transfer of the qualified business.

Conclusion

Proper planning is needed to take advantage of the estate tax deduction for qualified family-owned businesses. If you or a family member owns or could inherit such a business, your family should consult with an attorney or an accountant for assistance.