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Planning for Closely-Held Businesses:

Section 6166 Deferral and the Washington Qualified Family-Owned Business Deduction

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Presented by:

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Tax Cuts and Jobs Act of 2017

- Under the Tax Cuts and Jobs Act of 2017, the federal gift and estate tax exclusion amounts in 2018 increased to $11,180,000 per person, or $22,360,000 for a married couple
- Clients with estates worth less than that no longer have Federal taxable estates (assuming no lifetime gifts)
- Increased exclusion amounts scheduled to sunset on December 31, 2025

Washington Exclusion Amount Unchanged

- The Washington exclusion amount remains relatively low at $2,193,000 per person in 2018
- Clients with estates worth between $2,193,000 and $11,180,000 (or twice that for a married couple) no longer need Federal planning but are still subject to Washington estate tax at rates of 10-20%
- Washington residents with estates in excess of the WA exclusion amount continue to need planning even if not subject to Federal estate tax

Section 6166 and QFOBI

- Decedents whose estates include interests in closely-held businesses that meet certain requirements may qualify for special deductions or estate tax deferral
- Section 6166 permits an estate to defer payment of estate tax for up to 14 years at favorable interest rates. Washington offers this deferral at the state level as well.
- A Washington estate may deduct up to $2.5MM in connection with qualified family-owned business interests (QFOBI)

Planning for Section 6166 and QFOBI

- **Lifetime Gifts:** Be thoughtful as to what assets are gifted and how much of them is being transferred relative to the entire estate. Gifts may help or hurt the estate's ability to qualify for the QFOBI deduction, or for deferral of estate tax under Section 6166.
- **Restructuring of Business Holdings:** If feasible, restructuring clients' business holdings may help qualify for Section 6166 deferral and maximize its benefits
- **Dispositive Estate Plan:** QFOBI deduction requires business interests to pass to qualified heirs who will meet certain requirements. Married couples may be able to take steps to qualify for the QFOBI deduction on the death of the first spouse.

Estate Administration Considerations

- **Section 6166:**
  - Be thoughtful regarding dispositions or withdrawals of Section 6166 property and undistributed net income of closely-held businesses during the principal repayment period
  - Interest on deferred tax deductible on the Washington estate tax return when paid
- **QFOBI:** Be sure qualified heirs understand their obligations for the three-year period following the decedent's death.

Section 6166: Purpose and WA Equivalent

- Section 6166 permits deferral of Federal estate tax for a period of up to 14 years
- Intended to prevent fire sales of closely-held businesses in order to fund estate tax liability
- Washington State “will abide by the provisions of section 6166 of the 2005 IRC for granting of payment plans for closely held businesses”

Benefits of Section 6166 Election

- Personal representative may elect to defer portion of estate tax attributable to the interest in a closely-held business
- Payment may be made in up to 10 annual installments, beginning on the date selected by the PR that is no later than 5 years after the unextended due date of the estate tax return
- Interest on the first $608,000 of deferred tax in 2018 will accrue at a rate of 2%, and interest on the remaining deferred tax will accrue at 45% of the statutory underpayment rate

Section 6166 Requirements

- Decedent a U.S. citizen or resident at date of death
- Interest in a closely-held business includible in the gross estate
- Value of the interest in a closely-held business exceeds 35% of the adjusted gross estate ("35% Test")
    - Adjusted gross estate equals the gross estate less any Section 2053 and 2054 deductions

35% Test: Example

- Decedent dies with a $29MM gross estate, consisting of a $10MM interest in a closely-held business and $19MM in other assets
  - The closely-held business interest is 34.48% of the value of the gross estate, less than 35%
  - If the estate has $500,000 of Section 2053 expenses, the adjusted gross estate equals $28,500,000
  - $10MM = 35.09% of adjusted gross estate, and estate may qualify for deferral

Interest in Closely-Held Business

- Sole proprietorship qualifies if decedent carried on a trade or business
- Corporation that carried on a trade or business qualifies if:
  - 20% or more of the total voting stock is includible in the gross estate ("20% Test"), or
  - The corporation has 45 or fewer shareholders ("45-Owner Test")

Interest in Closely-Held Business (cont.)

- Partnerships that carried on a trade or business qualifies if:
  - 20% or more of the total capital interest is includible in the gross estate ("20% Test"), or
  - The partnership has 45 or fewer partners ("45-Owner Test")
- No policy reason to treat corporations and partnerships differently (measuring voting shares v. capital interests for the 20% Test)
- LLCs may qualify whether taxed as a corporation/association, partnership, or disregarded for income tax purposes

Trade or Business

- Regardless of whether the interest is in a sole proprietorship, corporation, or partnership, there must be a trade or business on the date of death
- IRS considers activities of the decedent, entity (if any), and agents and employees
- Activities of a management company in which the decedent owned a “significant interest” may be imputed to the decedent
- Threshold question: did the activities of the decedent or entity exceed the level of someone merely holding an interest in investment property?

Trade or Business: Opco-Propco Structures

- Where an operating company and real property used by that operating company are separately held, analysis can be complicated
- Service has ruled for and against taxpayers in these circumstances
- Where the real property is leased to the operating company in a triple-net lease, this may prevent the Propco from qualifying under Section 6166. See PLR 8140020. But cf. Rev. Rul. 2006-34 and PLR 200006034.

Trade or Business: Property Management

- Rev. Rul. 2006-34 provides guidance on whether management of rental real property rises to the level of a trade or business
- IRS will consider six nonexclusive factors:
    1. The amount of time the decedent, entity, and any agents and employees devoted to property management;
    2. Whether an office was maintained from which the decedent's, entity's, and any agents' and employees' activities were conducted or coordinated, and whether regular business hours were maintained for that purpose;

Trade or Business: Property Management (cont.)

3. The extent to which the decedent, entity, and any agents and employees were actively involved in finding new tenants and negotiating and executing leases;

4. The extent to which the decedent, entity, and any agents and employees provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;

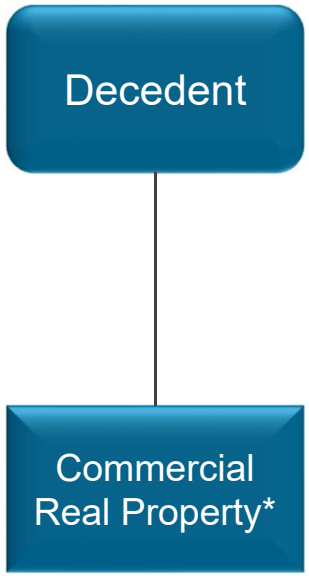
Trade or Business: Property Management (cont.)

5. The extent to which the decedent, entity, and any agents and employees personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and

6. The extent to which the decedent, entity, and any agents and employees handled tenant repair requests and complaints

- Use of an independent management company is a negative factor

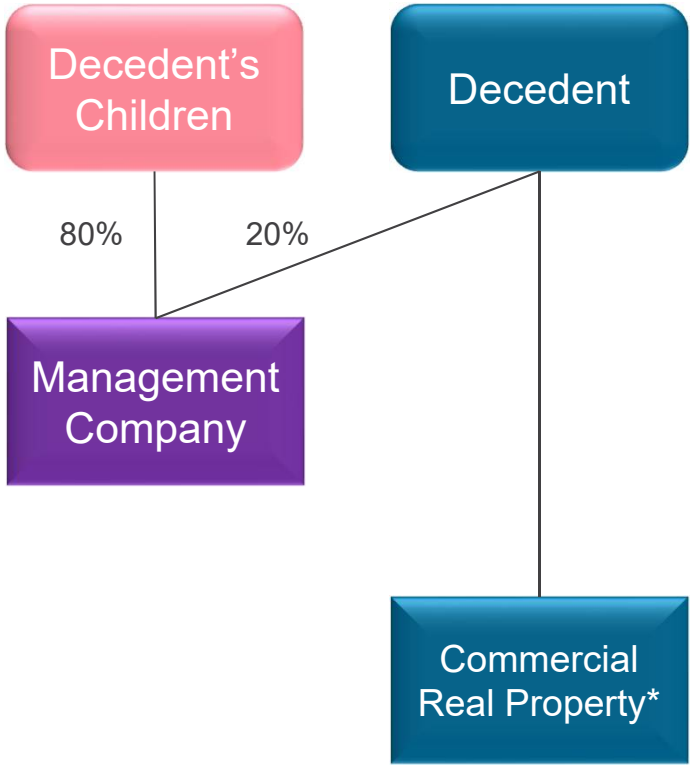
Trade or Business: Property Management Example 1



* Managed by Decedent

- If the decedent handled the day-to-day operation, management, and maintenance of the property, the property will qualify under Section 6166
- Hiring independent contractors to perform repairs that the decedent could not perform personally should not disqualify the property
- The more activities undertaken by an independent contractor, the less likely that the property will qualify
- If the decedent's activities were limited to collecting rent, making mortgage payments, and making necessary repairs, the property should not qualify under Section 6166

Trade or Business: Property Management Example 2



* Managed by Management Company

- Management Company is actively managing the property
- Because the decedent owns a "significant interest" in Management Company, the company's activities permit the property to qualify under Section 6166

Trade or Business (cont.)

- IRS has permitted deferral where a decedent ceased participating in a business due to physical incapacity
- Activities of a deceased spouse may be imputed to surviving spouse for purposes of qualifying for Section 6166 so long as there was no material change in the form or operation of the business between the first and second deaths
- Activities of one division of a corporation may cause the entire corporation to qualify (subject to the passive asset rule discussed below)

Treatment of Multiple Closely-Held Businesses

- If the estate includes interests in 2 or more closely held businesses, and if 20% or more of each such business is included in the value of the decedent's gross estate, then the interests are treated as a single interest
- For purposes of this 20% requirement, the interest of a surviving spouse in property held jointly by the decedent and the surviving spouse is included in determining the value of the decedent's gross estate

Attribution Rules

- Section 6166(b)(2) contains attribution rules
- Plain language of the statute applies these rules both for purposes of the 20% Test and the 45-Owner Test
- IRS position (based in part on legislative history) is that attribution rules apply only for purposes of the 45-Owner Test absent a 6166(b)(7) election (discussed below)

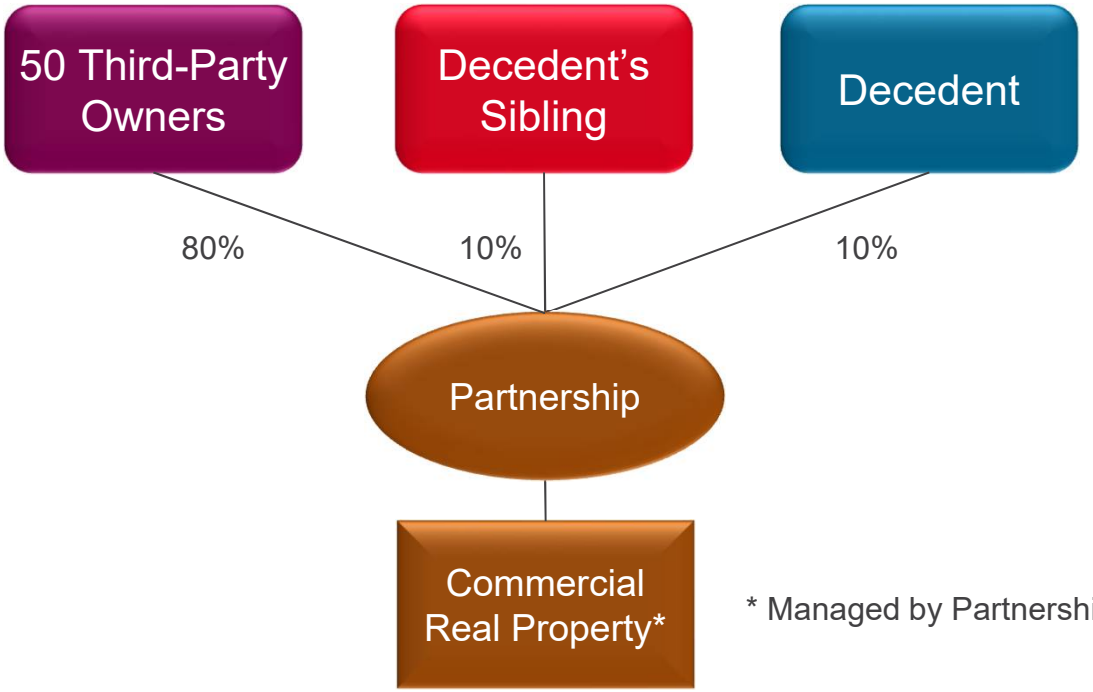
Attribution Rules (cont.)

- Interests owned by spouses as community property, tenants in common, tenants by the entirety, or joint tenants treated as owned by one person
- Interests owned by the decedent's (1) siblings, (2) spouse, (3) ancestors, and (4) lineal descendants treated as owned by decedent
    - Excludes nieces, nephews, and cousins
- Interests owned directly or indirectly by an entity, estate, or trust treated as owned proportionately by shareholders, partners, or current beneficiaries

Effect of Attribution Rules

- For purposes of the 45-Owner Test, a decedent is treated as the owner of any interest in a closely-held business owned by:
  - Siblings, spouse, ancestors, and lineal descendants (“family members”)
  - Corporations wholly owned by decedent and family members
  - Partnerships wholly owned by decedent and family members
  - Trusts, the only current beneficiaries of which are decedent and family members

Example: Property-Holding Partnership



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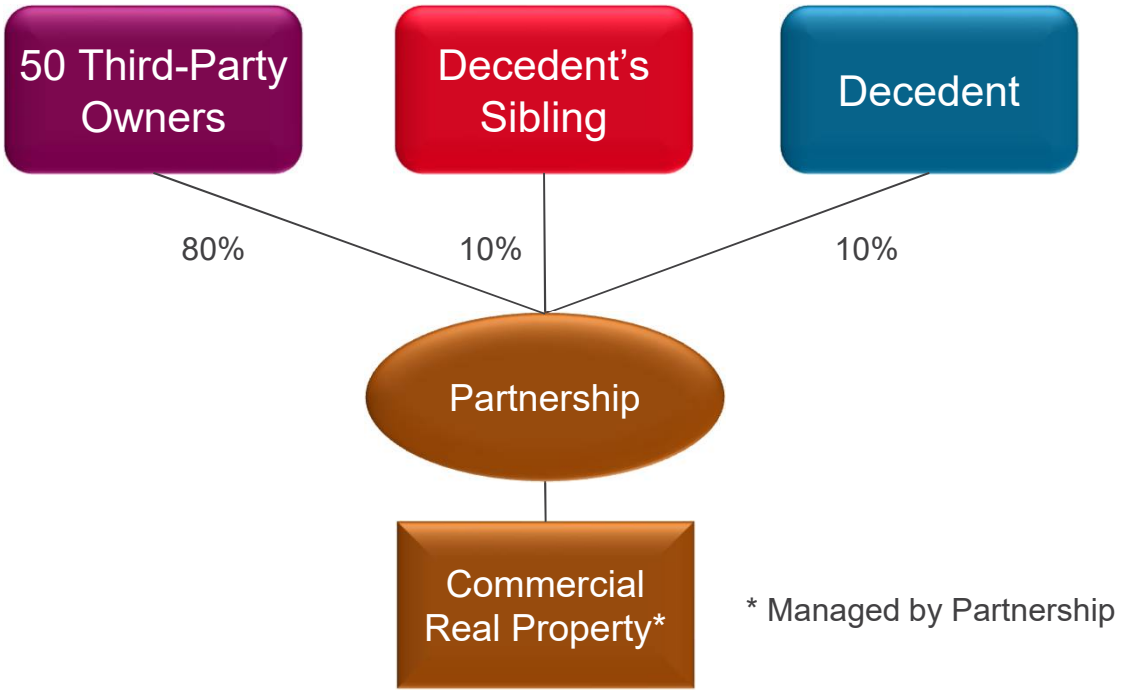
6166(b)(7) Election for Partnerships and Non-Readily Tradable Stock

- The estate may elect under Section 6166(b)(7) to have attribution rules apply for purposes of the 20% Test (including for purposes of aggregating multiple interests in closely-held businesses) to partnership interests and stock that is not readily tradable
- If election is made, estate forgoes first 5 years of principal deferral and cannot take advantage of the 2% interest rate for a portion of the deferred tax
- Election as to some but not all 6166 property not permitted

6166(b)(7) Election: Example



- Absent a 6166(b)(7) election, Partnership meets neither the 45-Owner Test nor the 20% Test
- With a 6166(b)(7) election, Sibling's interest is treated as owned by Decedent for purposes of the 20% Test
- 6166(b)(7) election may not qualify Sibling for deferral on his or her death

Example: Holding Company Structure

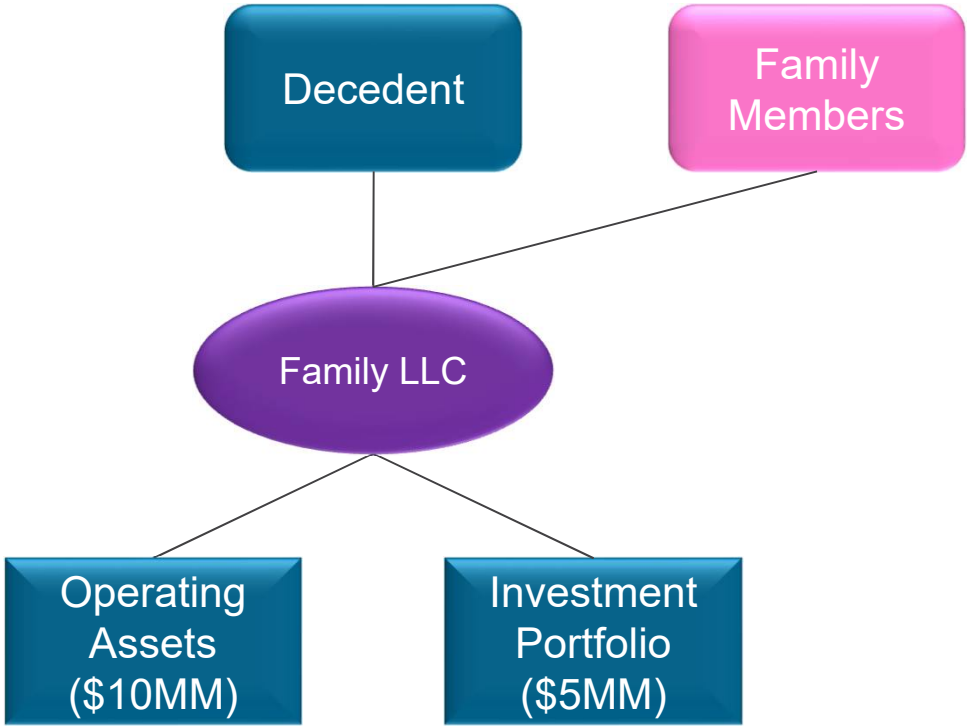
Section 6166(b)(8) Holding Company Election

- Where the estate owns stock in a "holding company" that in turn owns stock in a "business company," the PR may elect to treat both as a single company owned by the estate
- Intended to permit an interest owned through a tiered structure to qualify for deferral
- If election is made, estate forgoes first 5 years of principal deferral and cannot take advantage of the 2% interest rate for a portion of the deferred tax. Election as to some but not all 6166 property not permitted.
- Statute defines holding company and business company to include only corporations

Section 6166(b)(8) Holding Company Election: Example

- If Holdco is a passive holding company, it will not qualify under Section 6166 even if its sole significant asset is an interest in Opco
- A holding company election will cause the two corporations to be treated as a single company, at the cost of 5 years of principal deferral and the favorable 2% interest rate on a portion of the deferred tax
- If Holdco and Opco were both conducting a trade or business, the election might not be required

Example: Company with Passive Assets



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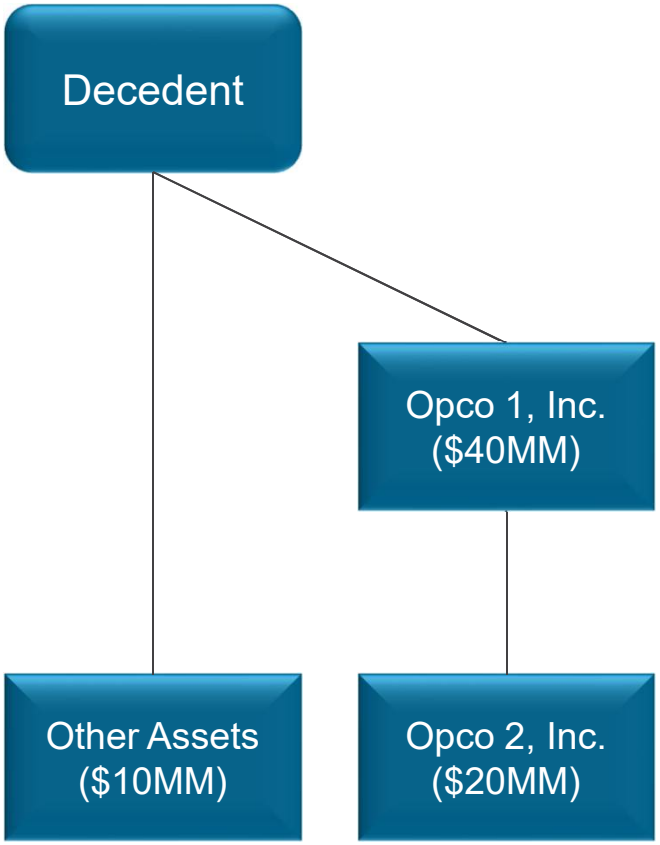
Treatment of Passive Assets

- The value of an interest in a closely held business does not include the portion of that interest attributable to passive assets held by the business
- Passive assets are defined as any asset not used in carrying on a trade or business
- Stock held by an entity is generally treated as a passive asset unless the holding company election is made and the subsidiary's stock meets the 35% Test
    - No policy reason not to treat partnership interests held by an entity as passive assets, although the holding company election on its face does not apply to partnerships

Treatment of Passive Assets (cont.)

- Stock held by another corporation is not treated as a passive asset if:
  - The subsidiary corporation meets either the 45-Owner Test, or the 20% Test with respect to the parent corporation; and
  - 80% or more of the value of assets of both the parent and the subsidiary is attributable to assets used in carrying on a trade or business
  - For purposes of determining whether the parent meets this 80% test, the value attributable to the subsidiary is disregarded

Example: Tiered Operating Companies



- If the value of more than 80% of the assets of both Opco 1 and Opco 2 is attributable to assets used to carry on a trade or business, no holding company election required

Making the 6166 Election

- PR checks the box in Part 3 of Form 706 and attaches a statement to the timely filed return including:
  - Decedent's name and TIN;
  - Amount of the estate tax to be paid in installments;
  - Date selected for the payment of the first installment;
  - Number of annual installments, including the first installment, in which the tax is to be paid;
  - Property shown on the estate tax return that constitutes a closely held business, identified by schedule and item number; and
  - Facts that serve as the basis for the conclusion that the estate qualifies for estate tax deferral
- The election is made on the Washington return by checking the box in Part 3, Line 3, and attaching the notice of election from Form 706

Making the 6166 Election (cont.)

- PR may make a protective 6166 election
- If no election is made on the timely filed return, the election may be made with respect to an estate tax deficiency not attributable to negligence, fraud, or intentional disregard of tax law
    - This election is limited to the deficiency amount and is prorated to the installments that would have been due if an election had been timely made at the time the estate tax return was filed, with the remaining portion payable at the time of the election
    - IRS may limit deferral to the portion of the deficiency equal to the portion of the estate's assets that qualify under Section 6166

Bond Requirement

- IRS can require a bond of up to twice the amount of the deferred estate tax
- Tax Court has held that IRS must determine whether to require bond on a case-by-case basis. IRS has published the factors it will consider in Notice 2007-90.
- Finding a provider for the bond can be difficult and expensive

Alternative to Bond: Special Lien

- As an alternative to posting bond, the PR can elect to submit to a special lien on property equal in value to the deferred tax plus the first four years of interest
- PR submits proposed collateral, which IRS must accept if it is:
  - expected to survive the deferral period;
  - identified in the security agreement; and
  - of sufficient value
- If the value of lien property falls below the required minimum, IRS can request additional security
- IRS typically sends a letter requesting that the estate provide a bond or submit to a special lien. If PR doesn't respond within 30 days, IRS unilaterally determines what security is required.

Administration of 6166 Estate

- Deferral can be terminated if there is:
  - Disposition of the closely-held business interest or withdrawal of funds from the business;
  - Failure to use undistributed income to pay deferred tax;
  - Default in payment of installment amounts or interest; or
  - Violation of a lien condition

Administration of 6166 Estate: Dispositions of 6166 Property

- Estate tax deferral is terminated if:
  - Any portion of an interest in a closely-held business is distributed, sold, exchanged, or otherwise disposed of, or money and other property attributable to such an interest is withdrawn from such business; and
  - The aggregate of such distributions, sales, exchanges, dispositions and withdrawals equals or exceeds 50% of the value of such interest
- If the estate includes more than one interest in a closely-held business, the 50% test takes into account the value of all such businesses

Administration of 6166 Estate: Dispositions of 6166 Property (cont.)

- The following will not jeopardize deferral:
  - Reshuffling of business interests among heirs within an estate;
  - Sale of assets of a closely-held business if the proceeds are applied to debts of the business;
  - Tax-free exchanges of stock under Section 368(a)(1)(D)-(F) and Section 355; and
  - Exchanges of real property for like-kind property under Section 1031

Administration of 6166 Estate: Dispositions of 6166 Property (cont.)

- The following will not jeopardize deferral:
  - Transfers of 6166 property to a decedent's heirs, or transfers of property on the death of those heirs to their family members; and
  - Distributions in redemption of stock under Section 303, if certain conditions are met

Example: Dispositions of 6166 Property

- Estate holds interests in three closely-held businesses, each valued at $5MM, for a total of $15MM Section 6166 property
  - Estate sells its interest in the first business – no loss of deferral, less than 50% of the value of the closely-held business interests
  - Estate then causes $3M of assets in the second business to be sold and the proceeds used to pay down debts of that business – no loss of deferral, and not treated as a disposition or withdrawal
  - Estate then pledges its interest in the third business as collateral for a loan – loss of deferral, as over 50% of the value of the estate's closely-held business interests has now been disposed of or withdrawn

Administration of 6166 Estate: Undistributed Net Income

- If the estate has undistributed net income for any taxable year ending on or after the due date for the first principal installment, PR must, on or before the filing date for the income tax return for such taxable year (including extensions), pay the undistributed net income in liquidation of the unpaid portion of the deferred tax
- Dividends paid to a holding company are treated as having been paid to the estate for these purposes

Administration of 6166 Estate: Failure to Make 6166 Payments

- If the estate misses any payment of principal or interest, the deferred estate tax becomes due and payable upon notice and demand from the IRS
- If the estate misses a payment but makes late payment within 6 months of the due date, deferred estate tax does not become due, but the 2% interest rate does not apply with respect to the payment, and a penalty equal to 5% of the payment, multiplied by the number of months (including fractions thereof) after the due date the payment is made, is imposed

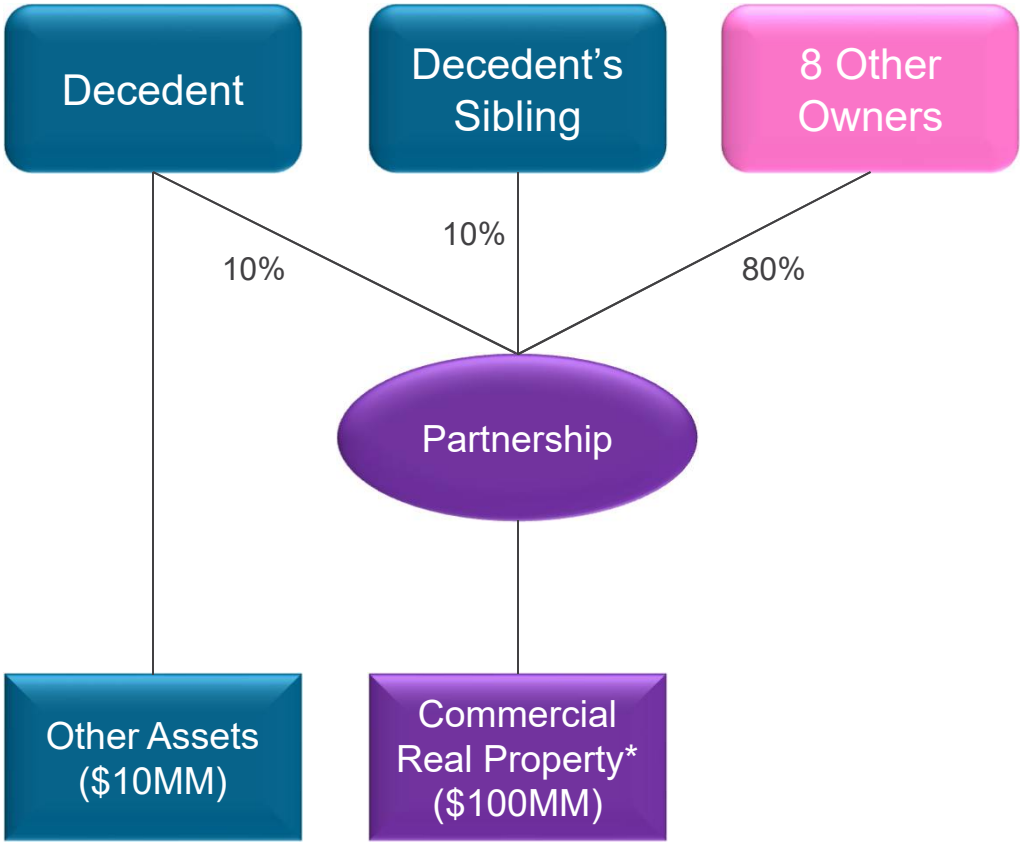
Section 6166: Interaction with Other Code Sections

- **Section 2035:** If property is includible in the estate under Section 2035, the 35% Test must be satisfied both with and without the addition of such property to qualify for Section 6166
- **Section 2032A:** If the conditions of Section 2032A are breached, resulting increase in tax is not eligible for deferral under Section 6166. Breaches resulting from a disposition of assets by a qualified heir can also accelerate the estate's deferred estate tax.
- **Sections 2056 and 2056A:** Property held in a qualified terminable interest property (QTIP) marital trust or a qualified domestic trust (QDOT) may qualify as Section 6166 property
- **Generation-skipping Transfer Tax:** If an interest in 6166 property is the subject of a direct skip, GST tax due is deferred as though it were estate tax

Section 6166: Deductibility of Interest

- Interest paid on estate tax deferred under Section 6166 is not deductible under Section 2053(c)(1)(D)
  - Cf. interest paid on estate tax deferred under Section 6161, which is deductible once paid
- Washington Estate Tax Filing Instructions indicate that accrued interest on deferred tax is deductible once paid
  - Interest on deferred Washington estate tax accrues at a single statutory rate – no 2% portion

Section 6166: Example 1



* Managed by Partnership.

- Trade or business requirement
- 45-Owner Test
- 20% Test
- 35% Test

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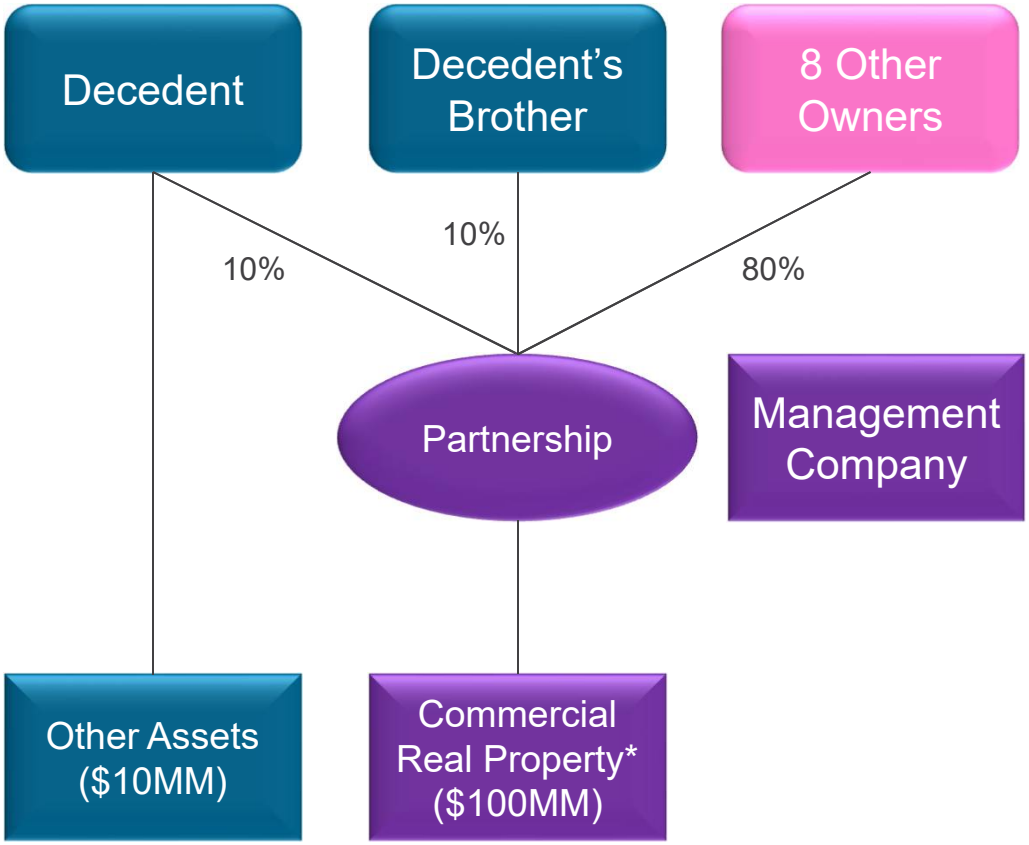
Section 6166: Example 2



- Trade or business requirement
- 45-Owner Test
- 20% Test
- 35% Test

* Managed by Management Company.

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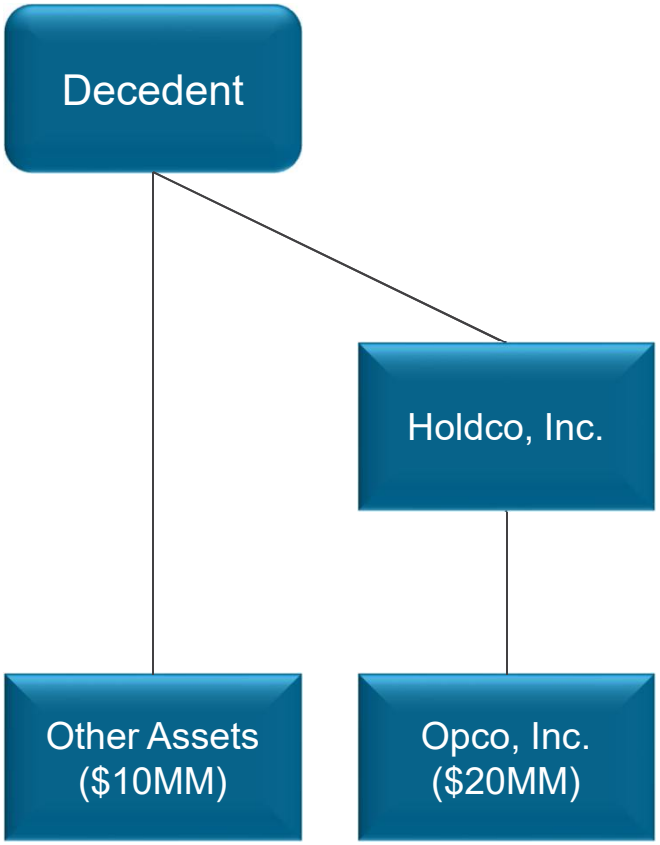
Section 6166: Example 3



- Trade or business requirement
- 45-Owner Test
- 20% Test
- 35% Test
- Ideally Holdco would be liquidated prior to death to avoid the need for a holding company election and loss of 5 years principal deferral and 2% interest rate on a portion of the deferred tax

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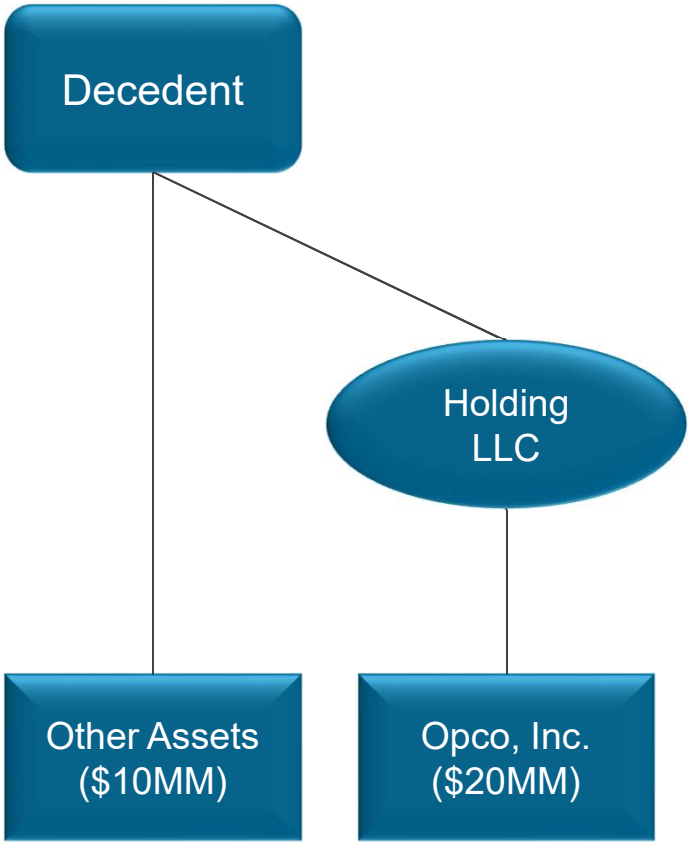
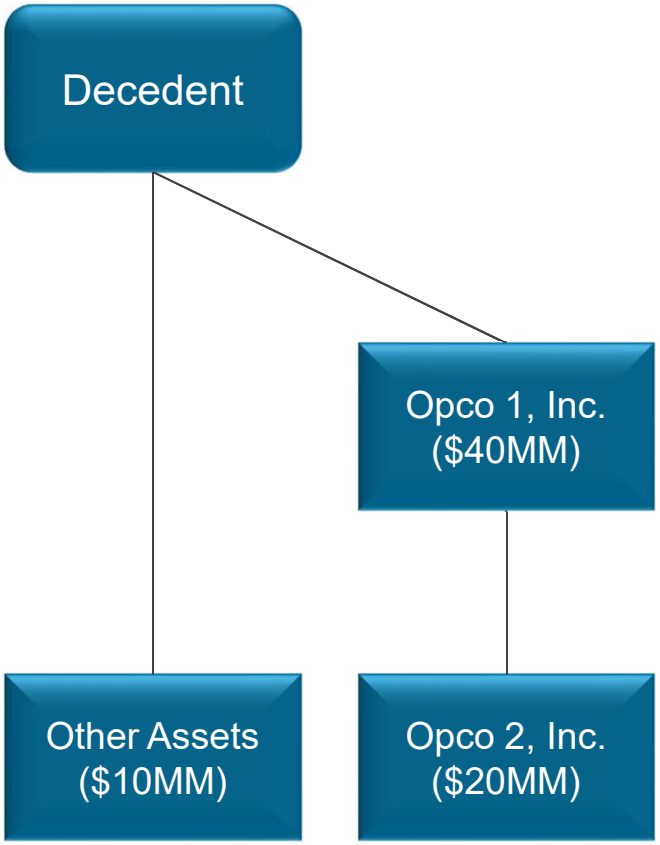
Section 6166: Example 4



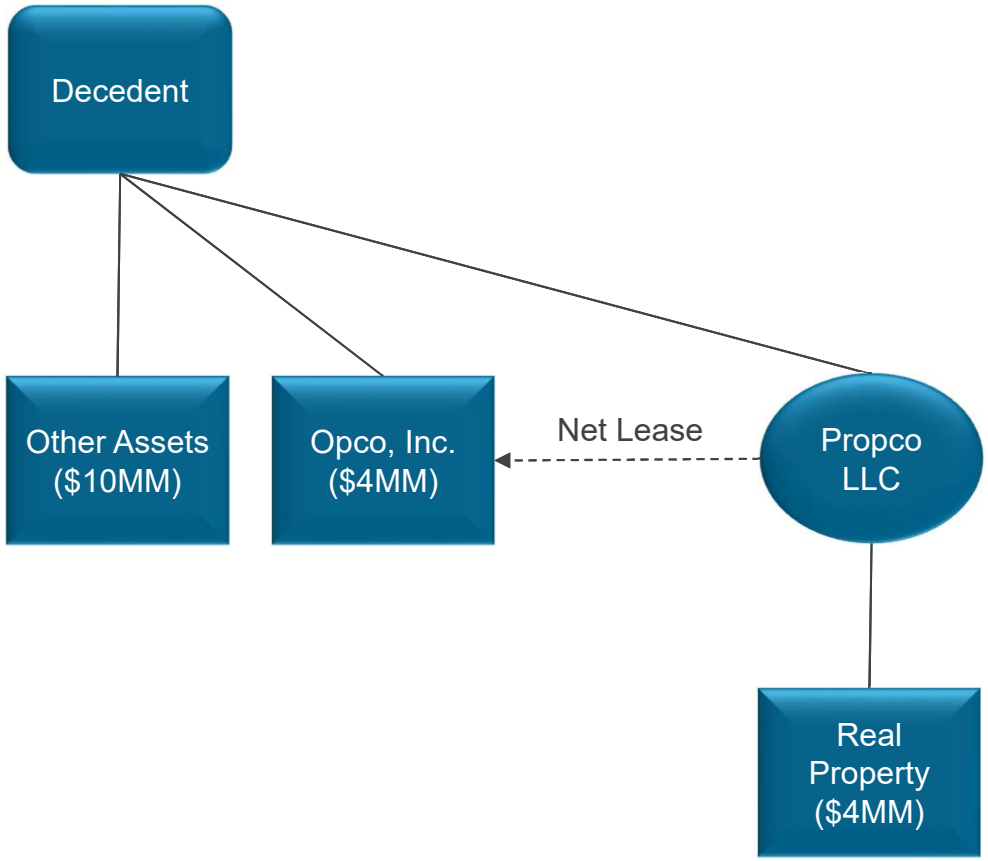
- Trade or business requirement
- 45-Owner Test
- 20% Test
- 35% Test
- Again, ideally Holding LLC would be liquidated prior to death

Section 6166: Example 5



- Trade or business requirement
- 45-Owner Test
- 20% Test
- 35% Test
- If the value of more than 80% of the assets of both Opco 1 and Opco 2 is attributable to assets used to carry on a trade or business, no holding company election required

Section 6166: Example 6



- Trade or business requirement
- 45-Owner Test
- 20% Test
- 35% Test

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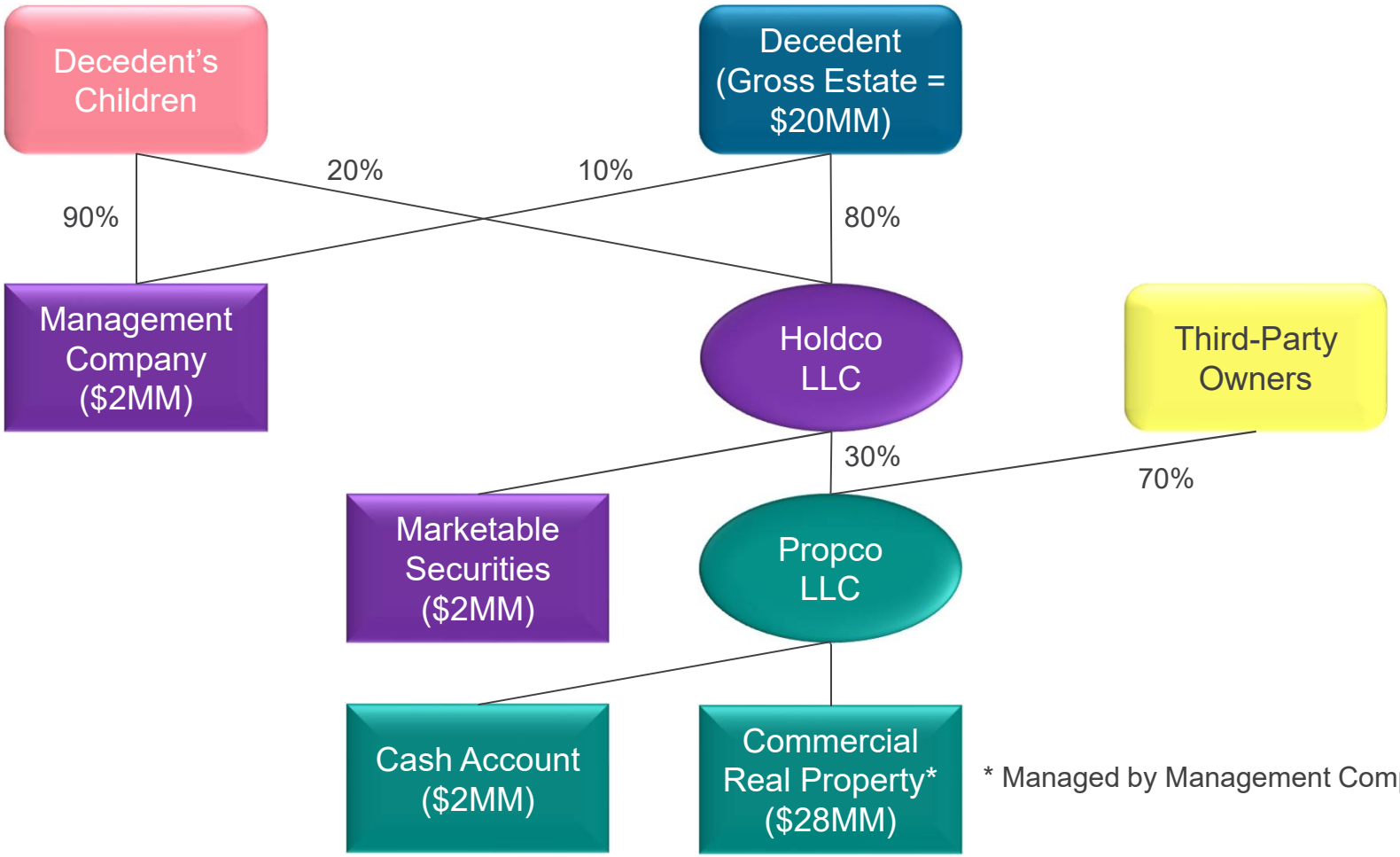
Section 6166: Example 7



* Managed by Management Company

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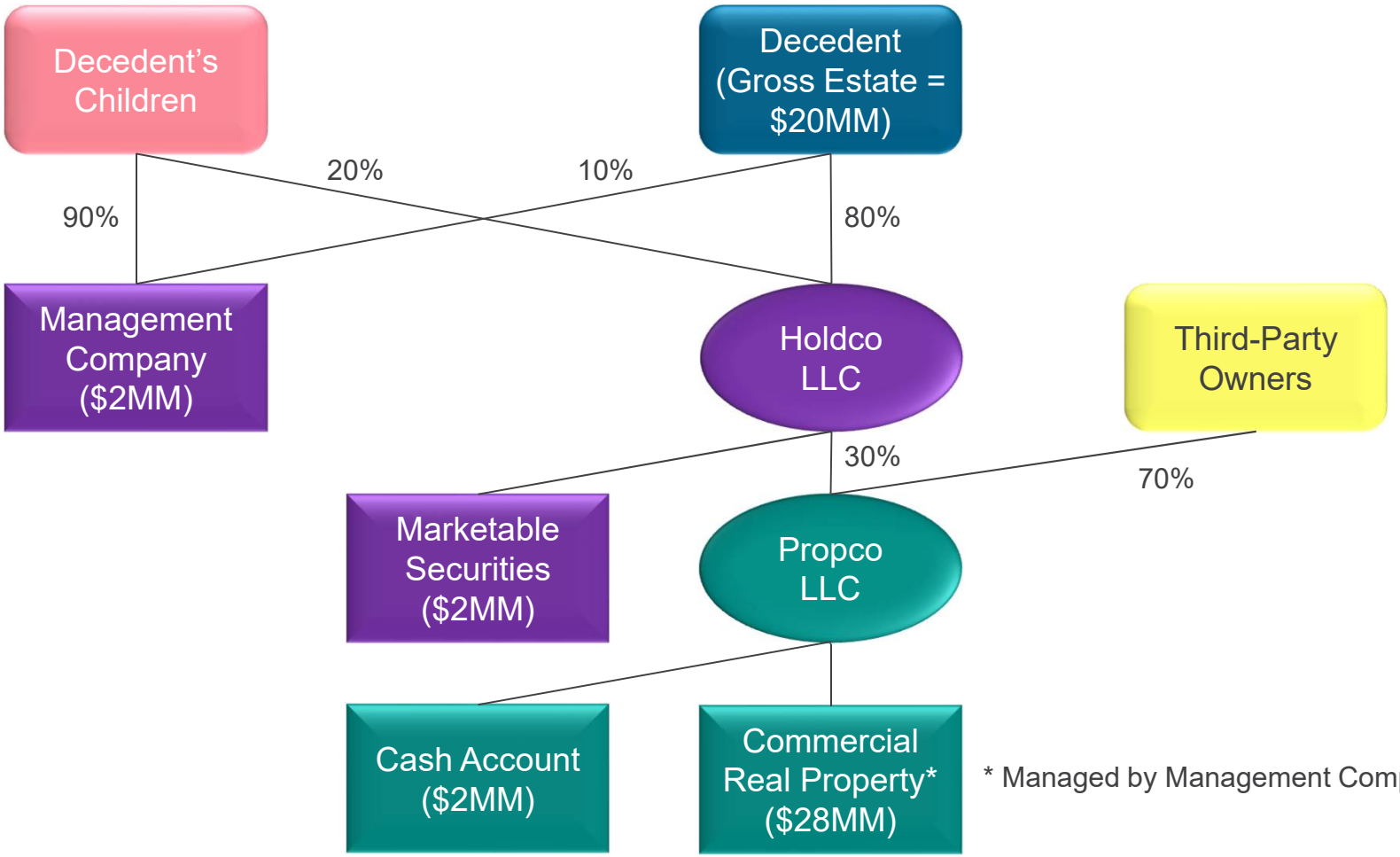
Section 6166: Example 7 (cont.)

- Management Company
  - Trade or business requirement
  - 45-Owner Test
  - 20% Test
  - 35% Test

Section 6166: Example 7



* Managed by Management Company

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Section 6166: Example 7 (cont.)

- Holdco LLC / Propco LLC
  - Trade or business requirement
  - 45-Owner Test
  - 20% Test
  - 35% Test
    - If Propco cash account is a passive asset, value of decedent's 6166 property is $6.92MM, or 34.6% of gross estate
    - If cash account is a reasonable reserve for business purposes, 6166 property is worth $7.4MM, 37% of gross estate

Section 6166: Example 7 (cont.)

- Pre-mortem planning:
  - Increase decedent's ownership of Management Company to at least 20%
  - Remove Holdco LLC from structure if feasible
  - Be mindful of 35% Test when planning for lifetime gifts of decedent's Propco interest
  - Remember to exclude value of passive assets from closely-held business interests

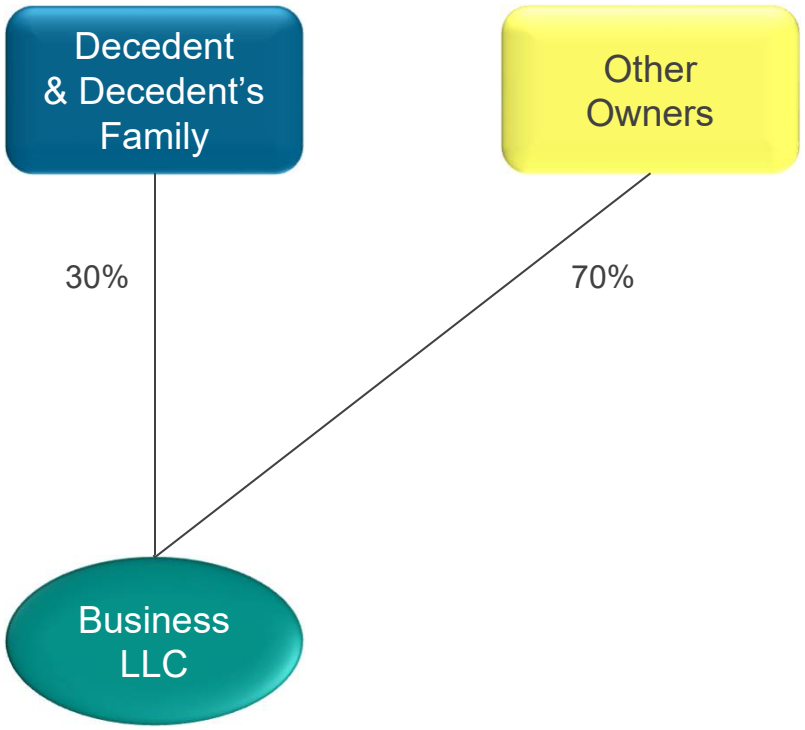
QFOBI Deduction

- Washington deduction of up to $2.5MM for qualified family-owned business interests was adopted by the Washington Legislature in 2013
- Deduction is intended to provide estate tax relief for families owning closely-held businesses
- Washington rules rely heavily on the now-repealed Federal QFOBI deduction under Section 2057

Definition of QFOBI

- Interest as a sole proprietor carrying on a trade or business, or an interest in an entity carrying on a trade or business, if:
  1) At least 50% of such entity is owned (directly or indirectly) by the decedent and members of the decedent's family;
  2) At least 70% of such entity is so owned by members of 2 families; or
  3) At least 90% of such entity is so owned by members of 3 families.
- For purposes of 2) or 3), at least 30% of such entity must be owned by the decedent and members of the decedent's family

Definition of QFOBI: Example 1



- Decedent and decedent's family members own less than 50% of Business LLC
- If one other family owns 40% of the remaining LLC interest, or if two other families own 60% of the remaining LLC interest, the interest qualifies as QFOBI

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QFOBI: Ownership Attribution

- An interest owned, directly or indirectly, by or for an entity is considered owned proportionately by the entity's shareholders, partners, or beneficiaries
  - Ownership of a corporation determined with respect to ownership % of voting stock, and by ownership % of all stock by value
  - Ownership of a partnership determined with respect to capital interests in the partnership
  - In a tiered entity structure, each tier's interest is considered separately
- A person is treated as a beneficiary of any trust only if such person has a present interest in such trust

QFOBI: Excluded Interests

- QFOBI does not include:
  - Interests in entities whose principal places of business are located outside the United States;
  - Interests in entities that were tradable in securities markets within three years prior to the decedent's death;
  - Interests attributable to cash or marketable securities held by a business in excess of reasonably expected working capital needs; or
  - Interests in trades or businesses other than banks or building and loan associations, more than 35% of the adjusted gross income of which would qualify as personal holding company income (generally, passive income)

QFOBI: Definition of Trade or Business

- No definition provided under WA statute or regulations
- Now-repealed Section 2057 provides some insight
- Under Section 2057, passive assets generally are excluded from the value of a trade or business, and interests that produce holding company income (other than rental income) do not qualify
- Generally, the decedent or entity must:
  - Bear the risks of production;
  - Bear the risks of a price change; and
  - Be actively involved in management of the business

QFOBI: Definition of Trade or Business (cont.)

- Activities of family members are imputed to decedent in determining whether there was a trade or business
- Interests in property generating rental income may qualify as QFOBI if:
  - Decedent or a member of the decedent's family materially participated in the leasing activity; or
  - Property was leased to a member of the decedent's family who carried on the trade or business with the property

QFOBI Deduction Requirements

- Decedent was a U.S. citizen or resident;
- **Value of QFOBI owned by decedent must exceed 50% of the Washington taxable estate, determined without regard to the deduction for the applicable exclusion amount;**
- During 5 of the 8 years prior to death:
  - QFOBI owned by the decedent or a member of the decedent's family; and
  - Material participation by the decedent or a member of the decedent's family in the operation of the QFOBI trade or business;
- QFOBI acquired from the decedent by a qualified heir; and
- Value of QFOBI owned by decedent does not exceed $6MM

QFOBI: 50% Test

- Value of the QFOBI must exceed 50% of the WA taxable estate, determined without regard to the deduction for the applicable exclusion amount
- Under RCW 83.100.020(15), this means that QFOBI must exceed 50% of: Federal taxable estate, plus amounts required to be added under RCW 83.100.047 (e.g., WA-only QTIP property), less:
  - Amount of any farm deduction;
  - Amount of any Washington-only QTIP deduction; and
  - Amount of the QFOBI deduction itself

QFOBI: 50% Test - Example

- Gross estate = $10MM
- Under estate plan, 50% of property (including QFOBI) passes outright to children, remaining 50% to a Federal and Washington QTIP trust
- Value of QFOBI = $2MM (assumes all other requirements met)
- Washington estate for purposes of 50% Test:
  - Federal taxable estate of $5MM, less
  - $0 farm deduction, less
  - $0 WA-only QTIP deduction, less
  - $2MM QFOBI deduction
  - $3MM
- QFOBI is 66.67% of Washington taxable estate for purposes of 50% Test

QFOBI: Planning Opportunity

- For married couples with relatively small QFOBI interests compared to their overall estate such that the 50% Test is unlikely to be satisfied on death of surviving spouse, consider planning that permits the QFOBI interests to pass to children or family members other than the surviving spouse
- For instance, a married couple with a $20MM estate, $2MM of which is QFOBI, might structure their estate plan so as to create:
  - Credit shelter trust with the Washington exclusion amount ($2,193,000 in 2018);
  - Second trust for descendants holding the QFOBI; and
  - QTIP marital trust to hold the residue of $15,807,000
- $2MM of QFOBI exceeds 50% of the deceased spouse's WA taxable estate (Federal taxable estate of $4,193,000, less $2,000,000 QFOBI deduction = $2,193,000)
- Estate would receive a $2MM QFOBI deduction

QFOBI Deduction Requirements

- Decedent was a U.S. citizen or resident;
- Value of QFOBI owned by decedent must exceed 50% of the Washington taxable estate, determined without regard to the deduction for the applicable exclusion amount;
- **During 5 of the 8 years prior to death:**
  - **QFOBI owned by the decedent or a member of the decedent's family; and**
  - **Material participation by the decedent or a member of the decedent's family in the operation of the QFOBI trade or business;**
- QFOBI acquired from the decedent by a qualified heir; and
- Value of QFOBI owned by decedent does not exceed $6MM

QFOBI: 5-Year Test

- During the 8-year period ending on the date of death, there must have been periods aggregating 5 years or more during which:
  - QFOBI was owned by the decedent or a member of the decedent's family; and
  - There was material participation by the decedent or a member of the decedent's family in the operation of the trade or business

QFOBI: Members of the Decedent's Family

- Includes:
  - Decedent's ancestors;
  - Decedent's spouse or registered domestic partner;
  - Lineal descendants of the decedent, the decedent's spouse or registered domestic partner, or the decedent's parent; and
  - Spouse or registered domestic partner of any such lineal descendant
- Legally adopted children treated as children

QFOBI: Material Participation

- Defined by reference to Section 2032A, and determined in a manner similar to that used for purposes of Section 1402(a) (relating to net earnings from self-employment)
- In general, individual must be involved in making significant management decisions, but not necessarily day-to-day operating decisions
- Physical presence and participation in management decisions are the principal factors to be considered, and regular consulting with any other managing parties is important

QFOBI: Material Participation (cont.)

- Individual should:
  - Make or participate in a substantial number of management decisions;
  - Work on a continuous and substantial basis in the operation of the trade or business; and
  - Work at least 500 hours per year, with no one else working more hours than the individual or receiving compensation for managing the operation

QFOBI: Material Participation (cont.)

- If QFOBI is held in a trust, material participation requirement will be satisfied if the decedent or family member:
  - Is the trustee and materially participates in the business;
  - Is employed by the trustee in an arrangement that requires his or her material participation in the business;
  - Enters into a contract with the trustee to manage the business; or
  - Is granted management rights over the business in the trust agreement

QFOBI: Material Participation (cont.)

- An individual is not materially participating where:
  - Management decisions are made by a third party under a management agreement or other arrangement
  - An agent of the decedent or family member is materially participating rather than the decedent or family member
  - Trustee who is not the individual is making management decisions, even if the individual is a beneficiary of the trust
- Attribution of an entity's activities to its shareholders, partners, or beneficiaries does not explicitly apply to the 5-Year Test, but there seems no policy reason not to permit this

QFOBI Deduction Requirements

- Decedent was a U.S. citizen or resident;
- Value of QFOBI owned by decedent must exceed 50% of the Washington taxable estate, determined without regard to the deduction for the applicable exclusion amount;
- During 5 of the 8 years prior to death:
  - QFOBI owned by the decedent or a member of the decedent's family; and
  - Material participation by the decedent or a member of the decedent's family in the operation of the QFOBI trade or business;
- **QFOBI acquired from the decedent by a qualified heir;** and
- Value of QFOBI owned by decedent does not exceed $6MM

QFOBI:
Interest Acquired from Decedent by Qualified Heir

- Property is acquired from the decedent if that property:
  - Is so considered under Section 1014(b);
  - Is acquired by any person from the estate; or
  - Is acquired by any person from a trust, to the extent the property is includible in the gross estate of the decedent
- Property passing from the decedent to a trust should qualify so long as all current beneficiaries are qualified heirs
- Sales of QFOBI by the estate to qualified heirs would seem to be permitted

QFOBI: Qualified Heir

- Members of the decedent's family (ancestors, spouse, lineal descendants, etc.) who acquired property from the decedent; and
- Any active employee of the trade or business, if such employee has been employed by the trade or business for at least 10 years before the date of the decedent's death
- If a qualified heir disposes of the QFOBI to a member of the qualified heir's family, the transferee continues to be treated as a qualified heir for purposes of the QFOBI deduction

QFOBI Deduction Requirements

- Decedent was a U.S. citizen or resident;
- Value of QFOBI owned by decedent must exceed 50% of the Washington taxable estate, determined without regard to the deduction for the applicable exclusion amount;
- During 5 of the 8 years prior to death:
  - QFOBI owned by the decedent or a member of the decedent's family; and
  - Material participation by the decedent or a member of the decedent's family in the operation of the QFOBI trade or business;
- QFOBI acquired from the decedent by a qualified heir; and
- **Value of QFOBI owned by decedent does not exceed $6MM**

QFOBI: $6MM Limitation

- Under RCW 83.100.048(d), the value of the decedent's QFOBI cannot exceed $6MM, or the entire deduction will be lost
- Harsh result for a decedent owning QFOBI valued at $6,000,001
- Statute and regulations unclear whether this requirement is satisfied if any interests in excess of $6MM that would otherwise be QFOBI fail to qualify because one or more of the QFOBI requirements are not satisfied (e.g., because they pass to someone other than a Qualified Heir), or if the PR does not make a QFOBI election with respect to such interests (e.g., where a decedent owns two businesses, one of which is expected to move overseas within 3 years)

QFOBI: Clawback of Tax Savings

- An amount equal to the tax savings with respect to the deduction for QFOBI acquired by a qualified heir may be clawed back with interest from that qualified heir if, within 3 years of the decedent's date of death and before the qualified heir's death:
  - Material participation requirement is not met by the qualified heir or a member of the qualified heir's family;
  - Qualified heir disposes of any portion of the QFOBI, other than a disposition to a member of the qualified heir's family, a person with an interest in the business, or through a qualified conservation contribution;
  - Qualified heir expatriates and fails to comply with the requirements of Section 877(g); or
  - Principal place of business ceases to be in the U.S.

QFOBI: Clawback of Tax Savings (cont.)

- Each qualified heir must sign an agreement, to be included with the WA estate tax return, that he or she will be liable for the clawback amount
  - Unclear whether entire deduction is lost if one qualified heir refuses to sign; better answer is that only a portion of the deduction should be lost
  - Unclear whether PR can elect not to treat an interest as QFOBI if PR anticipates clawback will be triggered (e.g., if decedent owned two businesses, one of which will move overseas within 3 years)
- Clawback amount due six months after the triggering event, which must be reported to the Department of Revenue
- Qualified heir personally liable for clawback amount unless a bond is posted

QFOBI: Clawback of Tax Savings (cont.)

- Clawback amounts due are secured by a lien on the property to which the QFOBI relates
- The lien arises when the WA return is filed and continues until:
  - Tax liability has been satisfied or has become unenforceable by reason of lapse of time; or
  - Department of Revenue is satisfied that no further tax liability will arise
- DOR may accept other security in lieu of this lien
- DOR may require qualified heirs to provide information as the department deems necessary

QFOBI: Making the Election

- PR files Washington State Estate Tax Addendum #3 with WA estate tax return
  - Signed by PR and Qualified Heirs
  - Include documents showing continuous ownership and ownership percentages (corporate charter, partnership agreement, and/or property tax statements)
  - Attach last three years of federal income tax returns, schedules, and attachments
- QFOBI deduction taken on Part 2, Line 4b of the WA estate tax return

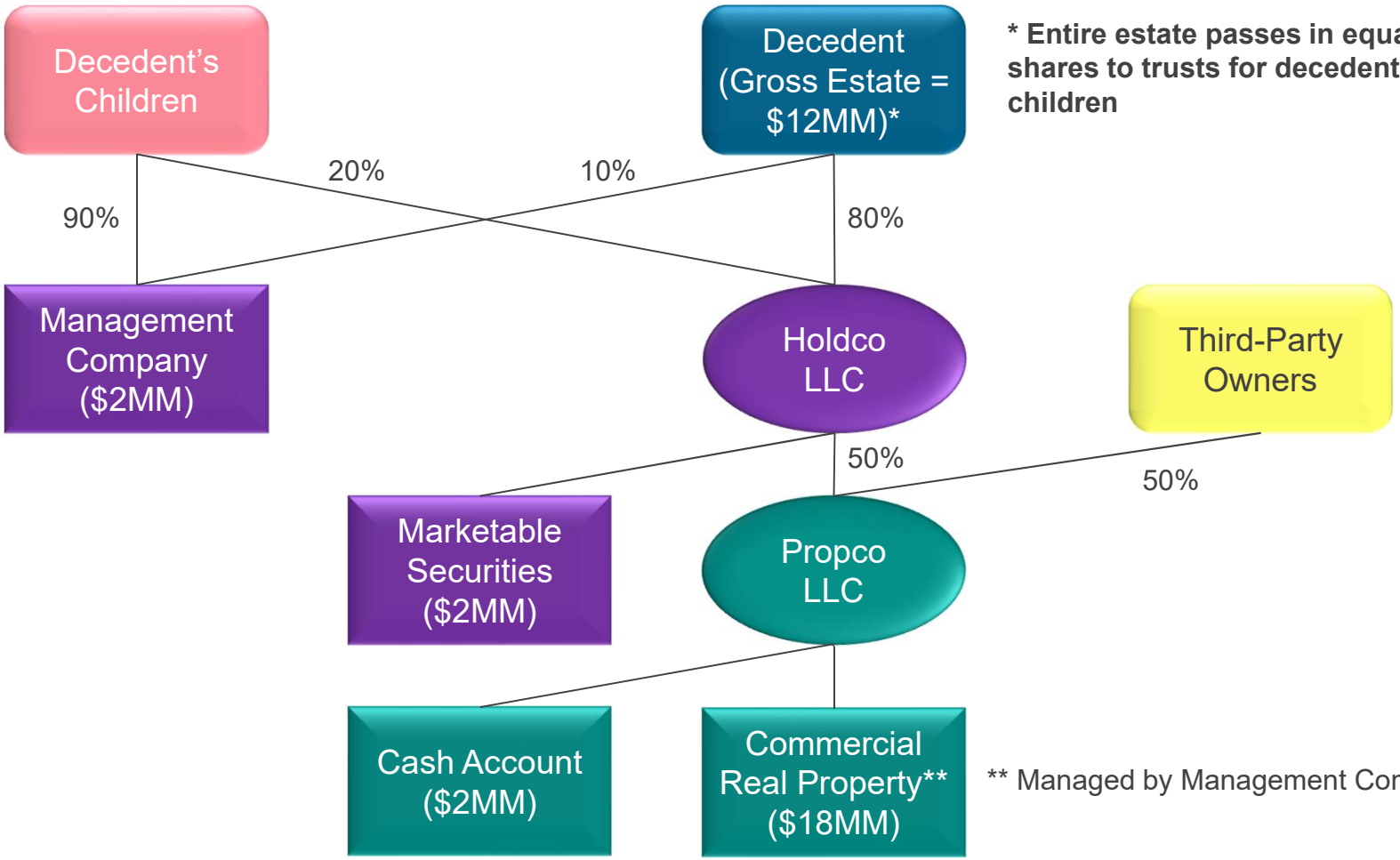
QFOBI and Section 6166: Example 1

- Decedent owns 25% of Opco, Inc., an auto dealership. The remaining 75% is owned by decedent's three siblings.
- Decedent's Opco interest is worth $10MM. Decedent's Federal adjusted gross estate is $20MM.
- **QFOBI analysis:**
  - Trade or business requirement
  - Ownership test
  - 50% Test
  - 5-Year Test
  - Acquired from decedent by qualified heir
  - $6MM requirement
- **6166 analysis:**
  - Trade or business requirement
  - 45-Owner Test
  - 20% Test
  - 35% Test

Making Both QFOBI and 6166 Elections

- Making a QFOBI election should not affect the amount of deferral available under Section 6166
- Washington State will "will abide by the provisions of section 6166 of the 2005 IRC for granting of payment plans for closely held businesses"
- Section 6166(a)(1) provides that "if the value of an interest in a closely held business, which is included in determining the gross estate of a decedent…exceeds 35 percent of the adjusted gross estate, the executor may elect…."
- Section 6166(b)(4) defines "value" for all purposes under Section 6166 to be the value determined for purposes of Chapter 11
- Since the QFOBI deduction is a deduction and not a valuation provision, the QFOBI election should not affect the amount deferred under Section 6166

QFOBI and Section 6166: Example 2



*** Entire estate passes in equal shares to trusts for decedent's two children**

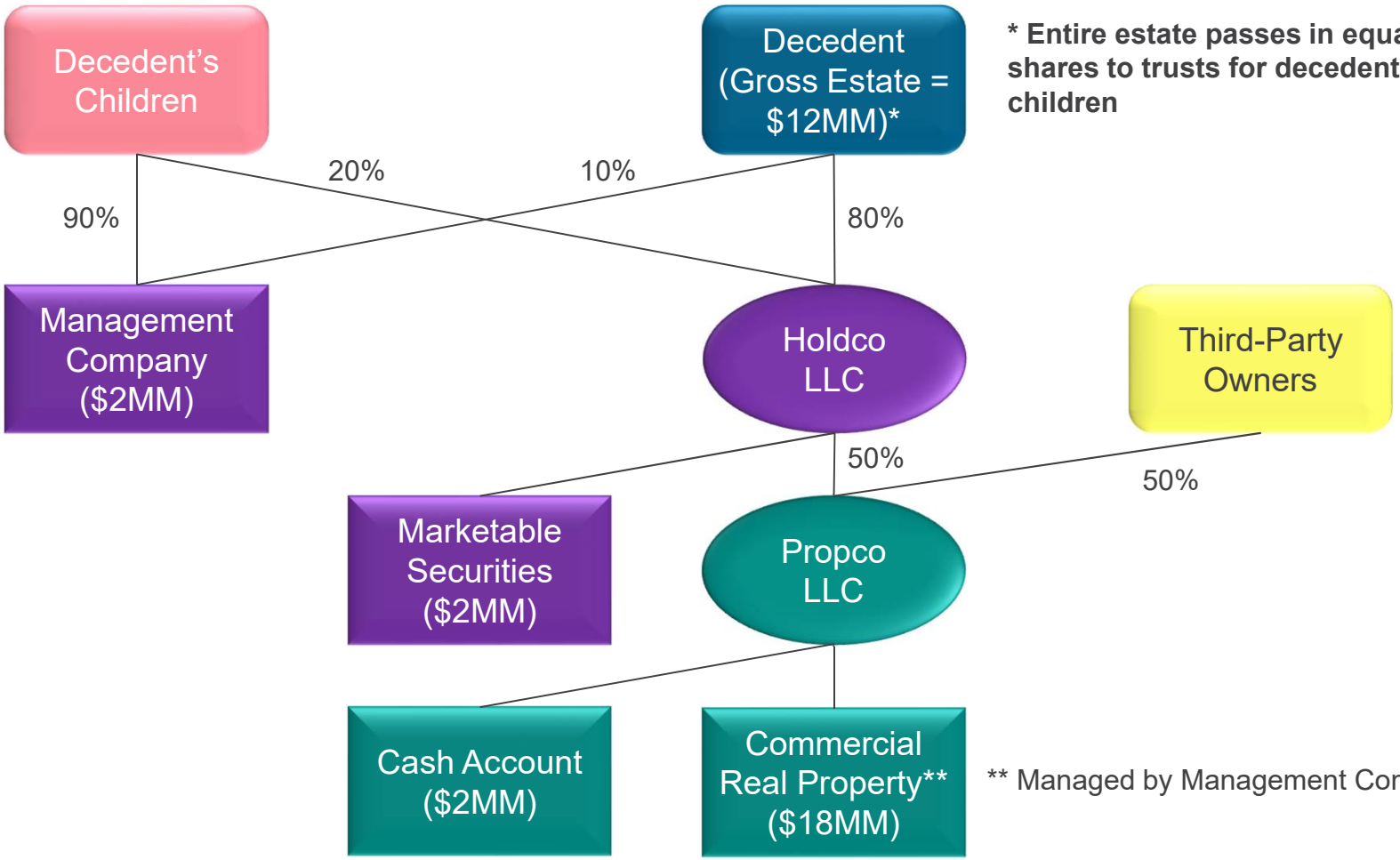
** Managed by Management Company

PERKINSCOIE

QFOBI and Section 6166: Example 2

- **6166 analysis for Management Company:**
  - **Trade or business requirement:** Likely satisfied
  - **45-Owner Test:** Satisfied, only owners are decedent and decedent's two children
  - **20% Test:** Decedent owns only 10% of the company. Decedent may make a 6166(b)(7) election and attribute children's ownership to decedent. This will sacrifice the 2% interest rate on a portion of the deferred tax and the ability to defer principal payments for 5 years.
  - **35% Test:** Value of decedent's 10% interest is only $200,000 of a $12MM gross estate. Test will not be satisfied unless decedent's interest in Propco also meets the 6166 requirements.

QFOBI and Section 6166: Example 2



*** Entire estate passes in equal shares to trusts for decedent's two children**

** Managed by Management Company

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QFOBI and Section 6166: Example 2

- **6166 analysis for Propco LLC:**
  - **Trade or business requirement:** Satisfied if decedent owns a "significant interest" in Management Company
  - **45-Owner Test:** Satisfied so long as 44 or fewer third-party owners
  - **20% Test:** Decedent does not own a direct interest in the company, and must make a 6166(b)(7) election for the entity attribution rules to apply. This will sacrifice the 2% interest rate on a portion of the deferred tax and the ability to defer principal payments for 5 years.
  - **35% Test:** Assuming Propco's other assets are not passive assets, following the 6166(b)(7) election the value of decedent's 40% indirect interest in Propco LLC is $8MM of a $12MM gross estate

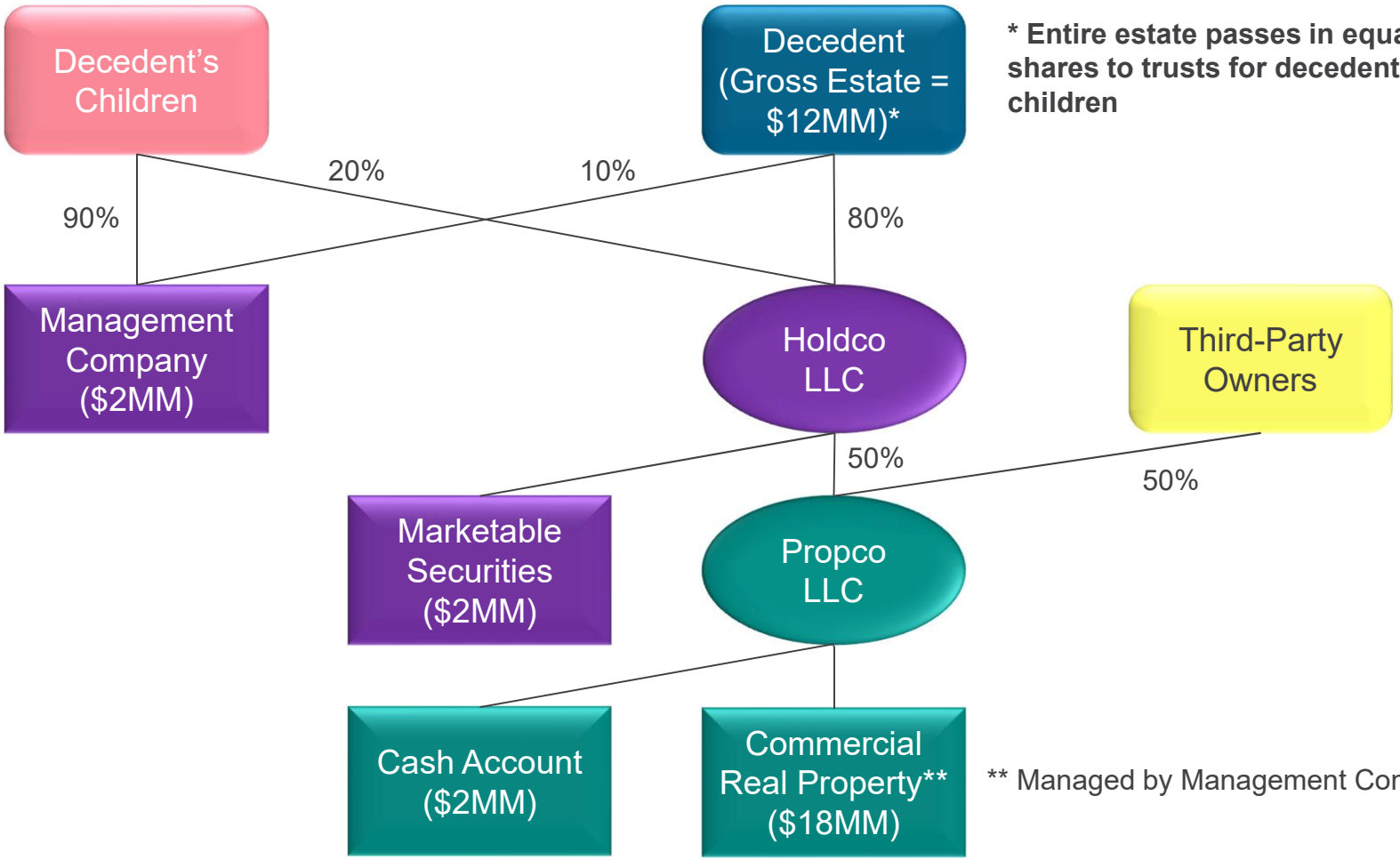
QFOBI and Section 6166: Example 2

- **QFOBI Analysis for Management Company**
  - **Trade or business requirement:** Likely satisfied
  - **Ownership test:** Satisfied, as 100% of company is owned by decedent and members of decedent's family
  - **50% Test:** Value of decedent's 10% interest is only $200,000 of a $12MM gross estate. Test will not be satisfied unless decedent's interest in Propco also meets the QFOBI requirements.
  - **5-Year Test:** Satisfied if, during the 8-year period ending on the date of death, decedent or a member of decedent's family owned and materially participated in the business for a total of 5 years

QFOBI and Section 6166: Example 2

- **QFOBI Analysis for Management Company (cont.)**
  - **Acquired from decedent by qualified heir:** Satisfied, as QFOBI passes to trusts, the sole current beneficiaries of which are members of decedent's family. To avoid clawback, at least one of decedent's children or a member of their family must materially participate in the business under the special rules applicable when a trust holds the QFOBI. Qualified heirs cannot dispose of their interests for 3 years, other than to members of their family.
  - **$6MM requirement:** Satisfied unless the value of decedent's interest in Propco is taken into account

QFOBI and Section 6166: Example 2



*** Entire estate passes in equal shares to trusts for decedent's two children**

** Managed by Management Company

PERKINSCOIE

QFOBI and Section 6166: Example 2

- **QFOBI Analysis for Propco LLC**
  - **Trade or business requirement:** Propco generates rental income, so test satisfied if decedent or a member of decedent's family materially participated in the leasing activity, or if the property is leased to a member of decedent's family who carries on a trade or business with the property
  - **Ownership test:** Satisfied, as 50% of company is indirectly owned by decedent and members of decedent's family
  - **50% Test:** Satisfied. Assuming Propco's other assets are not passive assets, decedent's indirect interest in Propco is $8MM of a $12MM gross estate.
  - **5-Year Test:** Satisfied if, during the 8-year period ending on the date of death, decedent or a member of decedent's family owned and materially participated in the business for a total of 5 years. Attribution of ownership does not expressly apply to this test, but no policy reason not to do so.

QFOBI and Section 6166: Example 2

- **QFOBI Analysis for Propco LLC (cont.)**
  - **Acquired from decedent by qualified heir:** Satisfied, as QFOBI passes to trusts, the sole current beneficiaries of which are members of decedent's family. To avoid clawback, at least one of decedent's children or a member of their family must materially participate in the business under the special rules applicable when a trust holds the QFOBI. Qualified heirs cannot dispose of their interests for 3 years, other than to members of their family.
  - **$6MM requirement:** Decedent's indirect interest in Propco is valued at $8MM, exceeding the maximum value. Taking into account decedent's interest in Management Company, if $2.2MM or more of decedent's Propco interest failed to meet the requirements for the QFOBI deduction, PR might make the election for the remaining $6MM QFOBI interest and argue that the deduction should apply.

Planning Considerations

- **Lifetime gifting:** Gifts of closely-held business interests may jeopardize the estate's ability to qualify for Section 6166 or the QFOBI deduction (or, for the QFOBI deduction, help limit the decedent's interest to $6MM). Gifts of other assets may increase the likelihood that the estate will qualify.
- **Restructuring of closely-held business holdings:** Consider restructuring where feasible so that decedent directly owns interests in 6166 property to avoid having to make the 6166(b)(7) or –(b)(8) elections
- **Disposition of assets on death:** QFOBI deduction requires one or more qualified heirs to acquire a family-owned business interest from the decedent, and to materially participate in the business for at least 3 years. Married clients might provide for QFOBI to pass to qualified heirs on first death where the QFOBI would otherwise not meet the 50% Test on the survivor's death.

Estate Administration Considerations

- **Section 6166:**
  - Be thoughtful regarding dispositions or withdrawals of Section 6166 property and undistributed net income of closely-held businesses during the principal repayment period
  - Interest on deferred tax deductible on the Washington estate tax return when paid
- **QFOBI:** Be sure Qualified Heirs understand their obligations for the three-year period following the decedent's death

Questions?

CHAPTER EIGHTEEN

PLANNING FOR CLOSELY-HELD BUSINESSES: SECTION 6166 DEFERRAL AND THE WASHINGTON QUALIFIED FAMILY-OWNED BUSINESS DEDUCTION

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Estate Tax Deferral under Section 6166

General Rule: Estate tax deferral is permitted if (1) an interest in a closely held business is includible in the gross estate; (2) the decedent was a U.S. citizen or resident as of the date of death; and (3) the value of the interest in a closely held business exceeds 35% of the adjusted gross estate (the "35% Test"). If the estate is eligible for deferral, the personal representative may elect to pay part or all of the estate tax in up to 10 equal installments. Section 6166(a)(1).

I. Washington Rule: Washington State "will abide by the provisions of section 6166 of the 2005 IRC for the granting of payment plans for closely held businesses." Wash. Admin. Code 458-57-135(3)(c)(v). *See also* Washington State Department of Revenue, *Estate tax installment plans for closely-held businesses*, *available at* https://dor.wa.gov/find-taxes-rates/other-taxes/estate-tax/estate-tax-installment-plans-closely-held-businesses (last visited Sept. 22, 2018). The filing instructions for the Washington State Estate and Transfer Tax Return also summarize the requirements for satisfying Section 6166.

II. Effect of Election: If an estate makes a valid 6166 election, it may defer payment of that portion of estate tax attributable to the interest in a closely-held business. The personal representative may elect to pay the deferred tax in up to 10 annual installments, beginning on the date selected by the PR that is not more than 5 years after the unextended due date of the estate tax return. Interest on the first $620,000 of deferred tax in 2019 will accrue at a rate of 2%, and interest on the remaining deferred tax will accrue at 45% of the statutory underpayment rate. Section 6166(a); Section 6166(k)(4); Section 6601(j).

A. Interest on Deferred Washington Estate Tax: Interest on deferred Washington estate tax accrues at the statutory rate for underpayment of tax. Wash. Admin. Code 458-57-135(5); RCW 82.32.050(2).

III. Purpose of Statute: Section 6166 is intended to prevent a business enterprise from being sold in a fire sale to fund an estate tax liability. Congress intended to permit deferral of tax on property used in an active business but not on property held as a passive investment. H.R. Rep. No. 85-2198 at 713 (1958).

IV. An Interest in a Closely Held Business Must Be Includible in the Gross Estate: An interest in a closely held business can be a sole proprietorship, a partnership, or a corporation. Section 6166(b)(1).

A. Sole Proprietorships: An interest as a proprietor in a trade or business carried on as a proprietorship qualifies. Section 6166(b)(1)(A).

B. Partnerships: An interest as a partner in a partnership carrying on a trade or business qualifies if either (1) 20% or more of the total capital interest in the partnership is includible in the gross estate (the "20% Test"); or (2) the partnership has 45 or fewer partners (the "45-Owner Test"). Section 6166(b)(1)(B).

1. Comment: Arguably general partner and limited partner interests should be treated differently, as a GP interest may be more likely to indicate an active business of the decedent.

C. Corporations: Stock in a corporation carrying on a trade or business qualifies if either: (1) 20% or more of the value of the corporation's voting stock is includible in the gross estate (again, the "20% Test"); or (2) the corporation has 45 or fewer shareholders (again, the "45-Owner Test"). Section 6166(b)(1)(C).

1. Different Treatment for Partnerships and Corporations: The 20% Test applies to a capital interest for partnerships but voting stock for corporations. There is no apparent policy reason for treating the two entity types differently. *See* Task Force of the American Bar Association's Real Property, Probate, and Trust Law Section, *Internal Revenue Code Section 6166: Comments to Tax Counsel for the Senate Finance Committee*, 41 REAL PROP., PROBATE & TRUST J. 73 (Spring 2006) [hereinafter referred to as ABA Comments].

D. Limited Liability Companies: The IRS has ruled that an LLC can qualify for deferral under Section 6166 regardless of whether it is taxed as an association, partnership, or is disregarded for Federal income tax purposes. *See* Rev. Rul. 2006-34; PLR 200340012; PLR 200845023.

E. Time for Testing: The above requirements are tested as of the date immediately before the decedent's death. Section 6166(b)(2)(A).

F. Definition of Trade or Business: Whether the decedent or an entity owned by the decedent was carrying on a trade or business is a facts and circumstances test. The Service will consider the activities of the decedent or entity, and any employees and agents. The threshold question is whether the activities of the decedent or entity were reduced to the level of merely holding investment property. Rev. Rul. 2006-34; PLR 201343004; PLR 8219007.

1. Activities of a Management Company May Be Imputed to Decedent: Where a decedent owned real property and 20% of a management company that managed the property, the Service ruled that the activity of the management company with respect to the property was sufficient to conclude that the property qualified under Section 6166. The ruling emphasized that the decedent held a "significant interest" in the management company. Rev. Rul. 2006-34, *Situation 3*.

2. Cessation of Active Participation Due to Incapacity: The Service has ruled that an estate qualified for deferral where the decedent had ceased actively participating in the business due to physical incapacity immediately prior to death. PLR 9801009.

3. Activity of Decedent Imputed to Surviving Spouse: If a decedent was actively engaged in a trade or business with respect to assets distributed to his or her spouse at death, those assets retain their character as qualifying for Section 6166 so long as there was no

material change in their form or operation. PLR 200518047 (assets held in marital trust qualified for deferral under Section 6166).

4. Separate Divisions of a Corporation: The Service has ruled that an active trade or business conducted by a division of a corporation owned by the decedent caused the entire corporation to qualify under Section 6166. This taxpayer-friendly result was presumably offset by the passive asset rule of Section 6166(b)(9) described below. PLR 201343004.

5. Separation of Real Property from Operating Business: Where a decedent has separated ownership of an operating business from real property used in that business, the Service has held the property does not qualify for deferral. *See* PLR 8140020 (no deferral for real property leased by decedent to decedent's operating company under triple-net lease). *But see* PLR 200006034 (deferral permitted where operating company used real property, apparently without paying rent); Rev. Rul. 2006-34, *Situation 5* (property leased to operating company under net lease and specially designed for that business qualified under Section 6166, where operating company's employees performed all maintenance and repairs to the property).

6. Management of Rental Real Property: The Service will consider six nonexclusive factors in determining whether a decedent or entity that managed rental real property was engaged in a trade or business: (i) the amount of time the decedent, entity, and any agents and employees devoted to property management; (ii) whether an office was maintained from which the decedent's, entity's, and any agents' and employees' activities were conducted or coordinated, and whether regular business hours were maintained for that purpose; (iii) the extent to which the decedent, entity, and any agents and employees were actively involved in finding new tenants and negotiating and executing leases; (iv) the extent to which the decedent, entity, and any agents and employees provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises; (v) the extent to which the decedent, entity, and any agents and employees personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and (vi) the extent to which the decedent, entity, and any agents and employees handled tenant repair requests and complaints. Rev. Rul. 2006-34.

7. Comments: The IRS sometimes seems to require, at least in the context of real estate ownership, material participation on the decedent's part. The decedent's activities must go beyond the typical activities associated with merely managing investment assets, such as collecting rents, making mortgage payments, and making necessary repairs. *See, e.g.*, PLR 200518047; ABA Comments. This requirement doesn't appear in the statute, which merely requires a trade or business.

G. Attribution Rules: A number of attribution rules apply for purposes of the 45-Owner Test. Although the statute does not explicitly say so, it would seem that absent a Section 6166(b)(7) election (discussed below), these rules do not apply for purposes of the 20% Test. PLR 8428088; PLR 9644053; PLR 200842012; ABA Comments. *But see* PLR 9015009, which states that the rule applies to attribute ownership from an entity, estate, or trust to the shareholders, partners, or current beneficiaries for purposes of both the 20% Test and the 45-

Owner Test. This is inconsistent with other IRS rulings and legislative history, which states that the rule was intended to prevent taxpayers from avoiding the 45-Owner Test by using entities to reduce the number of owners. H.R. Rep. No. 94-1380, 94 Cong., 2d Sess. 32 (1976), 1976-3 C.B. 738, 766, accompanying H.R. 10612.

1. Interests Owned by Husband and Wife: Stock or a partnership interest that is community property, or that is held by spouses as joint tenants, tenants by the entirety, or tenants in common, is treated as owned by one person. Section 6166(b)(2)(B).

2. Indirect Ownership of an Interest: Property owned directly or indirectly by an entity, estate or trust is treated as being owned proportionately by the shareholders, partners, or current beneficiaries. Section 6166(b)(2)(C).

3. Interests Owned by Family Members: All stock and partnership interests held by the decedent or any member of his family (siblings, spouses, ancestors, and lineal descendants) are treated as owned only by the decedent. Section 6166(b)(2)(D); Section 267(c)(4).

4. Interaction of Attribution Rules: Presumably (but not explicitly), a person who is an owner of multiple entities will be treated as a single owner for purposes of the 45-Owner Test. If this approach is applied in connection with the family attribution rule, then the following would count as one person: (i) the decedent; (ii) all family members of the decedent (as defined above); (iii) all corporations, the stockholders of which are limited to such persons; (iv) all partnerships, the partners of which are limited to such persons; and (v) all trusts, the current beneficiaries of which are limited to such persons.

H. Section 6166(b)(7) Election to Apply Attribution Rules to 20% Test and Entity Aggregation for Partnership Interests or Stock That Is Not Readily Tradable: The personal representative may elect to have any capital interest in a partnership, or any stock that is not readily tradable, that is owned by the decedent after the application the attribution rules of Section 6166(b)(2) treated as includible in the decedent's gross estate for purposes of the 20% Test and for purposes of treating multiple closely-held business as a single entity under Section 6166(c) (discussed below). Section 6166(b)(7); PLR 9301014; PLR 200529006.

1. Definition of Not Readily Tradable Stock: Stock for which there was no market on a stock exchange or over-the-counter market as of the date of death. Section 6166(b)(7)(B).

2. Effect of Election: If the personal representative makes the 6166(b)(7) election, the estate automatically elects to have the first principal installment payable as of the unextended due date for the return and may not take advantage of the 2% interest rate otherwise available (see below). Section 6166(b)(7)(A)(ii), -(iii).

3. Comments: Some commentators have suggested that the Section 6166(b)(7) election is effectively a holding company election for partnerships akin to that

provided to corporations in Section 6166(b)(8) (discussed below). Under this reading, the election would cause the attribution rules to apply for the 45-Owner Test, the 20% Test, and the 35% Test. *See* Miller, *Dividing a Family Business May Prevent Estate Tax Deferral*, 22 TAX'N FOR LAW. 96 (No. 2, Sept./Oct. 1993) (citing Stephens, Maxfield, Lind, and Calfee, *Federal Estate and Gift Taxation* (Warren Gorham Lamont 1991), at 2-20. This may be the right result given that there is no policy reason to permit such an election for corporations and not partnerships. *See also* ABA Comments.

I. Section 6166(b)(8) Election to Treat Holding Company Stock as Business Company Stock: The personal representative may elect to treat non-readily-tradable stock in a business company that is owned, directly or indirectly, by a holding company as being part of a single company that includes the holding company. Section 6166(b)(8)(A).

1. Purpose of the Holding Company Election: The election is intended to qualify certain interests for installment payment treatment that would not otherwise qualify by looking through one or more tiers of holding companies and aggregating their assets. CCA 201144027; S. Rep. 98-169; H. Rep. 98-861.

2. Definition of Holding Company: A holding company is any corporation holding stock in another corporation. Section 6166(b)(8)(D)(i).

3. Definition of Business Company: A business company is any corporation carrying on a trade or business. Section 6166(b)(8)(D)(ii).

4. Election Cannot Be Made for Partnerships: The rule on its face applies only to corporations and not to partnerships or, presumably, LLCs that are not taxed as corporations. The IRS has informally confirmed to the author that the election applies only to corporations (*see also* ABA Comments). As noted above, there is no policy reason to make such a distinction.

a. Comment: It was proposed in 1996 to permit the election to be made for partnerships and LLCs, but the proposal was not implemented. U.S. Dept. of the Treas., *General Explanation of the Administration's Revenue Proposals* (Mar. 1996); Aucutt, *Legislative Proposals Affecting Closely Held Businesses*, 23 ESTATE PLANNING J. No. 5 (June 1996). Some commentators have suggested that the lack of an explicit provision for tiered partnerships results from Congress's belief that it is not necessary because partnerships are inherently "look-through" entities. Houghton & Solomon, *Installment Payment of Estate Taxes: IRS Interpretation of Legislative Intent Denies Election to Many Real Estate Owners*, 13 J. REAL EST. TAX'N. 177 (No. 2, Winter 1986). This seems inconsistent with the inclusion of attribution from partnership to partner provided for in Section 6166(b)(2)(C).

5. Effect of Election: If the personal representative makes the 6166(b)(8) election, the estate automatically elects to have the first principal installment payable as of the unextended due date for the return and may not take advantage of the 2% interest rate otherwise available. Section 6166(b)(8)(A)(ii), -(iii).

6. Special Rule Where Only Holding Company Stock Is Not Readily Tradable: If the stock of the holding company is non-readily tradable, but the underlying stock is traded on an exchange or over the counter, the election may still be made, but the maximum number of installments that may be made on the estate tax liability is 5 instead of 10. Section 6166(b)(8)(B).

7. Special Rule Where Active Corporation Owns Active Subsidiaries: The Service has ruled that where a corporation carrying on an active trade or business owns one or more subsidiaries, more than 80% of the assets of which are used to carry on an active trade or business, the holding company and its subsidiaries will be treated as a single corporation without the need to make a holding company election. PLR 8813047. *See also* Section 6166(b)(9)(B)(iii).

8. Partial Elections Not Permitted: The holding company election must be made with respect to all of the 6166 property. CCA 201144027.

J. Special Rule for Farmhouses and Certain Other Structures: For purposes of the 35% Test, an interest in a closely-held business that is in the business of farming includes an interest in residential buildings and related improvements on the farm that are occupied on a regular basis by the owner or lessee, or by persons employed by such owner or lessee for purposes of operating or maintaining the farm. Section 6166(b)(3).

V. The Interest in a Closely Held Business Must Exceed 35% of the Adjusted Gross Estate: Section 6166(a)(1).

A. Definition of Adjusted Gross Estate: The value of the gross estate reduced by the sum of the amounts allowable as a deduction under Section 2053 or 2054. Section 6166(b)(6).

B. Passive Assets Excluded from Value of Interests in Closely Held Business: For purposes of the 35% Test, the value of an interest in a closely held business does not include the portion of that interest attributable to passive assets held by the business. Section 6166(b)(9)(A).

1. Definition of Passive Assets: A passive asset means any asset not used in carrying on a trade or business. Section 6166(b)(9)(B)(i). The Code does not affirmatively define passive assets. Congress intended the IRS to provide regulations on this matter, but this was never done. Rules similar to those governing the accumulated earnings tax under Section 537 were intended to apply. S. Rep. No. 98-369 at 715 (1984); ABA Comments.

2. Stock Generally Treated as Passive Asset: Stock held by a corporation generally is treated as a passive asset unless the holding company election is made under Section 6166(b)(8) and the subsidiary's stock meets the 35% Test. Section 6166(b)(9)(B)(ii).

a. Exception for Active Corporations: No holding company election is needed if (1) the subsidiary corporation meets either the 45-Owner Test or the 20% Test with respect to the parent corporation, and (2) 80% or more of the value of assets of both the parent and the subsidiary is attributable to assets used in carrying on a trade or business. For purposes of determining whether the parent meets this 80% test, the value attributable to the subsidiary is disregarded. Section 6166(b)(9)(B)(iii); PLR 8813047.

b. Exception for Stock in a Qualifying Lending & Finance Business: Stock in a qualifying lending and finance business is treated as stock in in a company conducting an active trade or business. Section 6166(b)(10).

3. Comment: Although the rule that stock in a corporation is generally a passive asset does not on its face apply to partnerships, there is no policy reason to distinguish the two.

4. Working Capital Not a Passive Asset: Working capital and reasonable reserves for business expansion that will be spent in 2 years should not be treated as passive assets. Staff of Joint Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* at 1113 (Comm. Print 1984).

C. Aggregation of Interests in 2 or More Closely Held Businesses: If the estate includes interests in 2 or more closely held businesses, and if the estate owns 20% or more of each such business, then the interests are treated as a single interest. For purposes of this 20% requirement, the interest of a surviving spouse in property held by the decedent and the surviving spouse generally is included in determining the value of the decedent's gross estate. Section 6166(c).

D. Property Includible in the Estate under Section 2035: If property is includible in the estate under Section 2035, the 35% Test must be satisfied both with and without the addition of such property to qualify for Section 6166. Section 6166(k)(5); Section 2035(c)(2).

VI. Making the Section 6166 Election: The 6166 election is made on and as an attachment to a timely filed estate tax return. The election applies to deficiencies subsequently assessed and not attributable to negligence, fraud, or intentional disregard of tax law. Section 6166(d)-(e); Rev. Proc. 79-55; Treas. Reg. § 20.6166-1(b).

A. Mechanics of Federal Election: The personal representative should check the election box in Part 3 of Form 706 and attach a statement to the return that includes (1) the decedent's name and taxpayer identification number as each appears on the estate tax return, (2) the amount of the estate tax to be paid in installments, (3) the date selected for the payment of the first installment, (4) the number of annual installments, including the first installment, in which the tax is to be paid, (5) the property shown on the estate tax return that constitutes a closely held business, identified by schedule and item number, and (6) the facts that serve as the basis for the personal representative's conclusion that the estate qualifies for payment of the estate tax in installments. Treas. Reg. § 20.6166-1(b).

B. Mechanics of Washington Election: An installment election is made on the Washington estate tax return under Part 3 – Elections by the Personal representative, Line 3. The personal representative should attach the notice of election included with the Federal return. Washington State Department of Revenue, *Estate Tax Filing Instructions* (rev. Nov. 29, 2017).

C. Protective Election Permitted: A protective election may be made with a timely filed estate tax return. Treas. Reg. § 20.6166-1(d).

D. Late Election Permitted with Respect to Estate Tax Deficiency: If a timely election is not made, the personal representative may make the election within 60 days of receiving a notice and demand for the payment of an estate tax deficiency, to the extent of the deficiency amount and prorated to the installments that would have been due if an election had been timely made at the time the estate tax return was filed, with the remaining portion payable at the time of the election. The deficiency cannot be attributable to negligence, fraud, or intentional disregard of tax law. Section 6166(h); Treas. Reg. § 20.6166-1(c).

1. Limits on Deferred Amount of Deficiency: In at least one case, the Service has permitted deferral only of that portion of the deficiency equal to the portion of the estate's assets that qualify under Section 6166. TAM 8846001.

VII. Security or Bond Required When Making Section 6166 Election: The Service can require a bond of up to twice the amount of the deferred Federal estate tax. Section 6166(k); Section 6165. Alternately, the Service and estate can agree to place a special lien on estate assets in lieu of a bond. Section 6324A; Section 2204(c). The lien can apply to estate assets valued up to the total amount of the deferred estate taxes plus the computed interest for the first four years. Section 6324A(b)(2), -(e).

A. Determination Whether to Require Bond: The Tax Court has held that the Service must determine whether to require a bond on a case-by-case basis. *Estate of Roski v. C.I.R.*, 128 T.C. 113 (2007). The factors considered are (1) the duration and stability of the business; (2) the ability of the estate to pay the deferred tax and interest in a timely manner; (3) the tax compliance history of the closely held business as well as the personal representatives individually; (4) the expertise of the current managers in running the business, and (5) the general economic climate. Revenue Notice 2007-90. *See generally* Goldsmith & Choi, *How to Administer a Section 6166 Estate*, 156 TRUSTS & ESTATES No. 5 (May 2017).

B. Mechanics of Request for Bond or Lien: When an estate makes a 6166 election, the IRS typically sends a letter requesting that the estate provide a bond or submit to a special lien. If the estate doesn't respond within 30 days, the Service unilaterally determines what security is required. The estate should be prepared to respond promptly and, if required, to request relief from both the special lien and the bond.

C. Requirements for Collateral: If property offered by the estate as collateral: (1) is expected to survive the deferral period; (2) is identified in the security agreement, and (3) is of sufficient value to pay the estate tax liability plus the aggregate amount of interest payable over the first four years of the deferral period, the Service must accept that collateral.

The Service determines whether these requirements have been met. Section 6324A(b)(1); CCA 200803016.

D. Violation of Lien Requirements: If the value of property secured by the lien is at any time less than the amount of unpaid portion of the deferred taxes plus interest, the IRS may request additional security. If such security is not furnished within 90 days following notice and demand for it, the remaining installments due are accelerated. Section 6324A(d)(5).

VIII. Loss of Right to Defer Estate Tax: Deferral can be terminated if there is: (1) a disposition of the closely-held business interest or withdrawal of funds from the business, (2) a distribution of insufficient income by the estate, (3) a default in payment of installment amounts or interest, or (4) a violation of a lien condition. Section 6166(g).

A. Disposition of or Withdrawal of Funds from a Closely-Held Business: If (1) any portion of an interest in a 6166 entity is distributed, sold, exchanged, or otherwise disposed of, or money and other property attributable to such an interest is withdrawn from such entity, and (2) the aggregate of such distributions, sales, exchanges, dispositions and withdrawals equals or exceeds 50% of the value of such interest, deferral ceases to apply and all outstanding tax comes due upon notice and demand from the IRS. Section 6166(g)(1)(A).

1. Policy: The purpose of Section 6166 is to preserve closely-held businesses. Once the business has been disposed of, there is no further reason to extend the time for paying tax. PLR 8730006. The intent is to preserve the value of the businesses as of the date of death. Therefore, mere changes in form to the 6166 assets may not be treated as dispositions, and distributions of amounts earned after death (e.g., dividends paid) have sometimes been ignored for purposes of this rule. Rev. Rul. 66-62; Rev. Rul. 75-401; PLR 9222040; PLR 201403012.

2. Notification Requirement: The personal representative must notify the IRS in writing of any withdrawals or dispositions within 30 days of becoming aware of such an event, or on the date of an installment payment if not already reported. Treas. Reg. § 20.6166A-3(f)(1)-(2).

3. All 6166 Interests Treated as a Single Interest: For purposes of the 50% calculation, the value of the decedent's interest in all of his or her 6166 interests is used as the denominator. H. Rept. No. 97-201; Treas. Reg. § 20.6166A-3(d)(3), Example (3).

4. Use of 6166 Property to Secure Debt Considered a Withdrawal: The use of 6166 property to secure debt, even if the loan proceeds are used to pay estate tax, is considered a withdrawal of property that can jeopardize deferral. PLR 8224074; PLR 8841006.

5. Sale of Assets Used to Pay Business Debts: The sale of some of the assets of a 6166 entity is not treated as a disposition if the proceeds are applied to reduce mortgage debt on encumbered assets of the operating business or applied to debts of the business. Rev. Rul. 89-4; PLR 8841006.

6. Distributions as Part of 303 Redemptions: Distributions in redemption of stock under Section 303 are not treated as dispositions or withdrawals and reduce the

denominator of the estate's 6166 interests for purposes of the 50% test, if certain conditions are met. Section 6166(g)(1)(B).

7. Tax-free Reorganizations: Exchanges of stock under Section 368(a)(1)(D)-(F) and Section 355 are not considered dispositions or withdrawals for these purposes, and any stock received in such an exchange is treated as 6166 property. Section 6166(g)(1)(C).

8. Section 1031 Exchanges: Exchanges of real property for like-kind property under Section 1031 are not treated as dispositions for these purposes. PLR 8829013; PLR 8626069; PLR 8539018.

9. Transfers to Decedent's Heirs: Transfers of property to a person entitled by reason of the decedent's death to receive such property under the decedent's will, intestacy law, or a trust created by the decedent are not considered dispositions or withdrawals for these purposes. A similar rule applies to a series of subsequent transfers by reason of death so long as each transfer is to a member of the family (within the meaning of section 267(c)(4)) of the transferor. Section 6166(g)(1)(D).

a. Dispositions of 6166 Interests by Heirs: If the estate distributes a 6166 interest to the decedent's heirs and the heirs subsequently dispose of the interest during life, even to each other, this counts as a disposition under Section 6166(g). PLR 8730006 (but intra-estate "shuffling" of business interests among heirs does not jeopardize deferral).

10. Effect of Holding Company Election: If the holding company election is made under Section 6166(b)(8), a disposition of an interest in the holding company or a withdrawal of property from the company will be treated as a disposition of or withdrawal from the underlying 6166 company. Section 6166(g)(1)(E). Similarly, a disposition by the holding company of its subsidiary business company can jeopardize deferral. Section 6166(g)(1)(F).

B. Undistributed Income of the Estate: If the estate has undistributed net income for any taxable year ending on or after the due date for the first principal installment, the personal representative must, on or before the filing date for the income tax return for such taxable year (including extensions thereof), pay the undistributed net income in liquidation of the unpaid portion of the deferred tax. Section 6166(g)(2)(A).

C. Failure to Make 6166 Payments: If the estate misses any payment of principal or interest, the deferred estate tax becomes due and payable upon notice and demand from the IRS. Section 6166(g)(3)(A). However, if the estate misses any payment of principal or interest but makes late payment within 6 months of the due date, the payment becomes due and payable, the 2% interest rate does not apply with respect to the payment, and a penalty equal to 5% of the payment, multiplied by the number of months (including fractions thereof) after the due date the payment is made, is imposed. Section 6166(g)(3)(B).

IX. Coordination with Section 2032A: Section 2032A allows a valuation for estate tax purposes at less-than-fair-market value under certain conditions when real property has been used for farming or in a trade or business. If those conditions are subsequently breached, the resulting increase in tax, which is imposed under Section 2032A(c) and not Section 2001, is not

eligible for deferral under Section 6166. If the breach resulted from a disposition of assets by a qualified heir that falls within Section 6166(g) (discussed above), this can also accelerate the estate's deferred estate tax.

X. Property Held in QTIP or QDOT Trust: Property held in a qualified terminable interest property (QTIP) marital trust or a qualified domestic trust (QDOT) may qualify as Section 6166 property. Treas. Reg. § 20.2044-1(b); Section 2056A(b)(10)(A). *See also* PLR 200518047.

XI. Deferral of GST Tax: To the extent an interest in 6166 property is the subject of a direct skip, GST tax due is deferred as though it were estate tax. Section 6166(i).

XII. Interest Not Deductible on Federal Return: Interest paid under Section 6166 is not deductible on the Federal estate tax return as a Section 2053 expense. Section 2053(c)(1)(D). Note that the provision does <u>not</u> prevent deduction of interest paid on tax deferred under Section 6161.

A. Interest Deductible on Washington Return: Accrued interest that has been paid can be deducted as an administrative expense of the Washington estate. Washington State Department of Revenue, *Estate Tax Filing Instructions* (rev. Nov. 29, 2017).

Washington Qualified Family-Owned Business Interest (QFOBI) Deduction[1]

I. QFOBI Deduction: A deduction of up to $2.5MM is allowed for the value of a decedent's Qualified Family-Owned Business Interests (QFOBIs) if (A) the 50% Test is met; (B) the 5-Year Test is met; (C) the decedent was a U.S. citizen or resident; (D) the QFOBIs are acquired from the decedent by a Qualified Heir; and (E) the value of the QFOBIs does not exceed $6MM. RCW 83.100.048(1); WAC 458-57-175(3).

A. Qualified Family-Owned Business Interests: A QFOBI is an interest as a sole proprietor in a trade or business carried on as a proprietorship, or an interest in an entity carrying on a trade or business, if (1): at least 50% of such entity is owned (directly or indirectly) by the decedent and Members of the Decedent's Family; (2) 70% of such entity is so owned by members of two families; or (3) 90% of such entity is so owned by members of 3 families, and for purposes of (2) or (3), at least 30% of such entity is so owned by the decedent and Members of the Decedent's Family. RCW 83.100.048(6)(b); Section 2057(e) (repealed); WAC 458-57-175(2)(c).

1. Definition of Trade or Business: No definition of a trade or business is provided by the statute or regulations, but the now-repealed federal QFOBI deduction under former Section 2057 provides some insight. Generally, passive assets are excluded from the value of a qualified business. Business interests that produce personal holding company income generally do not qualify (see below). Section 2057(e) (repealed); Harl & McEowen, 829-2nd T.M., *The Family-Owned Business Deduction — Section 2057* at ¶ II.E [hereinafter "TMP"].

a. Trade or Business Requirements: Generally, three requirements must be met at the time of death for there to be a trade or business. The person or entity must: (1) bear the risks of production; (2) bear the risks of a price change; and (3) be actively involved in management of the activity. TMP at ¶ II.E.

b. Activity of Family Imputed to Decedent: A decedent is treated as engaged in a trade or business if any Member of the Decedent's Family is engaged in such trade or business. Washington State Department of Revenue, *Estate Tax Qualified Family-Owned Business Interests* (last visited September 22, 2018), https://dor.wa.gov/find-taxes-rates/other-taxes/estate-tax-qualified-family-owned-business-interests [hereinafter, "DOR QFOBI Web Page"].

2. Attribution of Ownership to Shareholders, Partners, and Beneficiaries: An interest owned, directly or indirectly, by or for an entity is considered owned proportionately by the entity's shareholders, partners, or beneficiaries. A person is treated as a beneficiary of any trust only if such person has a present interest in such trust. Washington State Department of Revenue, *Instructions to Washington State Estate Tax Addendum #3* (rev. Nov. 23, 2015) [hereinafter, "Instructions to Addendum #3"]; DOR QFOBI Web Page.

[1] For the discussion of the QFOBI deduction I am greatly indebted to Schindler, *Overcoming "QFOBIa": Utilizing the Estate Tax Deduction for Family Business Interests*, 42 REAL PROP., PROBATE & TRUST No. 3 (Summer 2015), and to its author, Steven Schindler.

a. Ownership of Corporations: Ownership of a corporation is determined by the holding of stock possessing the appropriate percentage of the total combined voting power of all classes of stock entitled to vote, and the appropriate percentage of the total value of shares of all classes of stock. Instructions to Addendum #3.

b. Ownership of Partnerships: Ownership of a partnership is determined by the owning of the appropriate percentage of the capital interest in such partnership. Instructions to Addendum #3.

c. Ownership of Tiered Entities: In a tiered entity, each tier's interest is looked at separately to determine the rules regarding ownership for QFOBI. DOR QFOBI Web Page.

3. Non-U.S. Principal Place of Business Limitation: QFOBIs do not include any interest in a business, the principal place of business of which is outside of the United States. RCW 83.100.048(6)(b); WAC 458-57-175(2)(c); Section 2057(e) (repealed).

4. Readily Tradable Limitation: QFOBIs do not include any interest in an entity if the stock or debt of such entity or a controlled group of which such entity was a member was readily tradable on an established securities market or secondary market at any time within 3 years of the date of the decedent's death. RCW 83.100.048(6)(b); WAC 458-57-175(2)(c); Section 2057(e) (repealed).

5. Personal Holding Company Limitation: QFOBIs do not include any interest in a trade or business not described in Section 542(c)(2), if more than 35% of the adjusted ordinary gross income of such trade or business for the taxable year that includes the date of the decedent's death would qualify as personal holding company income if such trade or business were a corporation. This generally covers interest, dividends, rents, and royalties. RCW 83.100.048(6)(b); WAC 458-57-175(2)(c); Section 2057(e) (repealed).

a. Exception for Certain Businesses Generating Rental Income: An interest in a business generating rental income may qualify as QFOBI if: (i) the decedent or a Member of the Decedent's Family materially participated in the leasing activity; or (ii) the property is leased to a Member of the Decedent's Family who carries on the trade or business with the property. Section 2057(e) (repealed); S. Rep. No. 174, 105th Cong., 2d Sess. (1998); TMP at ¶ II.E.

6. Passive Asset Limitation: QFOBIs do not include that portion of an interest in a trade or business that is attributable to (a) cash or marketable securities, or both, in excess of reasonably expected day-to-day working capital needs, and (b) any other assets of the trade or business (other than assets used in the active conduct of a trade or business described in Section 542(c)(2)), that produce, or are held for the production of, personal holding company income. RCW 83.100.048(6)(b); WAC 458-57-175(2)(c); Section 2057(e) (repealed).

B. 50% Test: The value of the QFOBIs must exceed 50% of the Washington taxable estate, determined without regard to the deduction for the applicable exclusion amount. RCW 83.100.048(1)(a); WAC 458-57-175(3)(b)(i).

1. Calculation of Washington Taxable Estate: This means that QFOBIs must exceed 50% of the federal taxable estate, plus amounts required to be added under RCW 83.100.047 (e.g., Washington-only QTIP property), less (a) the amount of any farm deduction under RCW 83.100.046; (b) any Washington-only marital deduction under RCW 83.100.047; and (c) the QFOBI deduction itself. RCW 83.100.020(15).

2. Pre-Mortem QFOBI Planning: For married couples with QFOBI interests that are relatively small compared to the overall estate, such that the 50% Test is unlikely to be satisfied on the death of the surviving spouse, consider planning that permits the QFOBI interests to pass to children or family members other than the surviving spouse. For instance, a married couple with a $20MM estate, $2MM of which is QFOBI, might structure their estate plan so as to create (a) a credit shelter trust with the Washington State exclusion amount ($2,193,000 in 2018); (b) a second trust for descendants holding the QFOBI; and (c) a QTIP marital trust to hold the residue. Since the $2MM of QFOBI exceeds 50% of the deceased spouse's WA taxable estate (which excludes the QTIP residue and the QFOBI deduction itself), the estate would receive a $2MM QFOBI deduction. If the QFOBI had been included in the surviving spouse's estate, it would have comprised less than 50% of the Washington taxable estate, and no deduction would be permitted.

C. 5-Year Test: During the 8-year period ending on the date of death, there must have been periods aggregating 5 years or more during which: (1) the QFOBIs were owned by the decedent or a Member of the Decedent's Family; and (2) there was Material Participation by the decedent or a Member of the Decedent's Family in the operation of the trade or business to which such interests relate. RCW 83.100.048(1)(b); WAC 458-57-175(3)(b)(ii).

1. Member of the Decedent's Family: This includes: (a) the decedent's ancestors; (b) the decedent's spouse or registered domestic partner; (c) the lineal descendants of the decedent, the decedent's spouse or registered domestic partner, or the decedent's parent; and (d) the spouse or registered domestic partner of any such lineal descendant. RCW 83.100.048(6)(a); RCW 83.100.046(10)(d)(i); WAC 458-57-175(2)(b).

a. Adopted Children: A legally adopted child of an individual is treated as the child of such individual by blood. Instructions to Addendum #3.

2. Material Participation: This is defined by reference to Section 2032A, and thus determined in a manner similar to that used for purposes of Section 1402(a) (relating to net earnings from self-employment). RCW 83.100.048(1)(b)(2). This generally means the individual is involved in making significant management decisions, but not necessarily day-to-day operating decisions. WAC 458-57-175(2)(a). Physical work and participation in management decisions are the principal factors to be considered, and regular consulting with any other managing parties is important. Reg. § 20.2032A-3(e)(2). The individual should work on a continuous and substantial basis on in the operation of the trade or business, working at least 500 hours per year, with no one else working more hours than the individual, and no one else receiving compensation for managing the operation (an agent or trustee does not qualify). The individual should be the one making (or participating in) a substantial number of the management decisions. *Id.*; Instructions to Addendum #3.

a. Material Participation Where QFOBI is Held in Trust: If QFOBI is held in a trust, the material participation requirement will be satisfied if the individual: (i) is the trustee and materially participates in the business; (ii) is employed by the trustee in an arrangement that requires his or her material participation in the business; (iii) enters into a contract with the trustee to manage the business; or (iv) is granted management rights over the business in the trust agreement. Reg. § 20.2032A-3(f)(1).

b. No Material Participation Where Management Decisions Made by Third Party: A decedent or Qualified Heir will not be treated as materially participating if the income derived from carrying out the trade or business is from the management decisions of another individual or entity under a management agreement or other arrangement. WAC 458-57-175(2)(a)(A)(i).

c. No Material Participation Where Agent's Acts Not Attributed to Decedent or Qualified Heir: A decedent or Qualified Heir will not be treated as materially participating if the activities that constitute Material Participation of any agent of the decedent or Qualified Heir are not attributed to the decedent or Qualified Heir. WAC 458-57-175(2)(a)(A)(ii).

d. Trustee's Activities Not Attributed to Beneficiaries: A trustee's activities managing a trust for the benefit of other individuals is not considered when determining whether any of the current beneficiaries of the trust materially participate in the family-owned business. WAC 458-57-175(2)(a)(A)(iii).

3. Indirect Ownership by Decedent or Family Members: While attribution of ownership from entities to their shareholders, partners, or beneficiaries does not explicitly apply to the 5-Year Test, there seems no policy reason not to permit this.

D. Acquired from the Decedent: QFOBI must be acquired from the decedent by a Qualified Heir. Property is acquired from the decedent if that property: (a) is so considered under Section 1014(b); (b) is acquired by any person from the estate; or (c) is acquired by any person from a trust, to the extent the property is includible in the gross estate of the decedent. RCW 83.100.048(1)(c); RCW 83.100.046(2); WAC 458-57-175(3)(b)(iii).

1. QFOBI Passing to Qualified Heirs in Trust: This should be permitted so long as all of the trust's current beneficiaries are Qualified Heirs. RCW 83.100.048(6)(c); Section 2057(i) (repealed); WAC 458-57-175(2)(d); Section 2032A(g); Treas. Reg. § 20.2032A-3(b).

2. Acquisition by Purchase: QFOBI acquired by a Qualified Heir by purchase from the estate is permitted; this allows for post-mortem estate planning.

3. Comment: The DOR has taken the position in at least one case that the deduction is lost in its entirety if any portion of a decedent's QFOBI passes to someone other than a Qualified Heir. This position does not seem to be supported by the statute or regulation, or by the language of Section 2057. The definition of QFOBI in RCW 83.100.048(6)(b), which refers to Section 2057(e), generally requires only that a sufficient portion of the business be owned by the decedent or a Member of the Decedent's Family. So long as the business meets

this requirement, the interest should qualify as QFOBI. If some but not all of a decedent's QFOBI passes to someone other than a Qualified Heir (or fails to meet any other requirement for the deduction), the result should be that a deduction is permitted only as to the QFOBI that does pass to a Qualified Heir.

E. Qualified Heir: (1) A Member of the Decedent's Family who acquired property from the decedent (as defined above); and (2) any active employee of the trade or business to which the QFOBI relates if such employee has been employed by such trade or business for at least 10 years before the date of the decedent's death. RCW 83.100.048(6)(c); Section 2057(i) (repealed); WAC 458-57-175(2)(d).

1. Transference of Qualified Heir Status to Family Members: If a Qualified Heir disposes of any interest in qualified real property to any member of his or her family, the transferee is treated as the Qualified Heir with respect to such interest. RCW 83.100.048(6)(c); Section 2057(i) (repealed).

F. $6MM Limit on QFOBI: This can lead to a harsh result for a decedent with QFOBI worth $6,000,001, in which case the deduction would seem to be lost entirely. The statute and regulations are unclear as to whether the $6MM limit is satisfied if any interests in excess of $6MM that would otherwise be QFOBI fail to qualify because one or more of the deduction's requirements are not satisfied (e.g., because they pass to someone other than a Qualified Heir). At least one commentator holds that it is more appropriate for the $6MM limit to apply only to business interests that meet all of the requirements for the QFOBI deduction. Schindler, *Overcoming "QFOBIa": Utilizing the Estate Tax Deduction for Family Business Interests*, 42 WSBA REAL PROP., PROBATE & TRUST NEWSLETTER 3 (Summer 2015).

II. Only Amounts Included in Taxable Estate Deductible: Only amounts included in the decedent's federal taxable estate may be deducted as QFOBI. RCW 83.100.048(2)(a); WAC 458-57-175(4).

III. Property Deductible as Farm Property and QFOBI: Amounts deducted under the farm deduction cannot be deducted again as QFOBI. RCW 83.100.048(2)(b); WAC 458-57-175(4).

IV. Clawback of QFOBI Tax Savings: An amount equal to the tax savings with respect to the deduction for QFOBI acquired by a Qualified Heir may be clawed back with interest from that Qualified Heir if, within 3 years of the decedent's date of death and before the Qualified Heir's death: (A) the Material Participation requirement is not met by the Qualified Heir or a Member of the Qualified Heir's Family; (B) the Qualified Heir disposes of any portion of the QFOBI, other than a disposition to a Member of the Qualified Heir's Family, a person with an interest in the business, or through a qualified conservation contribution under Section 170(h); (C) the Qualified Heir expatriates under Section 877 and fails to comply with the requirements of Section 877(g); or (D) the principal place of business of the business ceases to be in the United States. RCW 83.100.048(3)(a)-(c); WAC 458-57-175(5)(a)-(c); Instructions to Addendum #3.

A. Agreement to Clawback: Each Qualified Heir must sign an agreement in the decedent's Washington Estate Tax Return to be liable for the clawback amount if the above

requirements are not met. Washington Department of Revenue, *Washington State Estate Tax Addendum #3: Qualified Family-Owned Business Interests* (November 23, 2015) [hereinafter "Addendum #3"].

B. Due Date for Clawback: Tax due under a clawback is due six months after the triggering event and must be reported to the Department of Revenue. RCW 83.100.048(3)(d); WAC 458-57-175(5)(d).

C. Personal Liability of Qualified Heir for Tax: The Qualified Heir is personally liable for the clawback tax unless a bond is furnished. RCW 83.100.048(3)(e); WAC 458-57-175(5)(e).

D. Lien on QFOBI Property for Clawback Tax: Clawback amounts due are secured by a lien on the property to which the QFOBI relates. The lien arises when the Washington return is filed and continues until: (i) the tax liability has been satisfied or has become unenforceable by reason of lapse of time; or (ii) the DOR is satisfied that no further tax liability will arise. The DOR may accept other security in lieu of this lien. RCW 83.100.048(3)(f)-(g); WAC 458-57-175(5)(f)-(g).

E. Special Rule for Sole Proprietorships: A qualified heir may not be treated as disposing of an interest as a sole proprietor by reason of ceasing to be engaged in a trade or business so long as the property to which such interest relates is used in a trade or business by any Member of the Qualified Heir's Family. RCW 83.100.048(3)(i); WAC 458-57-175(5)(i).

F. Refusal of Heir to Agree to Clawback: The statute and regulations are unclear as to whether, if one of several heirs refuses to sign the agreement on Addendum #3, the estate's entire QFOBI deduction is lost. The better answer is that only the portion of the deduction attributable to the holdout heir's share of the QFOBI should be lost.

G. Partial Deduction Where Portion of QFOBI Expected to Trigger Clawback: The statute and regulations are similarly unclear as to whether an executor may opt to deduct only part of what would otherwise qualify as QFOBI in cases where clawback is likely to be triggered (e.g., where a decedent owned two businesses, one of which is likely to move overseas within three years). There seems no policy reason to prohibit a partial election by an executor under these circumstances, although the question becomes less clear if, absent the partial election, the deduction might otherwise not be available (e.g., where the total amount of QFOBI absent the partial election would exceed $6MM). However, even in that circumstance, there is no policy reason to disallow a partial election, in effect punishing a decedent for having owned an interest in a family-owned business worth more than $6MM.

H. Delayed Distribution of QFOBI to Qualified Heir: In practice, it may be several years or more before the QFOBI is actually distributed to the Qualified Heir (or to a trust for his or her benefit). Nevertheless, the 3-year clawback period (and hence the start of the Material Participation and other clawback requirements) begins on the decedent's date of death.

V. Information Required of Qualified Heirs: The DOR may require names and contact information of all Qualified Heirs. Qualified Heirs may also be required to submit on an ongoing basis such information as the DOR determines necessary or useful in determining

whether the Qualified Heir is subject to the clawback tax. A $500 penalty may be imposed on a Qualified Heir who fails to provide the information requested within 30 days of the DOR's written request for the information. RCW 83.100.048(4); WAC 458-57-175(6).

VI. Businesses Held in Trust: When a business interest is held in a trust, only the current beneficiaries of the trust may qualify as a Qualified Heir or Member of Decedent's Family. WAC 458-57-175(2)(e).

VII. Making a Dual QFOBI and 6166 Election: Making a QFOBI election should not affect that amount of deferral available under Section 6166. Washington State will "will abide by the provisions of section 6166 of the 2005 IRC for granting of payment plans for closely held businesses" under Wash. Admin. Code 458-57-135(c)(v). Section 6166(a)(1) provides that "if the value of an interest in a closely held business, which is included in determining the gross estate of a decedent…exceeds 35 percent of the adjusted gross estate, the executor may elect…." Section 6166(b)(4) defines "value" for all purposes under Section 6166 to be the value determined for purposes of Chapter 11. Since the QFOBI deduction is a deduction and not a valuation provision, the QFOBI election should not affect the amount deferred under Section 6166. *See* Bellatti, *Estate Planning for Farms and Other Family-Owned Businesses* (Thomson Reuters/Tax & Accounting, 1999 with updates through May 2016) at ¶ 10.04[4] (rule discussed in the context of the now-repealed Federal QFOBI deduction).