MINNESOTA · REVENUE

ESTATE TAX
Modifications to Small Business and Farm Deductions

April 2, 2013

	Yes	No
DOR Administrative Costs/Savings		X

Department of Revenue
Analysis of H.F. 386 (Urdahl)

	Fund Impact			
	F.Y. 2014	**F.Y. 2015**	**F.Y. 2016**	**F.Y. 2017**
		(000's)		
General Fund	$9,200	$13,300	$19,100	$25,400

Effective for estates of decedents dying after June 30, 2011.

EXPLANATION OF THE BILL

Current Law: The Minnesota estate tax statutes were changed in 2011 to allow executors of the estates of small business owners and farmers to deduct from the taxable estate up to $4 million for qualified small business property or qualified farm property. The statutes specify various requirements the small business property and the farm property must satisfy in order for the property to be considered qualified.

One of the requirements that must be met in order for the executor of an estate to take a small business or farm deduction on the state return is that the inherited small business or farm property must be retained by the qualified heir for three years after the death of the decedent. If the qualified heir disposes of any interest in the qualified property, other than by a disposition to a family member, an additional estate tax called the recapture tax is imposed. The amount of the recapture tax is equal to 16% of the amount of the deduction claimed by the estate when the estate tax return was filed.

Proposed Law: Under the proposal, some of the requirements are either clarified or modified. Those clarifications and modifications are as follows:

- The definition of "family member" is broadened to include certain qualifying trusts. This would allow for trust planning which would otherwise be disallowed.
- It is made clear that ownership interest includes the interest in transferred property the decedent is deemed to own under estate tax sections 2036, 2037, and 2038 of the Internal Revenue Code.
- For small businesses,
    - It is made clear that the decedent or the decedent's spouse must have materially participated in the business during the decedent's taxable year that ended before the decedent's death. The business must not have been a passive activity.
    - The definition of qualified small business property is modified to exclude assets that are not actually used in the business.

EXPLANATION OF THE BILL (Cont.)

  - The proposal allows that, for sole proprietors, property replaced by similar property within three years of death will be treated as having been owned for the required three-year period.
  - The proposal requires that a family member must materially participate in the operation of the business during the three-year period following the decedent's death. The business must not be a passive activity.
  - The definition of qualified small business property is narrowed a bit more by requiring that it not consist of qualified farm property.
- For farms,
  - The definition of farm property is clarified. It is made clear that farm property must be owned by a person or entity that is not excluded from owning farm property by M.S. section 500.24. The decedent must have owned the property for the three-year period ending on the decedent's date of death.
  - The proposal changes the requirement that a family member uses the property in the operation of the business for three years following the death of the decedent to a requirement that the property be classified as class 2a agricultural homestead under M.S. 273.13, subdivision 23, for three years following the death of the decedent. This allows the family member of the decedent to either farm or rent out the property regardless as to whether or not the decedent had been farming or renting out the property.
- The recapture tax would not be imposed if the qualified heir of a sole proprietor were to replace qualified business property with similar property during the three-year period following the death of the decedent.

In addition to the above clarifications and modifications, the bill would also make significant changes in the way in which the recapture tax is imposed. The qualified heir would have broader opportunities to dispose of qualified property while still avoiding the recapture tax. The broadened opportunities for disposition come about by allowing a "qualifying entity" to be the recipient of the qualifying property in addition to a family member. A qualifying entity is defined to be a corporation or other entity owned by a family member or family members, and for qualified farm property, that is not excluded from owning agricultural land under M.S. Section 500.24.

Also, if the recapture tax is imposed, the amount of the recapture tax is reduced. The reduction in the tax amount occurs because, under the bill, the recapture tax would be imposed only on the portion of the property that was disposed of, rather than on the amount of the deduction claimed by the estate when the estate tax return was filed.

REVENUE ANALYSIS DETAIL

- The proposed definition of qualifying entity requires that the entity be owned by a family member or family members. There is no requirement that the entity be wholly owned by the family. As a result, some or nearly all of the qualifying property could be converted to cash by disposing of the property to nonfamily members. As long as the qualified heir retained at least a small interest in the qualifying entity, no recapture tax would be imposed, assuming all other requirements continued to be met.
- By providing a way to dispose of some of the qualifying property in favor of cash while still retaining the opportunity to take the small business and farm deduction, the provision is at odds with other parts of the estate tax statutes (M.S. Section 291.03, Subdivision 9, clause (4), and M.S. Section 291.03, Subdivision 10) which specifically exclude cash from qualifying for the deduction.
- Because of the broadened opportunities to dispose of qualifying property without incurring a recapture tax, a larger number of estates may use the small business or farm deduction.
- As an example, consider a situation where two siblings inherit qualifying small business property. One of the siblings wants to continue to operate the business; the other wants to liquidate most of his or her interest in the business. Without the broadened opportunities to dispose of qualifying property without incurring a recapture tax, it would be less likely that the small business deduction would be claimed when the estate tax return is filed. By broadening the opportunities for disposition, the siblings can claim the deduction. Then the disposition can take place, a nonfamily member can take over a large portion of the business, one of the siblings gets cash, and there is a loss of revenue for the state.
- The deductibility of qualified small business property and qualified farm property is a new provision in Minnesota estate tax statutes. While information is starting to be collected regarding how often the deduction of qualified small business property and qualified farm property is occurring, it is not known if any of these deductions would have been affected by the provisions of the proposal.
- The estimate is based on the February 2013 forecast.
- The estate tax database for estate tax returns filed in 2008 was used for this analysis. The database included information from Minnesota and federal estate tax returns including gross estate, taxable estate, and estate tax.
- After the small business and farm property deductions were enacted in 2011, it came to light that some additional changes were needed in order for the statute to be consistent with what was thought to be legislative intent and the estimates made at the time of enactment. From information in the 2008 estate tax database it was estimated that estate tax collections could be reduced by as much as an additional 12.5% if the additional changes were not put in place. Since the additional changes were not enacted in 2012, the February 2013 estate tax forecast was reduced accordingly.
- It was assumed that the full impact of not making changes would be phased in over time. Because the changes are made in this bill, the revenue gain is based on the reduction made in the forecast. For purposes of this analysis, the phase in is as follows: 0% for 2013, 40% for 2014, 60% for 2015, 80% for 2016, and 100% for 2017.

REVENUE ANALYSIS DETAIL (Cont.)

- Previous estimates of the impact of the small business and farm deduction were made using the estate tax database for estate tax returns filed in 2008. The total of those estimates was a 7% reduction in estate tax revenue.
- For purposes of this estimate, it is assumed that the increased revenue loss due to increased use of the deduction for qualified property because of the increased opportunity to avoid the recapture tax is 10% of 7% or 0.7%.
- The 0.7% reduction was applied to the February 2013 estate tax forecast adjusted for the non-recapture tax impact of this proposal.
- It is assumed that returns are filed and tax is paid nine months after the death of the decedent.

Number of Taxpayers: While the estate tax database for returns received in 2012 is still not quite complete, the database currently contains about 2,000 estate tax returns. About 1,200 of the returns have an estate tax amount greater than zero. About 100 of the returns show a positive small business or farm property deduction.

Source: Minnesota Department of Revenue
Tax Research Division
http://www.revenue.state.mn.us/research_stats/Pages/Revenue-Analyses.aspx

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