Chapter VI

Calculating the Federal Estate Tax That an Estate Will Pay

A. Overview and Purpose

The discussion of federal estate taxes and state inheritance taxes appearing in Chapter V is an important start toward identifying the impact these taxes will have on a person's estate after death. In addition to understanding what these taxes are, it is important to recognize how these taxes are calculated in a specific situation. In this chapter the primary focus is on calculating the federal estate tax. This tax was selected as it will have the most significant impact on a person's estate if it applies to transfers under it. In the discussion of state inheritance taxes, reference is made to a typical calculation of state inheritance taxes. That general discussion addresses most of the standard questions that people face in calculating a state inheritance or estate tax. Not all issues that apply in each state were identified and discussed in Chapter V, or elsewhere in this book. It is also important to note that the calculation of property subject to state inheritance tax may not equal the value calculated as the federal gross estate. States that impose inheritance taxes are free to decide what types of transfers are or are not subject to their taxes.

B. Lesson Objectives

When you have successfully completed this chapter, you will be able to accomplish these objectives:

1. Describe what is meant by a "gross estate" under federal estate tax law.
2. Describe the general types of property that are included in the federal gross estate and the general rules for determining how and when these items of property are valued**.**
3. Describe special valuation rules that apply to land that is subject to conservation easement or that elects special use valuation**.**
4. Describe the impact that the Family Owned Business Deduction can have on estate plans that involve a family-owned business.
5. Describe the valuation opportunity that is available to owners of land that is subject to a qualified conservation easement**.**

C. Calculating the "Federal Gross Estate"

The ***gross estate*** includes all property the decedent owned in his or her name alone, one-half of all property owned jointly by the decedent and his or her spouse, a proportionate share of other jointly owned property equal to the decedent's contribution to the purchase and improvement of the property and proceeds of any life insurance policies which are paid to or for the benefit of the decedent's estate or for which the decedent is considered to hold the incidents of ownership.

Incidents of ownership of an insurance policy is a concept that describes the ability of the person, acting alone or in conjunction with any other person, to determine who or what receives the economic benefit of the insurance policy. Authority such as the ability to designate a beneficiary, to surrender or cancel the policy, to assign the policy or revoke an assignment, to pledge the policy for a loan or to borrow against the cash surrender value of the policy is generally considered to be an incident of ownership. If the terms of the policy provide for the possibility of the policy or its proceeds returning to the decedent or the decedent's estate or the decedent has a power of disposition over the policy, either of which is valued at more than 5% of the value of the policy immediately before the insured's death, the holder of such power is deemed to have an incident of ownership.

The gross estate also includes the value of property interests over which the decedent held a **general power of appointment** at death. If a power of appointment is not considered to be a general power, it is considered a limited power of appointment. A power of appointment determines who will own or enjoy the property subject to the power and when they will own or enjoy it, and is created by someone other than the person who holds it. A general power of appointment for estate tax purposes is one in which decedents can appoint the property subject to the power to themselves, their creditors, their estates or creditors of their estates. A general power includes the unlimited right to use principal, income, or principal and income for the decedent's benefit. If a decedent has a power to use or consume that is limited by an ascertainable standard relating to health, education, support or maintenance, the power is not considered a general power. A power to use property for the comfort, welfare, or happiness of the decedent is not an ascertainable standard and therefore is a general power.

In addition to those powers that the decedent held at death, the gross estate will also include the value of property subject to a power of appointment that was transferred during the decedent's lifetime, but in which the decedent retained a life interest in the property or the right to revoke the transfer. If the decedent transferred the power but delayed the effective date of the transfer until after the decedent's death, the value of the property subject to the power is likewise included.

In addition to separate and joint property, the federal gross estate includes the value of property transferred during lifetime if after the transfer the decedent retained a right to use, possess, or enjoy the property or the income from it. Also, transfers where the recipient's right to possession and enjoyment is delayed until the decedent's death are included in the federal gross estate of the former owner. Transfers where the decedent retained a right to reacquire property transferred during life, that is valued at more then 5% of the value of the property will result in the entire value of the property, being included in the federal gross estate at the former owner's death. If the owner of property transfers it during lifetime, but retains the right to alter, amend, revoke, or terminate the transfer at the time of death, the value of such property, will be included in the deceased owner's estate. Common examples of revocable transfers are "in trust for" savings accounts and custodial accounts in which the person creating the account is the custodian of the account. A living trust in which the person who creates the trust reserves the right to revoke or terminate the trust is another example of a revocable transfer which is included in the gross estate of the deceased owner. General powers of appointment which are exercisable in favor of the person holding the power, the person's estate, the person's creditors, or creditors of the person's estate result in the value of the property over which the power is held being included in the federal gross estate of the person holding the power at death.

Gifts made by a decedent within three years of his or her death are not included in the gross estate of the decedent. If, however, the gift is considered a transfer with a retained lifetime interest, a transfer taking effect at death, a transfer with a right to revoke, or a transfer of a life insurance policy, the gift will be included in the gross estate of the deceased owner if made within three years of his or her death.

The significance of the gross estate for federal estate taxes is that it may be a different calculation than that made to determine state inheritance tax. As such, transfers that may avoid inheritance tax must be considered in light of federal estate tax requirements to be effective in avoiding federal estate tax requirements. Given the fact that two calculations are made, coordination in meeting both requirements is a central issue in planning these estates.

D. Valuing Property Subject to Tax - General Rules

Estate Tax Regulations and Gift Tax Regulations define **fair market value,** in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. This is often referred to as an "arm's-length transaction." Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property. An example of an arm's-length transaction is an auction where the owner of property invites all interested parties to bid on the purchase of the property. Auction sale of estate property is a common way to determine its value, and it may be the transfer method that is mandated in the decedent's will or living trust.

The general rule for valuing property subject to federal estate tax and most state inheritance and estate taxes is to determine the value at the time that the owner of the property dies. If the property is sold in close proximity to the date of determining value and the sale is an arm's length sale, the sale price can be considered its fair market value. If the property is not sold, then value is determined by evaluating information from sales of other comparable properties. Comparing an existing property to another property permits the person making the value determination to estimate its value by evaluating sales of other properties.

E. Valuing a Business

Because of the potential complexity of this problem, readers who are interested in business-related issues, such as choosing an organization form when the business begins, should refer to a the soon to be published companion publication, Organizing, Operating and Planning for the Transfer of a Family Business.

Fractional Ownership Shares; Discounts for Lack of Control and Lack of Market

Considering all of the attention that is paid to the issue of valuation, the Internal Revenue Service has recognized that valuation is not an exact science. Sound valuation decisions will be based upon all relevant facts, as well as on common sense, informed judgment, and reasonableness in weighing the facts and in determining their significance. Among the factors that are considered are the size of the block of stock being transferred in a corporation or share of a partnership. Two recognized discounts that are available are discounts for a minority interest and discounts for lack of marketability. The discount for a minority interest recognizes that a minority interest in a company that is not listed on a recognized exchange will be more difficult to sell than a larger interest. Equally true, a block of stock or a partnership percentage that offers control represents an added measure of value that can increase the value of property beyond that value obtained by simply dividing the net worth of the business assets by the outstanding ownership shares.

Valuing property interests for federal estate and gift tax purposes is a question of fact, and minority and lack of marketability discounts have been allowed in many situations. In a case involving shares of stock that were subject to securities law restrictions, the court allowed a lack of marketability discount. Minority interests in partnerships have also been allowed minority and lack of marketability discounts. Court have directed businesses to first determine the liquidation value of the partnership. Liquidation value is what remains after all partnership assets are sold, all debts and obligations are paid, and all expenses of the liquidation sale are paid. Once that is determined, the percentage interest in the partnership is applied to the liquidation value and minority and lack of marketability discounts applied, if applicable. Both minority and lack of marketability discounts may apply, no matter what type of business the partnership is involved in, as long as the discounts reflect a reasonable valuation of the particular interests.

The Internal Revenue Service’s review of estate tax returns that apply discounting to general or limited partnership interests and other forms of intra-family transactions have been subject to close scrutiny on two specific fronts: (1) Should the partnership be given consideration as a legal entity for estate tax valuation purposes? and (2) Should any of the restrictions on the right to transfer partnership shares, which are often reflected in the certificate of limited partnership, be disregarded in establishing the value of the partnership share? An important starting point for reviewing the facts establishing the limited partnership is the presumption that intra-family transactions are inherently not arm’s length transactions. A leading case that supports the IRS view in this area is the Estate of Elizabeth B. Murphy, deceased v. the Commissioner. In this case Mrs. Murphy took considerable steps toward developing an estate plan that was built around the premise of keeping control of a wide-ranging business enterprise in the Murphy family. The following case study describes the Murphy estate situation.

> *Example: Mrs. Murphy inherited control of the business from her husband, who had inherited it from his parents. As Mrs. Murphy was near death, her financial advisors convinced her to make changes to her asset holdings in order to lower her shares to less than a controlling percentage, and thereby qualify for minority and lack of marketability discounts. Mrs. Murphy, who was suffering from a diagnosed terminal condition at the time, made the changes and died less than three weeks later. When her estate tax return was filed, her personal representative claimed a minority interest and lack of marketability discount. The IRS challenged the*

discounts. The Tax Court ruled that estate was entitled to a lack of marketability discount, particularly in light of a state law provision that prevented the sale of substantially all of the assets of a business unless more than two-thirds of the stock in the company favored such action. On the issue of the minority interest discount, the Tax Court deemed the estate ineligible for the discount despite the fact that Mrs. Murphy's holdings in the company slipped just below 50% at the time of her death. The Tax Court concluded that, despite the reduction below 50%, nothing actually happened to Mrs. Murphy's ownership of the company that can be said to result in the loss of control between the time she transferred shares of stock and her death less than three weeks later. She continued to serve as chairman of the board of the company and her children served in the same capacity in which they previously served. Noting that no changes took place after the transfer, the Court concluded that tax reduction was the only purpose served by the transfer. Under prevailing law, tax savings alone is an insufficient purpose for recognizing the stock transfer and giving it the legal affect that the estate sought to give it.

From the Murphy decision, the Internal Revenue Service (IRS) has drawn several conclusions that appear in technical advice memoranda responding to questions about valuing limited partnership interests. First, if the time period between events affecting the value of assets is short, it is likely that the IRS will disregard the creation of a business entity that seeks to qualify for the reduced valuation. Second, despite the creation of a family limited partnership, the Internal Revenue Code provides the IRS with authority to disregard common types of restrictions or limitations on the transfer of limited partnership interests that are often used to enhance eligibility for lack of marketability and minority control discounts.

Under these provisions, when property is valued for federal estate or gift tax purposes, the value of the property is determined without regard to any restrictions on the right to sell or use the property unless the restrictions are part of a bona fide business arrangement; the restriction is not a device to transfer property to a family member for less than full and adequate consideration in money or money's worth, and the terms of the restriction are comparable to similar arrangements entered into by person's in arm's-length transactions. Each of the three elements must be met and it is clear that their focus is one of essential fairness, commercial reasonableness, and a significant emphasis on the purpose or motive for carrying out the transaction.

In the case of both of these discounts, a question often asked is whether these discounting opportunities can be taken in addition to any of the special valuation opportunities described below. In several litigated cases involving the special use valuation opportunity the Courts have recognized that determining an asset's fair market value for special use valuation purposes necessarily would include whether the asset carries majority control or lacks it. Without this evaluation, the valuation determined cannot be said to be the asset's fair market value.

Given this recognition of the importance of control and market situations, the more difficult question becomes one of placing a figure on an appropriate discount amount to be taken in reaching fair market value. Based on reported decisions, discounts in the range of 25% to 35% are frequently allowed in cases where all requirements for eligibility are met. Eligibility will depend on the facts and circumstances of each case. Building the evidence to support the outcome is an important obligation to undertake. For estates that otherwise face the potential of federal estate tax, such discounts can save considerable tax.

F. Special Use Valuation of Land and Real Estate Used in a Closely Held Business

1. Valuation Dates

A third estate planning opportunity is the value assigned to real property for estate tax purposes. The general rule for valuing property for federal estate tax purposes is its fair market value as of the date of the decedent's death. An alternate valuation date of six months after the decedent's death can be elected by the estate if the effect of selecting the alternate valuation date is to lower the value of the gross estate **and** lower federal estate tax liability. If property is sold during the six-month period in a freely negotiated sale that is not influenced by family relationship or other factors that lower sale prices, the sale price can be used as the value of the property.

2. Valuing Land in a Closely-Held Business at Its Use Value Rather Than Fair Market Value

In addition to the opportunity to use an alternate valuation date, certain estates are able to use a special use valuation formula found in section 2032A of the Internal Revenue Code. This formula determines value of real estate used in a trade or business based on its particular use. If an estate is eligible, it can reduce the taxable value of the real estate by up to $820,000. This concept recognizes that the value of some properties will vary according to the use of the property rather than fair market value considerations. Not all land owners are willing to sell their land to the highest bidder. If the alternate valuation date election is made, the use value calculations will be made as of the alternate valuation date. As will be seen in the later discussion of federal gift tax, a special use valuation opportunity is not available for the federal gift tax.

For purposes of the special use valuation rule, land used for farming purposes is considered to be used in an eligible business activity. Farming purposes include planting, cultivating, caring for and cutting of trees or the preparation, other than milling, of trees for market. The Internal Revenue Service has ruled that merchantable timber and young growth should be treated as a crop and not as part of the real estate. However, the personal representative of an estate that includes such assets has a statutory opportunity to elect to treat the land as “qualifying woodlands,” which results in growing trees that are treated as part of the real estate for federal estate tax purposes. To be eligible for this election, the land must be used in timber operations and be an identifiable area of land for which records are normally maintained in conducting timber operations.

> *Example: In Private Letter Ruling 9924019, March 17, 1999, the decedent owner regularly performed maintenance operations with respect to timberland owned. The decedent inspected the acreage daily and cleared debris to prevent fire and to create better growing conditions. Harvesting timber, however, would not have been profitable. The decedent made all management decisions*

> *that were consistent with good land management principles. In this case the decedent was considered to be using the parcel of land for planting, cultivating, caring for, and preparing trees for market. The IRS concluded that the timber land qualified for special use valuation where the personal representative made the election to treat the land as "qualified woodland."*

3. Requirements for Special Use Value Election for Federal Estate Tax

To qualify for the election to specially value land at its use value rather than its fair market value, several pre-death requirements must be met.

For 5 of the 8 years preceding the property owner's death, retirement or disability, the property owner, or a member of his or her "family", must have "materially participated" in farming or other business in which the real estate to be valued was used. "*Family*" means an individual's ancestors, spouse, lineal descendants, lineal descendants of a spouse of the person's parent or spouse of any of the mentioned people. "*Material participation*" for purpose of this valuation election is determined in the same manner as determining net earnings from self-employment in a trade or business. It generally involves consideration of the labor and effort that the individual directed to the business activity.

Fifty percent or more of the value of the gross estate, less mortgages and debts applicable to real and personal property included in the decedent's gross estate, must be comprised of the adjusted value of real and personal property used in the business use.

Twenty-five percent or more of the value of the gross estate, less mortgages and debts on real estate included in the gross estate, must be comprised of the adjusted value of the real estate used in the business use.

If property is held by a partnership or a corporation, the decedent's interest in the partnership or corporation must meet other requirements. For a partnership, the decedent's interest must be 20% or more of the capital interest in the partnership, or the partnership had 15 or fewer partners. If owned by a corporation, the decedent's interest in the corporation must be 20% or more of the value of the voting stock in the corporation, or the corporation had 15 or fewer shareholders.

The purpose of the special valuation rule is to enable the owner of qualifying land to continue the use without the threat of being forced to end its business activity to pay estate taxes. Once the pre-death requirements are met, a series of post-death requirements also are applicable:

The specially valued property must pass to a qualified heir who continues the qualified use or faces an obligation to pay a recapture tax based on the tax savings generated by using the tax saving provision. A qualified heir is a member of the decedent's family as that term is described above.

A qualifying use ends in various ways. For example, a qualifying use ends when the qualified heir is no longer financially at risk in the closely held business as to profits because the heir does not have an ownership interest in the farming operation, or the heir, or a member of the heir's family does not materially participate in the qualifying use for a period of more than 3 years during the 8-year period that begins with the decedent's death. The following discussion of recapture taxes identifies the consequences of ending a qualified use.

4. Additional or "Recapture" Tax

If within 10 years after the decedent's death and before the qualified heir's death, requirements for continuing eligibility are not met, an additional tax is imposed on the qualified heir. The additional tax is generally calculated to be the difference of what the federal estate tax would have been had the special use value election not been made and the estate tax that was paid as a result of the election. This additional tax can be calculated on either the entire amount of the specially valued property or on only a portion of it, depending on the circumstances and events that triggered the additional tax.

All qualified heirs who inherit an interest in the specially valued property accept the obligation to continue the qualifying use and recognize their obligations by signing and filing an agreement that acknowledges their responsibility to pay the additional tax.

The events that trigger this recapture tax include:

- the qualifying use ceases during the recapture period;
- the land is sold to someone outside the qualified heir's family; or
- the qualified heir or a member of his or her family ceases to materially participate in the qualifying use.

A surviving spouse who is the qualified heir of qualifying property can lease the property to a member of his or her family without having the lease treated as a termination of the qualifying use of the property.

If a personal representative elects to treat growing timber as "qualified woodland" such that its value is considered part of the value of the land and the special use valuation election is made, then a qualified heir's decision to dispose of or sever standing timber, or the right to sever the timber, is treated as a sale or disposition of a portion of the qualified heir's interest in the property. This disposition triggers an additional tax. This tax is calculated as the sale of a portion of the qualified heirs interest in the specially valued property. The additional tax imposed in such a situation is the ***lesser*** of the amount realized on the disposition of the standing timber or the amount of additional estate tax that would be due if the entire interest of the qualified heir in the qualified woodland were disposed of, less any other additional estate taxes imposed. If the qualified heir subsequently disposes of the heir's remaining interest in the specially valued property, the amount of additional tax paid when the standing timber was transferred will be deducted from the amount of additional tax calculated when the second disposition is made.

5. Calculating the Special Use Value

By making the election to value the property in this manner, the qualified heir's tax basis in the property becomes the value calculated under the qualifying use. Use value in this context is determined according to one of two formulae. The first formula utilizes the average cash or crop share rental value of comparable land in the same locality minus real estate taxes. The figure obtained by this calculation is then capitalized by an average annual interest rate for federal land bank loans for the land bank district in which the land is located.

> *Example: At Helens death, she owned a 450-acre forest on which a brick farm house and barn were located. The acreage is in woodland consisting of mature northern hardwoods, mixed oak types, and 25 acres of black cherry trees, and is managed as a business. A fair market value for her farm is $1,150,000. An adjoining property of comparable size and soil type has been rented on a cash basis for the last 10 years. Over the last 5 years, the average annual gross cash rent has been $45,000. The average annual real estate tax has been $5,500. After deducting the average real estate tax, the average rent net of taxes is $39,500. The average rent net of taxes is divided by the average annual effective interest rate charged on federal land bank loans. For the year in which Helen died, this interest rate is 9.0%. The average cash rent net of taxes ($39,500) divided by the average effective interest rate (9.0%) yields a special use value of $438,888.88 ($39,500 ? 9.0%).*
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> *In valuing Helen's land for federal estate tax purposes, special use valuation rules will enable Helen's estate to reduce the value of the farm real estate from $1,150,000 to $438,888.*

A second formula is used when sufficient information on cash or share rental of comparable land cannot be obtained. Under this alternative method the following five factors are considered in calculating the value of the land: capitalization of expected income from the activity; capitalization of the fair rental value of the land in the closely held business use; preferential assessment values for the land; comparable sales of other land that are not affected by non-agricultural uses; and any other factor that fairly values the closely held business property. It is generally considered that the five-factor method results in a higher use value than a calculation based on capitalization of comparable rents, thereby decreasing the benefit to be gained by electing special us evaluation in such cases.

In Technical Advice Memorandum 9328004, the Internal Revenue Service advised that in an estate that included real estate used for both pasture and woodland purposes, the executor could elect to treat the woodland as "qualifying woodland." In submitting cash rental information from "comparable" land, the executor did not include other woodlands that had made similar elections. Therefore, the Service concluded that the estate was required to use the five-factor method described above because cash rent information was not comparable.

The decision in Estate of Rogers v. Commissioner 2000 T.C. Memo 133 is an example of the impact on an estate of its election to specially value, for estate tax purposes, standing timber growing on qualified woodlands. The decision of the United States Tax Court addresses two important points for timber land owners. First, the decision to treat timber land as "qualified woodland" under the estate tax law results in the standing timber being specially valued as part of the qualifying real property on which the timber is located rather than valuing it as other growing crops. Second, it is possible to use the rent capitalization method in valuing timber land that is subject to long-term timber leases designed to capture the value of the timber. The following summary provides important details about the decision.

> *Example: Carolyn J. Rogers died in 1992 -- she was a resident of Gainesville, Alabama. At the time of her death, her gross estate for federal estate tax purposes included five tracts of timber land located in the same county in which she lived. On her federal estate tax return the personal representative elected to treat some of the parcels as "qualified woodlands." In addition, the estate elected to value the timberland under the special use valuation provision. The gist of the differences between the estate and the Internal Revenue Service involved the method and evidence used to value the timberland, which in turn affected the value of any tax due from the estate. Under the formula method the estate determined use value by referencing cash rents from comparable properties and then capitalizing the excess of the average annual gross cash rental over the average annual state and local real estate taxes for comparable properties. By using an expert who made a comprehensive study of the land being valued and other timber land in the county where the decedent resided and in surrounding counties, the expert identified comparable properties that were also subject to long-term timber leases. Using this information, the personal representative was able to convince the Court, over objections from the Internal Revenue Service, that the cash rental information was on what is considered to be comparable land and that it met the rigorous requirements of the estate tax law and regulations. The estate was entitled to use that information in determining the use value of the timber land. Furthermore, the Court held that the special use value determined by the formula method included the value of the timber on those tracts which had been subject to a qualified woodland election.*

G. The Qualified Family Owned Business Deduction

1. In General

In the estates of people dying after 1997, Section 2057 offers additional federal estate tax relief for owners of family-owned businesses. The new provision, known as the "qualified family-owned business deduction," has many features that are similar to the special valuation opportunity under Section 2032A. The qualified family-owned business deduction allows a federal estate tax deduction for "qualified family owned business interests." Unlike Section 2032A, which involves real estate assets, the qualified family-owned business deduction can be taken against real or personal assets of the estate. Another key difference between 2032A and 2057 is that basis in property is not reduced when taking the 2057 deduction.

Under provisions in the 2001 amendments to the federal estate tax law, the family-owned business deduction will not apply to estates of people who die after December 31, 2003.

2. Amount of the Deduction

The amount of the deduction is capped at $675,000 and is coordinated with the exemption equivalent to the unified credit against federal and estate gift tax. As described earlier, as the exclusion increases over the next several years, the amount of property that will pass tax free under the exemption equivalent also increases. The maximum family-owned business deduction allowed under Section 2057 is $675,000, and when the deduction applies, the maximum property sheltered under the exemption equivalent is $625,000 for total protection of $1.3 million of business assets in an eligible estate.

Introducing the family-owned business deduction helps family businesses by allowing an additional amount of business property to pass free of federal estate taxes at the death of the business owner. This may enable the next generation family business owner to acquire the business interest at a lower cost and with a lower threat to sell business assets to pay estate taxes.

3. Eligibility Requirements

To be eligible for the deduction, there are four requirements: (1) the decedent must be a United States citizen at death; (2) the estate executor must make a 2057 election and file a recapture agreement; (3) the adjusted value of the qualified family-owned business interest must exceed 50% of the decedent’s adjusted gross estate; and (4) the decedent, or members of the decedent’s family, must have materially participated in the operation of the business in an aggregate of at least 5 years of the 8-year period ending on the decedent’s death. Requirement (4) may create some difficulty where business assets may turn over quickly within any five-year period.

Qualified family-owned trade or business interests can be carried on as sole proprietorships or as other entities. In regard to other entities, the decedent, or a member of his or her family must own: (1) at least 50% of the entity, or (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%. For corporations, the family must own the required percentage of the total combined voting power of all classes of stock entitled to vote and the required percentage of the total value of shares of all classes. For partnerships, ownership is determined by the percentage of capital interests of the partnership.

Certain interests *cannot* be qualified as family-owned business interests, such as: (1) interests in a business whose principal place of business is outside the United States; (2) interests in a business whose stock was readily tradable on an established securities market or secondary market within 3 years of the decedent’s date of death; (3) the portion of the interest that is attributable to cash and/or marketable securities in excess of the reasonable expected day-to-day working capital needs of the business or certain passive assets; and (4) an interest in a business if more than 35% of the adjusted ordinary gross income, of the business for the year of the decedent's death was personal holding company income as defined by section 543 of the Internal Revenue Code.

Certain assets are considered as passive assets and not eligible for the family-owned business deduction. These assets include: (1) assets producing interest, dividends, rents, royalties, annuities, and personal holding company income; (2) assets that are interests in a trust, partnership, or real estate mortgage investment conduit that are not in an active business; (3) assets producing no income; (4) assets giving rise to income from commodity transactions or foreign currency gains; (5) assets producing income that is equivalent to interest; and (6) assets producing income from "notional principal contracts" or payments in lieu of dividends.

4. Interest Passes to or is Acquired by a Qualified Heir

For purposes of the qualified family-owned business deduction, the person who acquires the qualified business interest must be a qualified heir. Such a person is a member of the decedent's family, and includes a person's ancestors, spouse, lineal descendants, lineal descendants of a spouse or parent, or the spouse of any of the lineal descendants previously described. In addition, and most importantly quite unlike the concept of a qualified heir for special use valuation opportunities, for qualified family-owned business deduction purposes, a qualified heir can also be any active employee of the trade or business who has been employed by the trade or business for at least 10 years before the decedent's death.

5. Additional, or "Recapture" Tax

As is the case of the special valuation opportunity under Section 2032A, the estate tax benefit of using the deduction can be recaptured in the form of an additional tax if within 10 years after the decedent's death and before the qualified heir's death certain events occur. This additional tax is imposed on the qualified heir and is based on the value of the qualified business interest that has passed to the qualified heir.

The events that trigger imposition of this additional tax include: (1) the material participation requirements are not met with respect to interests acquired from the decedent; (2) the qualified heir disposes of a portion of the qualified family-owned business interest to other than a member of the qualified heir's family or a qualified conservation organization; (3) the qualified heir loses U.S. citizenship or no longer is a U.S. resident; or (4) the principal place of business ceases to be located in the United States.

The adjusted tax difference attributable to a qualified family-owned business deduction is recaptured as the personal responsibility of the qualified heir to the extent of the heir's interest in the qualified family-owned, business if the recapture occurs within six years following the decedent's death. The percentage recaptured thereafter is annually reduced in 20% increments, until 20% is recaptured in the tenth year. Interest on the recaptured amount is also due at the rate set for underpayment of taxes for the period beginning on the date the estate tax liability was due under this chapter and ending on the date such additional estate tax is due. In the event of a recapture of the full amount of the additional tax, the interest obligation will make a significant addition to the qualified heir's obligation.

H. Paying the Tax that is Due in Full or in Installments

In general, the federal estate tax return and payment of federal estate tax is due within nine months of a decedent's death. In certain cases, however, an estate has the option to elect an installment payment arrangement that includes interest at the rate of 2% on a portion of the unpaid tax and allows the estate to pay the tax due in installments for 14 years beyond the normal tax payment date.

To be eligible for this installment payment option, the decedent must have been involved in a closely held business at the time of the decedent's death. To qualify for the installment payment option, the business must be considered an active business enterprise rather than simply being the passive owner of business assets. In Letter Ruling 8437001, May 9, 1984, the Internal Revenue Service indicated that a decedent's proprietorship that owned timber land would not be considered an active trade or business where the decedent did not engage in acts associated with or designed to produce crops or increase yields. In cases where assets are leased by a decedent owner, the degree of the decedent owner's involvement in important management decisions and physical presence on the site are important elements in determining the nature of the decedent's involvement in the business. If the decedent did not personally participate in the activities of management and decision making, but an agent of the decedent did, the acts of the agent will be imputed to the agent's principal.

The form in which the business is organized can be a partnership if 20% or more of the partnership interest is included in the decedent's gross estate or the partnership has 15 or fewer partners. If the business is organized as a corporation, it will qualify if 20% or more of the corporate stock is included in the decedent's gross estate or the corporation has 15 or fewer shareholders. For estates of individuals dying after December 31, 2001, the number of shareholders or partners is increased from 15 to 45. In the case of partnerships and corporations, ownership interest in partnerships and corporations held by husbands and wives as community property, as joint tenants, tenants by the entirety or as tenants in common are treated as owned by one shareholder or partner. Stock or partnership interests owned by an individual and the individual's brother, sister, spouse, ancestor, and lineal descendants are treated as if the ownership interests are owned by the decedent.

In addition, a qualifying business interest must also exceed 35% of the decedent's adjusted gross estate as determined immediately prior to the decedent's date of death. Interests in residential buildings and related improvements on land that are occupied on a regular basis by the owner or lessee of the land or by persons who are employed by the owner or lessee for purposes of operating or maintaining the business are included in the 35% calculation. Assets that are included in this valuation include interests in a partnership, corporate stock, proprietorship interests, and leasehold interests in which the decedent participated in important decisions regarding the leased business and was actively involved in management and decision-making situations.

The election to pay federal estate tax is made on a timely filed federal estate tax return. Once the election is made, the installment payment arrangement will be based upon the unpaid tax that is due plus interest at the rate of 2% per year on the first $1,100,000 of the taxable estate, which allows an estate in 2002 to have a favorable tax rate applied on the those taxable assets that exceed the amount excluded by the unified credit. Amounts that are beyond that amount bear interest that is calculated according to the rate of 45% of the rate that applies to the underpayment of tax

I. Student Exercises

1. Which of the following statements correctly describes the meaning of "incidents of ownership" as applied to the treatment of insurance policies under the federal estate tax law?
   a. The person who has these "incidents of ownership" will receive the proceeds of the policy when the payable.
   b. If a person has such "incidents" in a policy of insurance at the time of death, the value of the insurance proceeds will be included in the person's gross estate.
   c. Having an "incident of ownership" will result in no federal estate tax being applied to the policy proceeds.
   d "Incidents of ownership" require that the policy proceeds be shared equally among all of the lineal heirs of the deceased.

2. Which of the following statements correctly describes the impact of electing to treat land and growing trees as "qualified woodland" for federal estate tax value purposes?
   a. Qualified woodland is not subject to federal estate tax.
   b. Qualified woodland is taxed at the lowest rate of federal estate tax.
   c. For qualified woodland the value of the land is considered to be zero and the value of the timber is determined according to its fair market value.
   d. None of the above statements is a correct statement.

3. Which of the following statements about the concept of valuing property by its fair market value is a correct statement?
   a. The value of various things is reported annually in *The Book of Capital Values* available in most public libraries.
   b The value of a thing is determined by the average amount of annual income, rent or profit that it generates over a five-year period of time.
   c. The value of a thing is determined by what a willing and able buyer would pay to and be accepted by a willing and able seller of the property.
   d. None of these statements is a correct statement.

4. If a business is owned by several people, which of the following statements correctly describes an important element in determining the value of an individual owner's share of the business?
   a. The value of an owner's share will reflect whether the owner's share is large enough to control action to be taken by the business.

b. The value of any share is determined by dividing the assets of the business by the number of owners.
c. The value of the owner's share will be determined by the value of the time and effort that the owner puts into the business.
d. The value of any share will be determined by the value paid for it when the share is sold in a commercially reasonable way.

Short Essay Questions

5. Briefly describe the impact that each of the following estate planning techniques will have on the amount of property that will be subject to tax: Special Use Valuation, and the Family Owned Business Deduction.

6. George and Laura are the owners of a 500-acre farm business that includes a woodlot of about 150 acres that includes northern hardwoods and mixed oak timber types. The farm business is currently a proprietorship in which George and two of his children, a daughter and a son, are involved. The mix of other assets that George and Laura own includes:
   a. A collection of gold and silver coins from countries around the world and an extensive collection of American coins and paper money.
   b. Individual IRA's in each of their names.
   c. A $100,000 life insurance policy on Laura's life and a $50,000 policy on George's life. Both George and Laura pay the premiums on the policies from a joint checking account they maintain. Each of them has designated the beneficiaries of the policies.
   d. U.S. treasury bonds and treasury savings bonds that were issued before 1955.
   e. Several pieces of machinery and equipment that were used in the farm business.
   f. A number of Laura's paintings that were done over the last 40 years. Laura was an art major in college and continues to paint from time to time, particularly now that her children are grown and on their own.
   g. Two complete sets of oak dining room furniture (table, six chairs, and a breakfront in each set) that George built by hand as his hobby. In addition to the furniture that is finished, George also has a supply of oak, cherry, and walnut boards in his workshop that are part of other projects that are not yet complete.
   h. George's workshop also includes a variety of wood-working tools and equipment. It also contains supplies, paints, lacquers, and other furniture finishes that George uses in building furniture.

Based on this list of assets, develop a plan for determining the value of the property owned by George and Laura. All estate property is owned by George and Laura, husband and wife. Other assets are owned in a variety of ways -- some are considered separately owned, while others are not.