

Qualified Family-Owned Business Interest

IRC Sec. 2057 provides for a deduction from the gross estate of qualified family-owned business interest property (QFOBI). Under this provision, if more than 50% of an estate's assets are qualified family-owned business interests and certain other requirements are met, up to \$675,000 of such property may be deducted from the gross estate.¹ Act Section 512(d) of the Tax Act of 2001 repeals the QFOBI deduction, effective for decedents dying after 12/31/2003. Under the sunset provisions of the act, the QFOBI provisions will be reinstated for decedents dying after 12/31/2010.



The estate tax savings provided by this Code section can be lost if certain requirements are not met during the 10-year period following the decedent's death.

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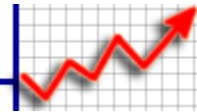
Business interests include sole proprietorships as well as other entities such as corporations, LLCs and partnerships. In general, the following are required to qualify for the deduction.

- **Ownership and material participation:** The decedent or family members² must have owned and materially participated in the business for at least five of the eight years prior to death.
- **Location of business:** The principal place of business must be located in the United States.
- **Percentage of estate assets:** The qualified family-owned business interest must make up more than 50% of the decedent's adjusted gross estate.
- **Decedent, executor and heirs:** At the time of death, the decedent must have been either a U.S. citizen or resident. The executor must choose to have the deduction apply to the estate and each qualified heir³ with an interest in the business must sign a recapture agreement.

¹ This was effective for estates of decedents dying after 12/31/97. The IRS Restructuring and Reform Act of 1998 amended the original QFOBI law and redesignated IRC Sec. 2033A as IRC Sec. 2057.

² Family members include the decedent's spouse, ancestors, lineal descendants and parents' lineal descendants, or spouses of any of these.

³ Qualified heirs include actual family members, as well as any person who has been actively employed by the business for at least 10 years prior to the date of the decedent's death. The IRS Restructuring and Reform Act of 1998 clarified that a trust may be treated as a qualified heir if all trust beneficiaries are qualified heirs.



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- **Ownership percentage:**¹ At the time of death, the decedent must have had an interest at least equal to one of the following.

One Family	Two Families	Three Families
50% owned by the Decedent (and family)	70% owned by the Decedent (and family) AND one other family, with the Decedent (and family) owning at least 30%	90% owned by the Decedent (and family) AND two other families, with the Decedent (and family) owning at least 30%

Deduction Amount

If all requirements are met, the executor may elect to deduct the lesser of the value of the QFOBI property or \$675,000.

Interaction with Applicable Credit Amount

Under the provisions of IRC Sec. 2057(a), the amount of the QFOBI deduction is coordinated with the applicable credit amount. The applicable credit amount protects a specified amount of property, known as the applicable exclusion amount, from estate taxes. This amount of protected property is scheduled to increase over time.

Year	Maximum Applicable Exclusion Amount	Maximum Deduction for QFOBI
2000 – 2001	\$675,000	\$675,000
2002 – 2003	\$1,000,000	\$675,000
2004 – 2005	\$1,500,000	QFOBI repealed
2006 – 2008	\$2,000,000	QFOBI repealed
2009	\$3,500,000	QFOBI repealed
2010	Federal estate tax repealed	
2011	\$1,000,000	\$675,000

The law limits the maximum amount that may be protected from estate tax by the combination of the QFOBI deduction and the applicable exclusion amount to \$1,300,000. If the maximum QFOBI deduction is taken, the applicable exclusion amount is limited to \$625,000 (\$1,300,000 - \$675,000 = \$625,000).

¹ Corporate stockholders need the appropriate percentage of both share ownership and voting power. Partners need the required percentage of both the capital interest and the profits interest. Special look-through rules apply to businesses which own other business interests.

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If QFOBI assets are less than \$675,000, the applicable exclusion amount is increased by the difference between the QFOBI assets and \$675,000, but not beyond what it would have been (under the scheduled increases) without the QFOBI deduction.

The following hypothetical examples illustrate this interaction.

A Year of Death	B QFOBI Value in Estate	C QFOBI Deduction Taken	D Applicable Exclusion Amount Maximum	E Applicable Exclusion Amount Allowed	F Total Sheltered (C + E)
2001	\$475,000	\$475,000	\$675,000	\$675,000	\$1,150,000
2003	\$450,000	\$450,000	\$1,000,000	\$850,000	\$1,300,000

Recapture of Benefits

The new law recaptures the federal estate tax savings if any of the following events occur during the 10-year period after the decedent's death.

- The material-participation requirements of IRC Sec. 2032A(c)(6)(B) are not met. In general, this Code section requires a qualified heir or family member to materially participate in the trade or business for at least five years of any eight-year period.
- A qualified heir disposes of any portion of the inherited business interest, except through a disposition to a member of the qualified heir's family or qualified conservation contribution.
- The qualified heir loses U.S. citizenship.
- The principal place of business ceases to be the United States.

If the event causing the recapture occurs between six and 10 years after death, only a partial recapture will be required.

Other Requirements to Qualify for the Deduction

- If the business is a corporation, its stock must not have been publicly traded within the three years before death. Personal holding company interests do not qualify for the deduction.
- If the business holds passive assets, such as publicly traded stock or cash in excess of reasonable day-to-day working capital needs, the value of such assets must be reduced for QFOBI purposes.
- The business must meet a liquidity test which looks at the business interests passing to qualified heirs at the time of death and certain lifetime gifts.

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Planning for the QFOBI Deduction

In order to meet the percentage requirements to qualify for the QFOBI deduction, an estate owner may wish to consider reducing nonbusiness assets in the gross estate. However, transfers of assets to a spouse are not effective unless completed more than 10 years prior to death. Transfers to others, except for nontaxable transfers to other family members, must be completed more than three years prior to death.

The requirements to qualify for the QFOBI deduction are complex. An estate owner should seek competent legal and tax guidance to make certain that all requirements are complied with.