LAW OFFICES OF
ROBIN C. BEVIER
A PROFESSIONAL LAW CORPORATION

2479 SUNRISE BLVD
GOLD RIVER, CA 95670
(916) 858-0904 FAX (916) 859-4895
robin@bevier.net www.robinbevier.com

1223 PLEASANT GROVE BLVD
SUITE 120
ROSEVILLE, CA 95678
(916) 787-0904 FAX (916) 787-0993

Estate Tax Planning For Closely Held Businesses, Farms and Ranches

In the context of effective estate planning, one of the primary goals is to reduce or eliminate, to the extent possible, the federal estate tax attributable to or assessed on an estate at death. The estate tax is based on the fair market value of all the deceased's assets, including life insurance, real property, financial instruments, vested portions of retirement funds, and other investments.

Often, one of the major components of an estate is also a closely held business. The term "closely held" business in this context will apply to a corporation, a Limited Liability Company, or even a sole proprietorship, where the decedent was the owner of 20% or more of the business interest. The estate tax is a progressive tax, in that the amount of the estate in excess of the applicable exemption amount is subject to increasing rates, with a current maximum rate of 45%. There is an exemption available, which in 2009 is $3.5 million per person. Under current law there will be no federal estate tax assessed if the year of death is 2010, and in 2011 the exemption is scheduled to revert to only $1 million per person, with the maximum tax rate also increasing to 55%. Although there is some discussion in congress regarding the possible extension of the $3.5 million exemption, or some other exemption amount, no decision has been made yet. California also does not assess an estate tax at death.

In this context then, flexibility in estate tax planning is important in order to reduce the federal estate tax, whatever the exemptions may be in the future. With respect to decedents who owned closely held businesses at the time of their death, there is a unique strategy that could be employed. Generally, the estate tax due is payable within nine months after the death of the decedent. However, for the portion of the tax attributable to a closely held business, a good portion of the estate tax may be deferred for a number of years, if the provisions of Section 6166 of the internal revenue code are met.

Section 6166, commonly known as the long term payout of estate taxes, provides that a certain portion of the estate taxes are paid over a ten year installment period, commencing five years after the decedent's death. For the first five years, the payments are interest-only. The portion of tax that can be postponed and paid in installments is equal to the same portion that the closely held business bears to the overall estate. For example, if the closely held business comprised 50% of the adjusted gross estate, then up to 50% of the tax liability could be postponed under a section 6166 election.

One of the benefits of this arrangement, in addition to freeing up cash-flow, is that while there is interest imposed on the deferral, the interest rate charged by the IRS is usually much lower than current market rates. In this regard, a decedent's estate which would otherwise have to sell a business (potentially at fire sale rates) or borrow money with interest accruing on it, this offers a unique alternative. If a requisite minimum proportion of the estate consists of the business, it may be more useful to rely on cash flow over time to pay estate taxes, as opposed to being required to have all the liquid cash available only nine months after death has occurred.

The specific requirements of the long term payout are that the decedent must have been actively involved in the business, that the closely held business constituted at least 35% of the estate, and that the closely held business is passing to a qualified heir. The term "active involvement" is a matter of fact in each particular case but essentially the supervision, planning and carrying out of the business goals by the decedent are sufficient. While the actual active involvement in any one case must be documented at the time of death, good pre-planning involves accounting for these factors in advance. The term "qualified heir" essentially is a lineal decedent or in-law who will continue to run the business for the requisite installment period of 15 years.

Use of the 6166 election <u>may</u> make sense from a business standpoint, since the IRS is allowing the business to continue operations. However, if in the future the qualified heir(s) ceases to run the business, then the IRS's involvement accelerates, and the remaining tax liability would become due and payable. In addition, the IRS will usually require a lien or other security to ensure that the taxes will be paid in the event of the cessation of business activity. Accordingly, if the long-term payout of the estate tax is to be considered in the estate plan, good <u>pre-planning</u> for the 6166 election is crucial. For example, use of the 6166 election requires that the deceased person had at least 20% of the ownership of the business. This sometimes is contrary to the idea of transferring ownership of a business <u>pre-death</u> for other tax or business planning purposes. Therefore, the long-term payout strategy is only <u>one</u> factor to consider in the overall tax planning process. Further, a business owner's estate planning should also incorporate the necessary provisions for transferring the ownership at death to a qualified heir <u>who is going to remain involved in running the business</u> over the long-term, rather than lineal decedents who are not.

Another offshoot to this planning is a specialized strategy for farmers and ranchers. Generally speaking, under Section 2032A of the internal revenue code, the real estate holdings of ranches and farming businesses can be valued at a "<u>special use valuation</u>", rather than "highest and best use value" for estate tax purposes. Obviously, especially in the farming and ranching industry, highest and best use of real estate arguably can be the development value vs. farming value. Further, many farming and ranching enterprises do not have adequate cash resources for the payment of estate taxes, especially if the property continues to be used in agricultural business, but is taxed at its highest and best use value.

Essentially the 2032A election allows the estate to utilize a value for the property based on its farming/ranching capabilities. There are specific technical criteria for the calculation of the value in accordance with this election, as well as a component that require active evolvement by the decedent in 5 of the previous 8 years, and the transfer of the farming/ranching operation to a qualified heir. The real property must comprise at least 25% of the adjusted gross estate, and the farm assets, both real and

personal, must comprise at least 50% of the adjusted gross estate. There is also a maximum decrease in assessed value that can be realized under this election, which in 2009 is $1,000,000. Depending upon the applicable estate tax rate at the time, using the "special use" election could potentially reduce the estate tax liability on the farming/ranching operation by $370,000 to $550,000.

As with the long term payout, the special use valuation is not a requirement but an option that agricultural families could plan for. Subsequent to the decedent's death, if there is a determination by the family to cease the farming operations within the ten year period following death, then the valuation would be increased and additional estate tax is due. However, as long as the agricultural business continues for the requisite period of time, the valuation for federal estate tax purposes can be lowered.

Again, good pre-planning is the hallmark to minimizing the federal estate tax bite.

"As a taxpayer, you are required
to be fully in compliance with the United States Tax Code,
which is currently the size and weight of the Budweiser Clydesdales."

\- Dave Barry, Humorist