

# Family-Owned Business Exclusion and Recapture

The family-owned business exclusion, enacted as part of the Taxpayer Relief Act of 1997, allows a decedent's estate to exclude at least a portion of the value of an interest in a qualified family-owned business that passes to the decedent's heirs. Without proper planning, however, heirs receiving an interest in a qualified family-owned business may lose some of the value to taxes in later years.

Rules for the family-owned business exclusion are complex and contain traps for the unwary. This article will help you use this tool to maximize your qualified family-owned business's value for your heirs.

## *What May Estates Exclude Under the Exclusion?*

An estate may generally exclude up to the lesser of:

- The adjusted value of the qualified family-owned business interests held by the decedent at death, or

- \$1.3 million less the applicable exclusion available to the decedent. In 1998, the applicable exclusion is \$625,000, so the maximum family-owned business exclusion is \$675,000. As the applicable exclusion amount increases through 2006, the family-owned business exclusion will decrease proportionately. In 2006 and later years, the applicable exclusion and family-owned business exclusion will be \$1 million and \$300,000 respectively.

## *What Is a Qualified Family-Owned Business?*

A qualified family-owned business is generally defined as a trade or business principally located in the United States that is owned:

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

If more than one family owns the business, the decedent and his or her family members must own at least 30% of the business.

### ***When Is the Exclusion Available?***

The family-owned business exclusion is available only if a transfer meets several requirements:

- The business is a qualified family-owned business.
- The total value of business interests that pass to qualified heirs (generally, the decedent's ancestors, spouse and lineal descendants) must exceed 50% of the value of the decedent's adjusted gross estate.
- The decedent must have been a U.S. citizen or resident at death.
- The executor must elect to apply the exclusion.
- Each person acquiring a qualified business interest must agree that under certain circumstances, referred to as recapture events, he or she will pay a part of the estate tax that would have been due but for the exclusion. The agreements

must be filed by the executor along with the election to apply the exclusion.

- The decedent or a member of his or her family must have participated in the family business for at least five of the eight years immediately preceding the death.

### ***What Are Recapture Events?***

A portion of the exclusion can be recaptured and taxes may be due if any of the following events occur:

- The qualified heir fails to materially participate in the business for at least five of the eight years during the 10-year period following the decedent's death.
- The qualified heir disposes of all or part of the interest to someone other than a family member.
- The qualified heir becomes disqualified by losing U.S. citizenship, ceasing to be a lawful permanent U.S. resident or commencing residency in a foreign country that has a treaty with the United States.

- The business's principal place of business ceases to be in the United States.

How are amounts previously excluded from the estate later recaptured? Each qualified heir is potentially responsible for a portion of the tax equal to his or her percentage interest in the business. This recapture tax applies on an event-by-event basis. A recapture event occurring with respect to one heir will not necessarily mean that other heirs will owe recapture tax.

The recapture tax equals a percentage of the estate tax that would have been imposed if the business had been included in the decedent's estate. If a recapture event occurs during the first six years of material participation, the total amount of the reduction in the estate tax attributable to the qualified heir's interest must be recaptured. Smaller amounts are recaptured if the event occurs after six years.

### ***A Case Study***

Beth and her siblings inherit equal qualified family-owned business interests from their father, Fred, whose estate elects to take the family-owned business exclusion. Only Beth

materially participates in the business, but her activity, as a family member, causes all her siblings to meet the participation requirements. If Beth ceases to materially participate within the first six years after Fred's death, and none of her siblings participate, each child will owe 100% of the reduction in estate tax attributable to his or her interest. The applicable percentage is 80% in the seventh year, 60% in the eighth year, 40% in the ninth year and 20% in the tenth.

### ***Get the Facts***

The new exclusion provides a welcome tax break to families owning substantial interests in qualifying businesses. Before an executor makes the election to use the family-owned business exclusion, however, qualified heirs should find out what events may force them to pay additional estate tax in later years. If you have questions, call us. We'd be pleased to provide you further information.