# Excise Tax Advisory

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**THIS DRAFT ETA IS TO BE USED SOLELY FOR DISCUSSION PURPOSES. UNDER NO CIRCUMSTANCES IS THIS DRAFT ETA TO BE USED TO DETERMINE TAX LIABILITY OR ELIGIBILITY FOR A TAX DEDUCTION, EXEMPTION, OR CREDIT.**

## Estate Tax Deduction for Qualified Family-Owned Business Interests: Real Estate Activities

**Purpose and scope**

This Excise Tax Advisory (ETA) addresses a deduction from the Washington taxable estate, without regard to the applicable exclusion, for the value of the decedent's qualified family-owned business interests. The purpose of this ETA is to focus on certain real estate business interests. This ETA does not address every type of family-owned business interest that may be deductible from a gross estate.

**Definitions**

***Washington Taxable Estate***:

Washington's estate tax is imposed on the value of the Washington taxable estate, at tax rates specified in RCW 83.100.040. "Washington taxable estate" generally means the federal taxable estate.[1] The federal taxable estate means the gross estate less any applicable federal deductions. [2]

The Washington estate tax is a stand-alone tax from the federal Internal Revenue Code (I.R.C.) that incorporates only those provisions of the Internal Revenue Code that do not conflict with Chapter 83.100 RCW.

***Qualified Family-Owned Business Interest (QFOBI)***:

A QFOBI has the same meaning as defined in I.R.C. § 2057(e) and generally refers to a trade or business conducted as a proprietorship. It may also refer to an interest in a trade or business entity if either (a) at least 50 percent of the entity is owned by decedent and members of the decedent's family or (b) at least 30 percent of the

[1] RCW 83.100.020(15); RCW 83.100.040(3); WAC 458-57-105(2)(a).

[2] 26 U.S.C. § 2051. Deductions from the gross estate are further described in §§ 2053-2058. The Internal Revenue Code at 26 U.S.C. is abbreviated hereafter as I.R.C. The federal estate tax is imposed under I.R.C. § 2001 on the taxable estate and the amount of adjusted taxable gifts.

entity is owned by the decedent and members of the decedent's family and either 70 percent is owned by 2 families or 90 percent is owned by 3 families.[3]

***Material Participation:***

"Material participation" is defined within the meaning of I.R.C. § 2032A(e)(6). It is determined in a similar manner as in I.R.C. § 1402(a)(1) relating to net earnings from self-employment.

***Qualified Heir*:** "Qualified heir" has the same meaning as provided in §2057(i)(1) of the 1986 Internal Revenue Code. It means a member of the decedent's family who acquired such property (or to whom such property passed) from the decedent, and also includes any active employee of the trade or business to which the QFOBI relates, if the employee has been employed by the business for a period of at least 10 years before the date of the decedent's death.

***Member of the decedent's family and member of the qualified heir's family***: means only (A) An ancestor of the individual; (B) The spouse or state registered domestic partner of the individual; (C) A lineal descendant of the individual, of the individual's spouse or state registered domestic partner, or of a parent of the individual; or (D) The spouse or state registered domestic partner of any lineal descendant described in (d)(i)(C) of this subsection. [4] A legally adopted child of an individual is treated as the child of such individual by blood.

## Background

Washington estate tax law incorporates by reference, federal estate tax law as written in the 2005 Internal Revenue Code.[5] The federal estate tax is imposed on a decedent's taxable estate, which is determined by subtracting certain deductions from the sum of the gross estate, and adding back any gift tax paid on gifts within three years of the date of death.[6] The Washington taxable estate means the federal taxable estate and includes the following: the value of any property included under I.R.C. § 2044 marital property provisions, regardless of date acquired, and amounts adjusting the taxable estate under RCW 83.100.046, RCW 83.100.047, and RCW 83.100.048.[7]

Under Washington estate tax law, the Washington taxable estate is reduced by an amount defined by statute ("applicable exclusion").[8] The amount of the federal applicable exclusion from the taxable estate has historically been greater than the Washington applicable exclusion. Estates that are not required to file federal estate tax returns because the estate's value is smaller than the federal exclusion, may nevertheless be required to file a Washington estate tax return if the estate value is greater than the Washington exclusion.

[3] RCW 83.100.048; I.R.C. § 2057(e)(1).
[4] RCW 83.100.048(6)(a); RCW 83.100.046(10).
[5] RCW 83.100.020(8; RCW 83.100.040(3).
[6] I.R.C. §§ 2001(a), 2035(b), 2051.
[7] RCW 83.100.020(15). RCW 83.100.048 is a deduction for qualified family owned business interests.
[8] For federal estates, the applicable exclusion functions to exempt a certain amount of value from the estate, equivalent to an applicable credit amount. *See* I.R.C. § 2010(c)(3); RCW 83.100.020(1), RCW 83.100.040(3).

As a result, Washington may review deductions from the gross estate that have not already been reviewed by federal authorities. This situation often occurs when no federal estate tax return is filed, or a simplified federal return is filed to preserve the portability exemption or deceased spouse unused exclusion under I.R.C. § 2010(c)(4). Additional review may occur with other estate tax returns because Washington law requires compliance with the Internal Revenue Code as written in 2005 and does not include many of the changes in the current Code.

## QFOBI Deduction

Congress created the QFOBI deduction in I.R.C. § 2057 in 1997, providing federal estate tax relief for closely held, family-operated businesses, and to address liquidity concerns for those businesses. Washington enacted a deduction for the value of a decedent's QFOBI in 2013 and incorporated by reference requirements for the federal QFOBI deduction in I.R.C. § 2057. In 2014, when the federal estate tax exclusion was substantially increased, I.R.C. § 2057 was repealed by Congress.[9] The Washington QFOBI deduction is codified in RCW 83.100.048 and incorporates I.R.C. § 2057 as if it were not repealed.

**Requirements for the QFOBI deduction**

In Washington, the amount of the deduction may not exceed $2,500,000 and the deduction only applies if all of the following requirements are met, in addition to the interest meeting the definition of a QFOBI:

- ***Interests ≤ $6,000,000.*** The value of the decedent's qualified family-owned business interests is not more than six million dollars;
- ***Interests > 50% of taxable estate*.** The value of decedent's family-owned business interests must exceed fifty percent of the taxable estate, determined without regard to the applicable exclusion amount;
- ***Material participation.*** During the eight-year period ending on the date of decedent's death, there is an aggregate of five years or more during which both (a) the business interests were owned by the decedent or a member of decedent's family, and (b) there was material participation by the decedent or a member of decedent's family in the operation of such business; and
- ***Acquired by or passed to qualified heir who is U.S. citizen or resident.*** The qualified family-owned business interests are acquired by any qualified heir from, or passed to any qualified heir from, the decedent, within the meaning of RCW 83.100.046(2), and the decedent was at the time of his or her death a citizen or resident of the United States.

The value of multiple qualifying businesses is aggregated for these requirements, though each business must separately meet the requirements to be included. Thus, the aggregate value of all qualifying interests, each separately meeting the material participation, qualified heir and other requirements, must not exceed $6,000,000 and must be greater than 50% of the taxable estate.

[9] The QFOBI deduction in I.R.C.§2057 was also in the 2005 Internal Revenue Code, though the federal deduction itself had become irrelevant in 2003.

In addition to the above, only amounts included in the decedent's federal taxable estate may be deducted and amounts deductible under RCW 83.100.046[10] may not be deducted under RCW 83.100.048.

**Recapture of QFOBI Deduction**

RCW 83.100.048(3) includes a recapture provision for the QFOBI deduction. The recapture provision applies if within three years of the decedent's death and before the qualified heir's death:

a) The material participation requirements described in I.R.C. § 2032A(c)(6)(b)(ii) are not met with respect to a qualified family-owned business interest that was acquired or passed from the decedent;
b) The qualified heir disposes of any portion of a qualified family-owned business interest, other than by a disposition to a member of the qualified heir's family or a person with an ownership interest in the qualified family-owned business;
c) The qualified heir loses United States citizenship within the meaning of I.R.C. § 877 or with respect to whom § 877(e)(1) applies, and such heir does not comply with the requirements of § 877(g) ; or
d) The principal place of business of a trade or business of the qualified family-owned business interest ceases to be located in the United States.

When any of the above conditions for recapture are met, additional estate tax equal to the tax savings for the original deduction with interest is imposed and the qualified heir becomes personally liable for that amount unless the qualified heir secured a bond necessary to secure payment satisfactory to the Department.

A family business interest may include an ownership interest in or an activity involving real property. The following sections of this ETA address additional nuances within the requirements of the QFOBI deduction.

**QFOBI Deduction and Interests in Rental Real Estate Activities**

Rental real estate investment activities generally do not meet the material participation requirement for the QFOBI deduction. In general, passive income investments are excluded from the definition of a qualified family-owned business interest. To be eligible for the QFOBI deduction, real estate activity *must involve* material participation from the decedent and qualified heirs.

The definition of material participation in RCW 83.100.048(1)(b)(ii) incorporates by reference I.R.C. § 2032A(e)(6), which provides that material participation is determined in a manner similar to I.R.C. § 1402(a)(1), which relates to net earnings from self-employment. I.R.C. § 1402(a)(1) expressly excludes from the computation income derived from "rentals from real estate and from personal property leased with the real estate ..., unless such rentals are received in the course of a trade or business as a real estate dealer." Thus, the material participation requirement is generally not met unless "such rentals are received in the course of a trade or business as a real estate dealer."

[10] RCW 83.100.046 addresses the deduction for property used for farming and its requirements and conditions.

The following Treasury Regulations provide interpretation of the applicable Internal Revenue Code provisions to clarify the requirements for material participation.

- ***Factual Determination – Passively Collecting Rents Not Sufficient.*** "Whether the required material participation occurs is a factual determination, and the types of activities and financial risks which will support such a finding will vary with the mode of ownership of both the property itself and of any business in which it is used. Passively collecting rents, salaries, draws, dividends, or other income from the farm or other business is not sufficient for material participation..." Treas. Reg. § 20.2032A-3(a)

- ***Active Trade or Business.*** "Under section 2032A, the term trade or business applies only to an active business such as a manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities, as distinguished from passive investment activities…. A trade or business is not necessarily present even though an office and regular hours are maintained for management of income producing assets, as the term "business" is not as broad under section 2032A as under section 162." Treas. Reg. § 20.2032A-3(b)

- ***Payment of Self-Employment Tax.*** "[I]f the participant (or participants) is self-employed with respect to the farm or other trade or business, his or her income from the farm or other business must be earned income for purposes of the tax on self-employment income before the participant is considered to be materially participating under § 2032A. Payment of the self-employment tax is not conclusive as to the presence of material participation. If no self-employment taxes have been paid, however, material participation is presumed not to have occurred unless the executor demonstrates to the satisfaction of the Internal Revenue Service that material participation did in fact occur and informs the Service of the reason no such tax was paid." Treas. Reg. § 20.2032A-3(e)(1).

- ***Real Estate Dealers.*** "Rentals from real estate and from personal property leased with the real estate …, unless such rentals are received by an individual in the course of a trade or business as a real-estate dealer, are excluded [from determining net earnings from self-employment]…. In general, an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is a real-estate dealer. On the other hand, an individual who merely holds real estate for investment or speculation and receives rentals therefrom is not considered a real-estate dealer." Treas. Reg. § 1.1402(a)-4(a).

- ***Significant Services*****:** When a taxpayer engages in activities related to real estate, and provides *significant* services primarily for the occupant's convenience, such as in hotels or similar lodging, and are services other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only, the income and expenses may be deemed to be income and expenses from a trade or business rather than from rentals from

real estate.[11] Such income from engaging in a trade or business reflects material participation under I.R.C. § 1402 and requires payment of self-employment tax.[12]

- Generally, "[p]ayments for the use or occupancy of entire private residences or living quarters in duplex or multiple-housing units are generally rentals from real estate," and therefore excluded in determining net earnings from self-employment when not received by a real estate dealer. However, "[p]ayments for the use or occupancy of rooms or other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services . . . do not constitute rentals from real estate . . . [and] such payments are included in determining net earnings from self-employment." Treas. Reg. § 1.1402(a)-4(c).

- "Generally, services are considered rendered to the occupant if they are primarily for . . . [the occupant's] convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, and so forth, are not considered as services rendered to the occupant." Treas. Reg. § 1.1402(a)-4(c)(2).

## Real Estate Dealer vs. Investor

As provided in the preceding section, material participation in a trade or business and self-employment income are important indicators of income derived from a trade or business.

Although most types of rental real estate are excluded from the definition of trade or business, engaging in business as a real estate dealer or other active real estate business providing significant services may constitute material participation in a trade or business. Determining when a real estate owner is a dealer or investor involves evaluating:

1. **Purpose for acquiring and holding the property**. Real estate dealers are considered to be in the business of selling real estate when they acquire and hold properties for sale, as a dealer with a profit motive in the ordinary course of business, instead of holding property as an investor to maximize profit on the sales.[13]

[11] The facts and circumstances of each taxpayer are carefully considered.
[12] See above discussion of payment of self-employment tax. If a person did not pay self-employment tax, the person is presumed to have not provided the significant services needed for material participation.
[13] *Pool v. Comm'r*, T.C. Memo 2014-3 (2014); *Moore v. Commissioner*, 30 T.C. 1306 (1958).

2. **Frequency, continuity and extent of sales activities.** Frequent sales are indicative of conducting a business, while infrequent sales are indicative of holding property as an investor.[14]

3. **Nature and extent of improvements or development activities, which are fact dependent.** Subdividing, developing, advertising, time and effort the owner devotes to sales, as well as the purpose of acquisition are indicative of a business owned by a real estate dealer.[15]

4. **Extent and substantiality of solicitation, advertising, and sales activities**. The greater the number of activities engaged in with respect to real property, the more likely it is that the taxpayer is engaged in a trade or business, rather than merely investing.

**Property leased to a business**

Some family-owned active businesses are situated on real property that may be held in a separate entity such as an LLC or corporation and owned and managed by the family business or the decedent.

If decedent owned an entity where the only activity is holding real property and the entity leased that entire property to an active trade or business also owned by decedent, both the value of the active trade or business and the entity holding the real estate may be treated as a part of the qualified family-owned business interest.

- If both entities are left to the same qualified heir, and that qualified heir continues to materially participate in the active trade or business and continues to lease the real estate to the active trade or business, the interest in both entities may continue to qualify as a QFOBI.
- However, if decedent left the active trade or business to two qualified heirs, and the heir who received the entity holding the real estate does not materially participate, that entity holding the real estate would no longer qualify as a QFOBI unless the qualified heir not materially participating is a member of the other qualified heir's family.

**I.R.C. § 199A Not Applicable**

Eligibility under I.R.C. § 199A for the qualified business interest deduction ("QBID")[16] under I.R.C. § 199A has no bearing on whether a real estate activity is eligible for a QFOBI deduction on a Washington estate tax return.

[14] *Suburban Realty Co. v. U.S.*, 615 F.2d 171 (5th Cir. 1980); *Buono v. Comm'r*, 74 T.C. 187 (1980); *Pritchett v. Comm'r*, 63 T.C. 149 (1974).

[15] *Biedenharn Realty Co. v. U.S.*, 526 F.2d 409 (5th Cir. 1976).

[16] Qualified Business Interest Deduction ("QBID") enacted in 2017 may be applied to rental real estate activity and is applicable for federal income and estate tax purposes for tax years beginning January 1, 2018. QBID provides a deduction of up to 20% of income from a domestic trade or business operated as a sole proprietorship or through a partnership or S corporation, trust, or estate, for tax years beginning after Dec. 31, 2017, and ending before Jan. 1, 2026. Under the new provision, some rental real estate may be treated as a trade or business for purposes of the QBID.

I.R.C. § 199A was enacted in 2017, effective in 2018 and has not been adopted by the Washington legislature. RCW 83.100.040(3) specifies that the Washington estate tax is a stand-alone estate tax that incorporates only those provisions of the internal revenue code as amended or renumbered as of January 1, 2005, that do not conflict with the provisions of this chapter and is independent of any federal estate tax obligation. RCW 83.100.048 and WAC 458-57-175 govern the eligibility criteria for the QFOBI estate tax deduction.

## Examples

*The examples found in this guidance identify a number of facts and then state a conclusion. These examples should be used only as a general guide. The tax results of other situations must be determined after a review of all the facts and circumstances.*

***Example 1***

**Facts**

An estate's inventory includes an apartment building owned by Apartment LLC. Apartment LLC's sole activity is ownership of the apartment building and renting units to tenants. Decedent owned 50% of Apartment LLC. The value of the interest in Apartment LLC is less than $6,000,0000 and more than 50% of the value of the taxable estate. The Decedent did not operate Apartment LLC as a real estate dealer and reported income from the rents as passive income, and did not report self-employment income. Decedent's son, a qualified heir and licensed real estate broker, managed the apartment building for over 10 years prior to Decedent's death and until the present time. Activities performed by Decedent's son included collecting rents and general property management, but not providing services to the tenants such as housekeeping or services similar to a hotel. Decedent's son was paid by Apartment LLC for his property management services and he paid self-employment tax on the income for performing such services. The son is a qualified heir. The son is also a licensed real estate broker.

**Result**

The estate has not met the requirements for the QFOBI deduction. Operating an apartment building, like rental of real estate in general, is not considered material participation in an active trade or business eligible for the QFOBI deduction, except when accompanied by certain services that are provided with the rental (such as those services provided by a hotel) or when the rental business is the activity of a real estate dealer. If Decedent's son's property management was a trade or business for services provided to Apartment LLC, it was a separate trade or business from Apartment LLC itself. Thus, there was no material participation in Apartment LLC by Decedent's son. Decedent and family members were not real estate dealers and significant services were not provided to the tenants with the rental of apartment units to indicate the rental activity was a trade or business rather than rentals from real estate. Thus, there was not material participation by decedent or family members of Apartment LLC.

***Example 2***

**Facts**
The Smith family owns and operates a grocery store business valued at $5,000,000. Members of the family work for the business full-time. The family also owns a separate but related delivery service with trucks and storage facilities worth $1,000,000 and employs family members, as well as others. In all other respects, the businesses meet the statutory qualifications for qualified family-owned business interests. Are both businesses eligible for the QFOBI deduction if the total value of the estate is valued at $7,500,000?

**Result**

If the decedent or his family meets one or any of the ownership percentage in I.R.C. § 2057(e)(1)(B)(i)(I)-(III) and (ii) for both businesses, and the businesses' value do not exceed $6,000,000, both business interests meet the material participation requirements and are aggregated to make the estate eligible for the maximum QFOBI deduction of $2,500,000.[17]

***Example 3***

**Facts**
Company A is a stand-alone business that sells products and services. Decedent materially participated in Company A for periods aggregating over 6 of the 8 years prior to his death. Decedent died in 2020 and in his will, he left Company A to two employees who were both employed by Company A for over 10 years. Both employees continue to operate Company A full-time. Company B owns a commercial building that is leased to Company A. Decedent bequeathed Company B to his daughter. The two long-term employees continue to lease the commercial building from Company B. Daughter does not have an interest in or materially participate in Company A in any way. She only leases the commercial building to Company A.

**Result**

Both businesses separately must qualify as a QFOBI, and continue to qualify for 3 years after the date of the decedent's death. Company B may potentially qualify as a QFOBI, because Decedent owned both the active trade or business, i.e., Company A and Company B, which is leasing the real property as an active trade or business. However, Daughter's lack of ownership interest or material participation in Company A and lack of material participation in Company B, will trigger recapture under RCW 83.100.048((3)(a)(i)). As the qualified heir of Company B, Daughter would be personally liable for the additional estate tax.

[17] RCW 83.100.048(1) For the purposes of determining the tax due under this chapter, a deduction is allowed for the value of the decedent's qualified family-owned business interests, not to exceed two million five hundred thousand dollars.

***Example 4***

**Facts**

Decedent directly owned real property that was leased to an active trade or business, which was an automotive repair business. The automotive business was a corporation, owned and operated by the Decedent. Decedent left the businesses to a qualified heir who materially participated for the requisite time period. In all other respects, the businesses met the requirements to qualify as a QFOBI.

**Result**

Both the value of the automotive repair business and the real estate business may qualify as qualified family-owned business interests, assuming all other requirements for the deduction are met.