

Estate tax relief for family businesses is available ... in the form of a deferral

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If a substantial portion of your wealth is tied up in a family or closely held business, you may be concerned that your estate will lack sufficient liquid assets to pay federal estate taxes. If that's the case, your heirs may be forced to borrow funds or, in a worst-case scenario, sell the business to pay the tax.

For many eligible business owners, Internal Revenue Code Section 6166 provides welcome relief. It permits qualifying estates to defer a portion of their estate tax liability for up to 14 years from the date the tax is due (not the date of death). During the first four years of the deferment period, the estate pays interest only, set at only 2%, followed by 10 annual installments of principal and interest.

A deferral isn't available for the total estate tax liability, unless a qualifying closely held business interest is the only asset in your estate. The benefit is limited to the portion of estate taxes that's attributable to a closely held business.

Eligibility requirements

Estate tax deferral is available if the value of an "interest in a closely-held business" exceeds 35% of your adjusted gross estate. To determine whether you meet the 35% test, you may only include assets actually used in conducting a trade or business — passive investments don't count.

Active vs. passive ownership

To qualify for an estate tax deferral, a closely held business must conduct an active trade or business, rather than merely manage investment assets. Unfortunately, it's not always easy to distinguish between the two, particularly when real estate is involved.

The IRS provided welcome guidance on this subject in a 2006 Revenue Ruling. The ruling confirms that a “passive” owner may qualify for an estate tax deferral, so long as the *entity* conducts an active trade or business. The ruling also clarifies that using property management companies or other independent contractors to conduct real estate activities doesn’t disqualify a business from “active” status, so long as its activities go beyond merely holding investment assets.

In determining whether a real estate entity is conducting an active trade or business, the IRS considers such factors as the amount of time owners, employees or agents devote to the business, whether the business maintains an office with regular business hours, and the extent to which owners, employees or agents are actively involved in finding tenants and negotiating leases.

Weigh your options

As you plan your estate, consider whether your family will be eligible to defer estate taxes. If you own an interest in a real estate business, you may have an opportunity to qualify it for an estate tax deferral simply by adjusting your level of activity or increasing your ownership in an entity that manages the property. Please contact us for additional details.

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