Qualified Small Business Property and Qualified Farm Property Deduction

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Estate Tax Fact Sheet 2

Fact Sheet

This fact sheet explains the qualified small business property and qualified farm property deduction for Minnesota estate tax purposes.

What's New in 2013

A new law passed during the 2013 legislative session clarified and changed parts of this deduction. These changes include:

- Clarified that "family member" includes trusts whose present beneficiaries are all family members.
- Clarified the material participation requirement for qualified small business property.
- Clarified that publicly traded securities and assets not used in the operation of the trade or business are not qualified property.
- Clarified the property tax classification requirements for qualified farm property.
- For qualified farm property, removed the requirement that for three years after decedent's death a family member must continuously use the property in the operation of the trade or business and added a requirement that the property must maintain its class 2a property-tax classification during that three year period.
- Clarified replacement property rules for sole proprietors for the qualified small business property.
- Created an informational return requirement during the three-year period after decedent's death.

Overview

Under the Federal Economic Growth and Tax Relief Reconciliation Act of 2001, the federal estate tax applicable exclusion amount was increased and the credit for state death taxes was phased out between the years 2002 and 2005.

Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, the federal estate tax applicable exclusion amount was increased to $5 million. This means that up to $5 million of assets can pass from an individual at death without incurring federal estate tax.

Minnesota did not adopt the above federal changes. As a result, the calculation of the Minnesota estate tax continues to be based under the federal law in effect prior to the changes enacted in 2001. Thus, the Minnesota applicable exclusion amount is limited to $1 million. This means that only $1 million of assets can pass from the decedent at the time of death without incurring Minnesota estate tax.

Under a law passed during Minnesota's 2011 special session, and clarified during the 2013 legislative session, a new deduction is available from the Minnesota adjusted taxable estate. This deduction is limited to decedents dying after June 30, 2011, who owned qualified small business property or qualified farm property and passed that property at death to a qualified heir. This deduction cannot exceed $4 million. Qualified heirs must pay a recapture tax if they or a family member do not meet the ownership, participation, or maintenance requirements of this deduction for the three years after the decedent's death. (See *Recapture Tax* on the next page)

Qualified Small Business Property

Qualified small business property must meet all of the following requirements:

1. The value of the property was included in the decedent's federal adjusted taxable estate, which is after deductions, including debts, expenses and bequests to a surviving spouse.
2. The property consists of trade or business property (or shares of stock or other ownership interests that are not publicly traded).
3. The decedent or decedent's spouse materially participated – as defined in IRC section 469(h) – in the trade or business during the taxable year that ended before the decedent's death.

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4. The trade or business had gross annual sales of $10 million or less during the last taxable year that ended before the decedent's death.
5. The property does not consist of cash, cash equivalents, publicly traded securities, or assets not used in the operation of the trade or business held by the corporation or other entity.
6. The decedent continuously owned the property for the three-year period ending at the decedent's death.
7. A family member materially participates in the operation of the trade or business – as defined in IRC section 469(h) – for the three years following the decedent's death.
8. The estate and qualified heir agree to pay the recapture tax, if applicable.

Qualified Farm Property

Qualified farm property must meet all of the following requirements:

1. The property's value was included in the decedent's federal adjusted taxable estate, which is after deductions, including debts, expenses and bequests to a surviving spouse.
2. The property consists of agricultural land and is owned by a person or entity that is either not subject to or is in compliance with M.S. 500.24.
3. The property was classified for property tax purposes in the taxable year of death as agricultural homestead, agricultural relative homestead, or special agricultural homestead under M.S. 273.124.
4. The property was classified for property tax purposes in the taxable year of death as class 2a property under M.S. 273.13, subd. 23.
5. The decedent continuously owned the property for the three-year period ending at the decedent's death.
6. A family member maintains the 2a classification for the three years following the decedent's death.
7. The estate and qualified heir agree to pay the recapture tax, if applicable.

Qualified Heirs and Family Members

To qualify as an heir, an individual must be a "family member" who acquired qualified property upon the death of the decedent. To qualify as a family member, an individual must be:

- the decedent's ancestors (parent, grandparent, etc.);
- the decedent's spouse;
- a lineal descendant (child, grandchild, etc.) of the decedent, of the decedent's spouse or of the decedent's parents;
- the spouse of any lineal descendant described above; or
- a trust whose present beneficiaries are all family members.

Recapture Tax

If **any** of the following occurs within three years of the decedent's death and before the death of the qualified heir, then a recapture tax is imposed:

- The qualified heir disposes of any interest in the qualified property (other than by a disposition to a family member).
- For the qualified small business property deduction, a family member does not materially participate in the operation of the trade or business.
- For the qualified farm property deduction, a family member does not maintain the 2a classification for the qualified property.

The recapture tax equals 16 percent of the amount of the deduction. The return must be filed and the recapture tax must be paid to the Minnesota Department of Revenue within six months after the date of disqualifying disposition or cessation of use.

Informational Returns

When an estate elects for this deduction, a qualified heir must file two information returns to confirm that no recapture tax is due. The first return is due 24 to 26 months after the decedent's death. The second return is due 36 months to 39 months after the decedent's death.

This requirement is effective for returns due after Dec. 31, 2013.

How to Claim the Election

To claim the election, the executor and qualified heirs must complete and submit Schedule M706Q, *Election to Claim the Qualified Small Business and Farm Property Deduction*, when filing the Minnesota estate tax return.