

Estate tax deferral for estates including closely-held business.

Dear Reader:

A special estate tax deferral election is available if a large portion (more than 35%) of an estate is comprised of a farm or other closely-held business. The election can substantially ease the immediate estate tax burden. If the estate qualifies, the tax is deferred for up to five years and is then paid off over a ten-year period. Interest on the deferred amount, subject to a limitation discussed below, is set at only 2%. Even though federal tax legislation enacted in 2001 repeals the estate tax, the repeal is not effective until 2010. In the meantime, the estate tax deferral election provisions remain in force.

How to qualify. The business interest test. The business interest must be of the type that qualifies for this treatment. If the decedent was the sole proprietor of the business (or farm), then it was his business entirely and you can proceed to the 35% test, below.

If the decedent had partners, however, you can proceed to the 35% test only if either (i) there were no more than 45 partners in the partnership or (ii) the decedent's interest in partnership capital was at least 20%. Similarly, if the business was a corporation, you can proceed to the 35% test only if either (i) there were no more than 45 shareholders or (ii) the decedent's ownership of voting stock was at least 20%.

In applying the 45 partner or shareholder test, above, interests or shares owned by the decedent's spouse, siblings, ancestors, and descendants are treated as owned by the decedent. And any interest owned jointly by a married couple is counted as one partner or shareholder.

In applying the 20%-interest test (tests (ii), above, for both partnerships and corporations), the executor may elect to have the interests of these family members counted as the decedent's. However, if this is the way the decedent's interest qualifies for the deferral, then (1) the five-year deferral period is lost (i.e., the ten-year payment period starts right away), and (2) the favorable 2% interest rate is not available on deferred amounts.

Example (1). M's adjusted gross estate (as defined below) is \$2 million. Included in his estate is a partnership interest valued at \$800,000 (i.e., 40% of the estate). However, there are 48 partners in the partnership (unrelated to M), and M held only a 16% interest. Result: M's estate does *not* qualify for the deferral provisions.

Example (2). The facts are same as in Example (1) except that M's wife, brother, sister, father and mother were among the 48 partners in the partnership. These five interests plus M's are treated as a single interest. There are only 42 other partners. Thus, in this case, there would be only 43 partners and M's estate would qualify for deferral.

Example (3). The facts are same as in Example (1) except that M's daughter was also a partner and her partnership interest was 8%. (The other 46 partners were unrelated to M.) Here, if the executor elects, the daughter's 8% interest is combined with M's 16% interest, so the 20% test is met. However, when this election is used, the estate loses the five-year deferral period and the benefit of the 2% interest rate.

The 35% test. The value of the business interest must be more than 35% of the "adjusted gross estate." (This is the gross estate minus deductions for expenses, debts, taxes, and losses.)

Businesses can be combined for purposes of this 35% test if additional tests are met.

How much estate tax qualifies for deferral? If the above tests are met, the part of the estate tax bill allocable to the qualifying business interest is deferred.

Example. M's estate's tax bill is \$1 million. The amount included for the qualifying business interest was 38% of the total adjusted gross estate. Thus, 38% of \$1 million, or \$380,000, qualifies for deferral.

How much of the tax being deferred qualifies for the 2% interest rate? The special 2% rate applies to the portion of the deferred estate tax that is attributable to the first \$1,330,000 (in 2009; subject to an adjustment for inflation) in taxable value of the closely held business. The first \$1,330,000 in "taxable value" of the business is the first \$1,330,000 above the applicable exclusion amount. Thus, for example, in 2009, when there is an effective estate tax exclusion of \$3.5 million, the amount of estate tax attributable to the value of the closely held business between \$3.5 million and \$4,830,000 is eligible for the 2% interest rate. The interest rate on deferred estate tax attributable to (1) the taxable value of the closely held business in excess of \$1,330,000, (2) holding companies, and (3) non-readily tradable business interests is reduced to an amount equal to 45% of the tax applicable to underpayments of tax. The interest paid isn't deductible for estate or income tax purposes.

Tax payments on the deferred amounts will be applied to each portion of the liability proportionately. (For example, assume one-third of the deferred amount qualifies for the 2% rate, and the remaining two-thirds is subject to the regular rates. A tax payment of \$90,000 reduces the 2% portion by \$30,000 (1/3) and the regular portion by \$60,000.)

Losing the deferral benefits. Lateness in paying tax due or interest can result in loss of the deferral benefits. And if the business interest is disposed of outside the family, the deferral benefits may be lost.

This is a complex area, but qualifying for deferral can significantly ease the immediate estate tax burden. If you have additional questions or would like my assistance in seeking to take advantage of these rules (for example, by combining business interests), please call.

