

**MINNESOTA STATE BAR ASSOCIATION
CONTINUING LEGAL EDUCATION**

October 16, 2013

**Minnesota's New Gift Tax and
Related Estate Tax Developments**

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INTRODUCTION

H.F. 677, the Omnibus Tax Bill, was adopted by the House on May 19, 2013 shortly after it was finalized by the joint House-Senate Conference Committee; it was adopted by the Senate in the closing hours of the session on May 20, 2013. It was signed by Governor Dayton on May 23, 2013, and became Chapter 143 of the 2013 Session Laws. I believe it is an understatement to say that almost no one believed even a week earlier that any of the gift tax provisions would be adopted, nor were several of the other provisions anticipated. These items are all contained in Article 7, which is a separate attachment to this outline.

As of October 3, 2013, the 2013 version of the M706 estate tax return or the new M709 gift tax return have not been issued; however, form M706Q has been revised to take into account the 2013 changes to the qualified farm/small business interest provisions, which were retroactive to estates of decedents dying after June 30, 2011.

Based on conversations with the Department of Revenue, I believe they will be working on a technical corrections bill to address various issues with the statutory language. As a technical corrections bill in the first year after adoption of the new law, I assume the effective date will generally be retroactive to June 30, 2013.

I. THE NEW MINNESOTA GIFT TAX PROVISIONS Sections 1, 2 11 - 16

A. Initial Comments

The new gift tax provisions will be found in Minnesota Statutes at new Chapter 292. Older attorneys will remember that Minnesota had a gift tax first enacted in 1937, which was also at Chapter 292, which was repealed by Laws 1979, chapter 303, article 3, section 41.

Except as otherwise noted, all of the new gift tax provisions are stated to be “Effective for taxable gifts made after June 30, 2013.”

Connecticut is the only other state with a gift tax; some provisions appear to have been patterned on its law, but other aspects are completely different.

TLS Initial Comments: The Minnesota gift tax is not unified with the federal gift tax, or with the Minnesota estate tax-- but they do interact sometimes in interesting ways! Do not assume that because Minnesota estate or gift provisions operate similarly to their federal counterparts!

B. Section 11 Definitions (New Minn. Stat. 292.16)

1. Subsection (a)[SIC] “for purposes of this chapter, the following definitions apply.” – do they not apply for other chapters, i.e. 291?

2. Subsection (b) Incorporates the estate tax definitions from 291.005.

3. Subsection (c) **“Resident”** – “has the meaning given in section 290.01, subdivision 7, paragraph (a). The entire subdivision 7 reads:

Subd. 7. Resident. (a) The term "resident" means any individual domiciled in Minnesota, except that an individual is not a "resident" for the period of time that the individual is a "qualified individual" as defined in section 911(d)(1) of the Internal Revenue Code¹, if the qualified individual notifies the county within three months of moving out of the country that homestead status be revoked for the Minnesota residence of the qualified individual, and the property is not classified as a homestead while the individual remains a qualified individual.

(b) "Resident" also means any individual domiciled outside the state who maintains a place of abode in the state and spends in the aggregate more than one-half of the tax year in Minnesota, unless:

(1) the individual or the spouse of the individual is in the armed forces of the United States; or

(2) the individual is covered under the reciprocity provisions in section 290.081.

For purposes of this subdivision, presence within the state for any part of a calendar day constitutes a day spent in the state. Individuals shall keep adequate records to substantiate the days spent outside the state.

The term "abode" means a dwelling maintained by an individual, whether or not owned by the individual and whether or not occupied by the individual, and includes a dwelling place owned or leased by the individual's spouse.

(c) Neither the commissioner nor any court shall consider charitable contributions made by an individual within or without the state in determining if the individual is domiciled in Minnesota.

Because subsections (b) and (c) are NOT included in the definition, it appears that for purposes of the new gift tax, only subsection (a) applies, and it excludes “qualified individuals.”

But NOTE, for the estate tax, Minn. Stat. 291.005, subd. 1(8) defines resident decedent as “an individual whose domicile at the time of death was in Minnesota.” There is no exclusion for “qualified individuals.”

Thus, we have three different definitions of residency, for income, gift and estate purposes! See also Larson v. Comm’r of Revenue, 824 N.W.2d 329 (Minn. 2013); and Mauer

¹ This refers to an individual whose tax home is in a foreign country who 1) if a U.S. citizen, has been a bona fide resident there for at least one full taxable year, or who 2) if a U.S. citizen or resident, during any period of 12 consecutive months has been present in a foreign country or countries for at least 330 days.

v. Comm'r of Revenue, 829 N.W.2d 59 (Minn. 2013) for recent court interpretations in the income tax context.

4. Subsection (d) “**Taxable gifts**” are defined as “the transfers by gift which are included in taxable gifts for federal gift tax purposes under the following sections of the Internal Revenue Code: 2503, 2511-2514, 2516-2519, less the deductions allowed in sections 2522-2524.” What do these sections refer to?

2503 (a) General definition. The term “taxable gifts” means the total amount of gifts made during the calendar year, less the deductions provided in subchapter C (section 2522 and following).

(b) Exclusions from gifts – then lists specific things excluded from “taxable gifts”, including:

- (i) annual exclusion gifts (as inflation adjusted; \$14,000 for 2013),
- (ii) certain transfers for benefit of minors, payable to minor upon age 21;
- (iii) qualified medical expenses and education expenses.

[TLS: Note: While 529 plans are not explicitly referred to, I think they probably will be treated as five annual exclusion gifts].

2511 Transfers in general. Subject to the limitations contained in this chapter, the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

2512 Valuation of gifts. Generally, valued at date of death; for property transfers for less than full and adequate consideration, the gift is the difference between the value of property given and the value of consideration received.

2513 Gift by husband or wife to third party – these are the “gift splitting rules” and procedures for electing gift splitting. Thus, Minnesota’s gift tax apparently adopts these rules also, and thus, the gift splitting rules help define the amount of taxable gifts an individual must report.

2514 Powers of appointment. Exercise or release of a general power of appointment created after October 21, 1942 is a deemed transfer by the powerholder (remember there are special rules for powers created before then). Subsection (c) contains various exceptions (ascertainable standards, 5 x 5 powers, etc.)

2516 Certain property settlements incident to dissolution proceedings are not treated as gifts.

2517 [repealed—why was it referenced??]

2518 Disclaimers. So qualified disclaimers also are not taxable gifts for the Minnesota gift tax.

2519 Dispositions of certain life estates (essentially, lifetime dispositions of all or part of the income interest of QTIP’ed property will be treated as a gift by the surviving spouse of the underlying property).

“Less the deductions allowed in sections:”

2522 Charitable Gifts

2523 Gifts to spouse

2524 The charitable and marital deductions can only be taken against gifts which are reported on the return, against which such deductions are applied.

5. Comments on the definition of “taxable gift”.
 - a. The definition clearly tries (generally) to follow federal gift tax definitions and valuation provisions. But, the above definition of taxable gift did not pick up IRC section 2505, which applies the federal unified credit against federal gift taxes owed. The calculation methodology DOES NOT follow federal pattern.
 - b. Does it apply to contributions to political parties?² Minnesota Department of Revenue says it won’t be interpreted to apply to such contributions.
 - c. There is another exclusion, not stated in this definition. New section 292.17, subd. 3 (section 12 of the Act) states:

Out-of-state gifts. Taxable gifts exclude the transfer of:

- (1) real property located outside of this state;
- (2) tangible personal property that was normally kept at a location outside of the state on the date the gift was executed; and
- (3) intangible personal property made by an individual who is not a resident at the time the gift was executed.

It seems like these should have been incorporated into the main definition. They also should have been reconciled better with the estate tax situs rules. It appears that this provision explicitly permits non-residents to make gifts of interests in pass-through entities which hold Minnesota real property, and have those interests treated as a transfer of an intangible property interest which is NOT a taxable gift, even though for estate tax purposes the pass-through entities rules would treat such assets as situated in Minnesota. See further discussion at section II-A-4.

- d. And there are other provisions incorporated but not stated in this definition:

² IRC 2501(a)(4) is an express exclusion for contributions to political organizations, so that such contributions are not taxable gifts. Without that exclusion, such contributions likely would be a gift, since it is a transfer of money without expecting or receiving consideration in return. Does the fact this section is NOT referred in the Minnesota gift definition imply that such contributions ARE potentially taxable gifts?

IRC 2501(a)(4) says: Transfers to political organizations. Paragraph (1) shall not apply to the transfer of money or other property to a political organization (within the meaning of section 527 (e)(1)) for the use of such organization.

Paragraph 1 states: “A tax, computed as provided in section 2502, is hereby imposed for each calendar year on the transfer of property by gift during such calendar year by any individual resident or nonresident.”

New section 292.21, subd. 4 says: “In administering the tax under this chapter, the commissioner shall apply the provisions of sections 2701 to 2704 of the Internal Revenue Code.”

These are generally referred to as the “special valuation rules”, which relate to transfers among family members where there is retention of certain discretionary rights—but these are also the provisions that explicitly validate grantor retained annuity trusts. See IRC section 2702(b).

e. Caution: The up-to-\$4 million qualified farm/small business interest deduction applies only for Minnesota estate tax purposes. There is NO MINNESOTA GIFT TAX EXCLUSION from the definition of taxable gift, nor a credit specific to such interests. Another example that Minnesota gift and estate taxes are not unified.

5. This section defining “taxable gifts” says it is “effective for taxable gifts made after June 30, 2013”—does this mean only a transfer by gift made after that date can be a taxable gift for purposes of Minnesota gift and estate taxes?

For purposes of the Minnesota gift tax, it appears the answer is clearly “Yes” – a transfer made before July 1, 2013 is not a taxable gift.

For purposes of the Minnesota estate tax, discussed later, there was an important question here, until the Department of Revenue issued an interpretation. See section II.A.2 below.

C. Section 12 – Gift Tax. (New Minn. Stat. 292.17)

1. Subdivision 1(a) “Imposition. A tax is imposed on the transfer of property by gift by any individual resident or nonresident in an amount equal to ten percent of the amount of the taxable gift.”

a. First, it probably would have been better to say, “transfer of property by a taxable gift” rather than a new phrase, “transfer of property by gift”.

b. Second, note this purports to apply to a transfer of property by gift by a non-resident—but as noted above, section 292.17, subd. 3 (section 12 of the Act) excludes from the definition of “taxable gift” the transfer of (1) real property located outside of Minnesota, (2) tangible personal property that was normally kept at a location outside of Minnesota on the date the gift was executed; and (3) intangible personal property made by an individual who is not a Minnesota resident at the time the gift was executed.

Practice Note: So there could be “taxable gifts” on a client’s federal gift tax return which are NOT taxable under the Minnesota gift tax. You cannot simply transfer them over; someone needs to review each gift to see if it is a taxable gift in Minnesota.

- c. Third, the language indicates this is a standalone flat tax, and does not follow the methodology of tax calculation of the federal gift tax or Minnesota estate tax. The tax is flat 10% of value, which allows a gift-by-gift tax calculation without regard to gifts made in prior years, offset by the \$100,000 credit discussed below (unlike a progressive tax rate that increases as the aggregate taxable gifts increase). This definition does not follow the IRC section 2505 methodology, under which taxes are calculated on a “tax on all transfers, minus tax on prior years’ transfers” basis.
- d. Note that in the state death tax credit table calculation (the “Table B” calculation) which determines many Minnesotans’ estate tax rates, the 10% bracket rate is not reached until a taxable estate is about \$3.5 million. So you have to think very carefully about what circumstances, if any, would justify paying a 10% lifetime gift rate if your estate would never reach that rate, because there is no refund except possibly as to gifts pulled back into the estate by reason of death within 3 years.
3. Subdivision 2 – Lifetime gift tax credit of \$100,000. “This credit applies to the cumulative amount of taxable gifts made by the donor during the donor’s lifetime.”

a. Given the 10% tax rate, this credit can offset \$1 million of taxable gifts.

b. **NOTE WELL:** The previous statement is not always true—as noted below, it only applies to taxable gifts made by donor after June 30, 2013 but not within 3 years of death since those gifts are pulled back into the estate tax calculation. See II.A.2 below. Taxable gifts made within three years of donor’s death will NOT be have this credit applied to them, even if the donor before death had filed a gift tax return and allocated the lifetime gift tax credit against the Minnesota gift tax otherwise due. The statute should have a qualifier added to it, “except for taxable gifts made after June 30, 2013 and within 3 years of the decedent’s death” with a cross reference to the new definition of “Minnesota adjusted taxable estate” which adds back taxable gifts within 3 years of death.

c. As a result, this is a separate transfer tax exemption, but is a “use it and live three years, or lose it” exemption. You must make the taxable gifts, and you must do so more than three years before death, or you lose it. There is no carryover to the estate tax, i.e. unlike the federal unified credit, you cannot take your unused gift tax credit as an estate tax credit.

Example: Assume client has a \$5 million estate, all to child, no lifetime gifts. The estate tax under 2013 law would be \$391,600. If client makes \$1 million of taxable gifts in 2013, and lives more than three years, at death the estate tax on a \$4 million estate is \$280,400 (assuming 2013 rates/brackets), a savings of

\$111,200. If the client makes the gifts, but dies within 3 years, the estate tax will be \$391,600—just as if no gifts were made.

But beyond the \$1 million of lifetime taxable gifts, there may not be much advantage except for clients at top brackets. Had the client above made \$2 million of gifts, and lived 3 years, there would be \$100,000 of gift tax, plus \$173,200 of estate tax—a savings of only \$7,200 (and then consider potential capital gains tax issues: 1) if the gifted assets had low basis (i.e. built in gains), the opportunity for tax free step up in basis in death is lost. 2) the post-gift appreciation is also subject to gains tax: in 7 years at 6% annually, \$1 million of assets grow to about \$1.5 million; at 30%, the capital gains tax is \$150,000. The gift turns out to be very expensive!

2. Subdivision 1(b) The donor is liable for payment of the tax. If the gift tax is not paid when due, the donee is personally liable for the tax to the extent of the value of the gift.

I believe this is the only statement we have on apportionment of gift taxes.³ This raises many questions:

- If the donor does not pay the tax when due, does he cease to be liable?
- How will the donee know if the tax has been paid?
- Will donee have funds to pay (especially if gift was not liquid), if donor does not pay?
- If the donee pays the tax, does he have a claim against the donor?
- What does “to the extent of the value of the gift” mean, when the tax is a flat 10%?
- Is this a reference to some type of gift to a group of people, and means one donee can be liable for all the tax to all members of the group, up to the amount the individual donee received?
- If donor owes this tax at time of death, is it a probate claim chargeable to the residuary share?
- Can the personal representative refuse to pay, thereby moving the liability to the donee?

4. Subdivision 3 is discussed above, in definition of taxable gifts, exclusions for items situated outside MN.

³ Minn. Stat. section 524.3-916 governs apportionment of Minnesota and federal estate taxes. To the extent a taxable gift made within three years of death is pulled back into the estate and causes increased estate tax, the statute may apply (assuming the decedent does not provide for an alternate method of allocation), though the language should probably be reviewed. It is doubtful the legislature or the drafters of this legislation necessarily considered this possibility!

**D. Sections 13 – 16. Gift Tax Returns, Filing Requirements, Procedure
(New Minn. Stat. 292.18-21)**

1. Due dates of filing returns and of paying gift tax.

Parts of these sections intermix some references to due date for filing and due date for payment of tax.

Section 14 (lines 10.18 - 10.22). Generally, gift tax returns must be filed by April 15th of the year following the year in which the taxable gift was made. No provision is made for an automatic extension if a federal gift tax extension is obtained. A return for a gift made by a decedent in the year of death must be filed by the last date, including extensions, for filing the gift tax return for federal purposes [this would usually be the due date of decedent's estate tax return, including extensions] if such date would be earlier than April 15 of the following year, so that the gift tax returns are filed before or by the time the estate tax return is filed.

Section 16 (lines 11.2 – 11.8). Generally, gift tax must be paid by April 15th of the year following year gift was made. And if the return is due to be filed sooner, the Minnesota gift tax is also apparently DUE sooner (Section 292.21, Subd. 1 – see handout, lines 11.5 - .7). The section provides for a penalty for failure to pay on time (10% of tax due, or \$100, whichever is greater)(lines 11.7 – 11.10), but I do not see any penalty stated for failure to file on time.

It is worth remembering that some people may not file federal gift tax returns if they are well under the unified credit exemptions, since there will be no tax owed, and hence no penalties paid for not filing (this is dangerous if it turns out the gifts and estate assets DO lead to taxes due!). Even if no federal return is filed, one may be “due” so those “due dates” need to be considered for Minnesota gift tax purposes.

At lines 11.11 – 11.16, there is provision that the Commissioner may extend the time to file returns for good cause (and no maximum limit for this extension power is stated), but a tentative return must be filed with the request, and the gift tax shown on the tentative return must be paid. Interest (presumably only on any deficit between the ultimate gift tax determined and the initial payment!) must be paid. It does not appear that the Commissioner was granted any authority to extend the time to pay the gift tax (even if a federal gift tax extension to pay is obtained, or even if the person being charged is the donee where the donor did not pay!).

New subdivision 3 (lines 11.17 – 11.35) contains provisions requiring a taxpayer to file with the Department of Revenue any federal gift tax returns of the taxpayer which are changed or corrected “by the IRS or other officer of the United States or other competent authority.” It does not refer to returns amended by the taxpayer, but the intent is clearly they should be filed.

2. Items still to be determined.

In reality, it appears much of the significant detail concerning the filing requirements, forms and procedures are left to the Commissioner of Revenue to establish, perhaps in conjunction with issuance of a technical corrections bill. New forms will need to be written,

and the most difficult issue may be whether, and the extent to which, the new forms will be tied to federal gift tax returns. New section 292.16, subd. 3, which requires taxpayers to file copies of amended federal gift tax returns implies that the prior federal gift tax returns were filed with the department, but this requirement is not explicitly stated. This process will also involve modifications to the Minnesota estate tax return forms, for the reasons discussed below.

It is not clear if this process will be completed by the due date for returns of decedents dying in early 2013. The Department in accordance with its work plan, first has completed and issued revised Form M706Q, regarding the qualified farm/small business interests deduction, since that was made retroactive to June 30, 2011. Second, the Department will soon be issuing the 2013 M706 estate tax return (as soon as the federal form is finalized), and then will turn attention to the 2013 gift tax return (M709), since that return will not come due until April of 2014. IRS delays in issuing the federal 2013 returns, in part due to the Supreme Court's Defense of Marriage Act ruling and the Treasury Department and IRS announcements as to how it will be implemented for same-sex married couples, have contributed to Minnesota's delay in issuing returns. The IRS has recently released a draft 2013 709 form. The Minnesota M709 will presumably use the federal gift tax return as a starting point, but then will need adjustments for items which are excluded from Minnesota's definition of taxable gift, even if such items are taxable gifts for federal purposes.

Question to ponder: Will we need TWO forms of M706, one for deaths through June 30, 2013, and one for deaths after that date (the latter to take account of lifetime gift issues and the changed definition of Minnesota adjusted taxable estate)?

E. Section 1 (Amend Minn. Stat. 270B.01, Subd. 1)

Adds gift tax to the list of taxes the Commissioner of Revenue administers, effective for "gifts made after December 31, 2012."

F. Section 2 (Amend Minn. Stat. 270B.03, subd. 1)

Minn. Stat. 70B.03, subd. 1 relates to who has a right of access to tax data, specifically copies of tax returns. This section adds a new section 9, which says that access to a gift tax return exists only for the "donor." The statute is effective "date following final enactment."

Given the language regarding access to other types of returns, it is unclear why a personal representative of a donor's estate or the trustee of donor's revocable trust, or spouse of a donor who signed a gift splitting agreement, or a donee (especially one who is liable for the tax if donor did not pay it) were not given a right of access to a gift tax return.

Note, subdivision 1(8), which refers to a "successor" is a reference to a transfer of a "business or stock of goods" where the concern was the liability of the successor owner for taxes owed by the prior business, so it does not cover the above cases. But note, it does also refer to a "gift of business interests", and might be relevant in a few unusual circumstances.

Perhaps subsections (8) and (9) should have been switched in order?

II. Minnesota Estate Tax Provisions (Sections 3-6)

All the changes in these sections are effective “for decedents dying after December 31, 2012” (i.e. all decedents dying in 2013, even those who died before this statute was enacted).

A. Section 4 (Amend Minn. Stat. 291.005, subd. 1) Definitions.

1. Minn. Stat. 291.005, subd.1(3) “**Internal Revenue Code**” – means as amended through January 3, 2013, but without regard for the provisions of subsection (f), i.e. the elimination of the state death tax credit for 2005 and subsequent decedents. The prior references which deleted references to EGTRRA sunset provisions are now part of the statute, so need not be restated here. Remember this definition does not apply to Minn. Stat. 291.03, the actual tax calculation methodology.

2. Minn. Stat. 291.005, subd.1(4) “**Minnesota adjusted taxable estate**” – **A MAJOR CHANGE** - It now includes “the amount of taxable gifts as defined in 292.16 and made by the decedent within 3 years of the decedent’s date of death”. [TLS: At end of line 3.9, I believe the word “plus” was inadvertently omitted, and should probably be penciled in.]

When the 2013 Omnibus Tax Act was enacted in May, there were two competing interpretations of this language:

a. First interpretation – “**Fully retroactive**” – for any decedent dying any time in 2013 (even before enactment), the Minnesota adjusted taxable estate includes all taxable gifts made by the decedent within 3 years of death. This interpretation would have construed “as defined in 292.16” to be a descriptor of the substantive federal tax provisions incorporated into the definition, but did not see this phrase as incorporating the effective date of section 292.16, i.e. after June 30, 2013. In other words, a decedent who died on January 1, 2013 would have brought back into his estate all his taxable gifts made during the full three years from and after January 1, 2010, even though at the time he made such gifts there was no Minnesota gift tax nor any notice that gifts made within three years of death would be brought back into the estate tax. Given the amount of gifting that occurred during these years due to the uncertainty of the estate and gift taxes (Sunset? Repeal? Exemption equivalent? Rates?), this interpretation would have caused vary large unanticipated tax liabilities for a significant number of estates of 2013 decedents, for which there are likely no testamentary provisions for allocation of the tax, and which may cause significant changes from the disposition of assets intended by the decedent.

If this interpretation had been adopted by the Minnesota Department of Revenue, I believe there would have been a number of litigated cases challenging the constitutionality of the legislation on due process grounds for retroactivity. It is, of course, not unusual for tax

legislation to have some degree of retroactivity, and this does not offend constitutional standards. However, courts have said that the period of retroactivity must be relatively brief, particularly in the case of a “new” tax. Our June 10-11, 2013 CLE outline summarized a number of relevant cases on retroactivity, and hence they are not included here. [See Slye & Lammers, June 10, 2013 Outline, pages 10-12].

b. Second Interpretation – “Phased implementation” – This interpretation noted the provision bringing taxable gifts within 3 years of death into the Minnesota adjusted taxable estate has two requirements--what is included is “the amount of taxable gifts, as defined in section 292.16 AND made by the decedent within three years of decedent’s date of death.” It noted this is a two-part test and construed “as defined in 292.16” to be a substantive part of the definition, so that only a gift made after June 30, 2013 which meets the substantive federal tax provisions incorporated into the definition is a “taxable gift.”

The argument would be,

If I make a \$1 million transfer TOMORROW (on June 11, 2013), that is NOT a “taxable gift as defined in section 292.16.”

If I made a \$1 million gift 2 years ago, that is also NOT a “taxable gift as defined in section 292.16.”

But if I make that gift on July 1, 2013, then it will be a “taxable gift as defined in section 292.16.”

And there is no reason NOT to apply the same definitions to interpret the phrase “as defined in section 292.16” for purposes of applying the law to people who died before there even was a Minnesota gift tax.

Under this approach, implementation would be phased in over next 3 years from July 1, 2013, so that a decedent dying on August 1, 2013 would only have taxable gifts made in July 2013 pulled into estate; a decedent dying on September 1, 2013 would have taxable gifts made in July and August 2013 pulled back; etc. This interpretation avoids retroactivity, and thus, avoids the potential constitutional challenges. It is also how Connecticut constructed implementation of its gift tax when enacted in 2005, i.e. only taxable gifts made after the effective date of the new gift tax were pulled back into the estate.

c. **The Department of Revenue saves the day.**

The Department of Revenue announced later in June 2013, that it would adopt the “phased implementation” approach. The current statement (8/20/2013) on the department website is at

<http://www.revenue.state.mn.us/businesses/estate/Pages/TaxableGifts.aspx>

It states:

Any federal adjusted taxable gifts made within three years of the decedent's death must be added to the federal gross estate when determining if the estate meets Minnesota's \$1 million filing requirement.

Any Minnesota taxable gifts made after June 30, 2013, and within three years of the decedent's death must be added to the Minnesota adjusted taxable estate when calculating the Minnesota estate tax.

Effective for estates of those who died after Dec. 31, 2012.

Underlining added to show the phased implementation approach.

As revised, the "Minnesota adjusted taxable estate" is the federal adjusted taxable estate (ie. federal taxable estate (gross estate minus deductions) less \$60,000), plus the addback of state death taxes paid, now plus the amount of (Minnesota defined) taxable gifts (made after June 30, 2013 and within 3 years of death), minus the deduction of the value of qualified farm/small business interests up to a maximum of \$4 million.

TLS Comment: As revised, this term bears no meaningful relationship to anything in the current federal estate tax code. If ever there was proof of how far Minnesota has departed from the federal estate tax code, this definition would be it!

3. Minn. Stat. 291.005, subd.1(9) **Situs of property.** The "situs" rules are amended to refer to lifetime gifts as well as estate dispositions. The situs of tangible personal property that is gifted within 3 years of death is the place it was normally kept or located when the gift was executed. The situs of gifted intangible property within three years of death is decedent's domicile at time of gift.

Note that whereas the section 292.17 subd. 3 exclusion from "taxable gifts" says tangible property that was normally kept at a location outside of the state on the date the gift was executed", the situs provision says "for a gift of tangible personal property within 3 years of death, the state or country in which it was normally kept or located when the gift was executed." Does this imply "normally located"? If not, should you move valuable tangible property to Florida or South Dakota before making a gift of it? This seems like to be dealt with by technical correction.

As written, these provisions refer to "a gift of tangible personal property" or "a gift of intangible personal property". More precisely, this probably should have referred to "a taxable gift of tangible personal property/intangible personal property." Otherwise, this language would sweep in small gifts which would be under the level reported in federal gift tax returns

Note that the definition of intangible personal property situs says the situs is the "state in which the decedent was domiciled when the gift was executed." So if an Iowa resident makes a gift of intangible personal property within 3 years of death, but a year before death moves to become a Minnesota resident, it appears that this gift is NOT treated as sited in Minnesota or

brought back into the decedent's estate. So if you have a Minnesota decedent with gifts within 3 years of death, be certain you check for a change of residence within those three years!

The reference to "within three years of death" will be troublesome—at the time you make a gift, how do you know if you are within three years of death? Situs does not change because an owner died, does it? By implication, could the situs of gifted property be somewhere other than what the statute states, if the donor lives the three years? I believe the phrase is there primarily to limit application only to gifts within 3 years of death, but perhaps a more artful way of phrasing this could have been found.

4. **Pass through entity situs rules** (lines 4.4 – 4.10) Real or tangible property in Minnesota, owned by a non-resident decedent via an ownership interest in a "pass-through entity" ("PTE") is deemed situated in Minnesota as if the PTE did not exist and the decedent owned the interest personally. PTE's include an entity electing S corporation status, an entity taxed as a partnership, a single member LLC or similar entity, and a "trust to the extent the property is includible in the decedent's federal gross estate". This last reference was modified from the Governor's prior form of this proposal, which just said "any trust", whether or not it was includible in the decedent's federal gross estate, and hence would have picked up irrevocable trusts created by someone other than the decedent, such as a parent or grandparent. But note, this test DOES pick up QTIPed trusts—this could be problematic where lifetime QTIP trusts were created by non-residents and hold Minnesota real property.

These new rules upend much of the planning that has been done in recent years for former residents of Minnesota who are now non-residents but hold real property in Minnesota. Many of them had been advised to use one of these entity forms.

As now written, and taken together with the provisions of new section 292.17 discussed above (the exclusion for "out-of-state gifts"), it appears these new situs rules would not treat a nonresident who gifts interests in a PTE holding Minnesota real property as making a taxable gift—such a gift seems expressly excluded from taxation. Query—do even death bed gifts of such interests avoid the gift tax? The language appears to say, Yes, they do, because they are expressly excluded from the definition of taxable gift. The situs of gifted property does not somehow create a pullback of assets into the gross estate.

Is there a Privileges and Immunities constitutional question here? This rule applies only to non-residents, and is not really reciprocal. Minnesota does not say that a resident who owns real property in a PTE in another state can treat it as real estate held in that state, and hence NOT taxable in Minnesota.

Note also, the rules do not apply to Minnesota real property held in a type C corporation. If there is not concern about double taxation of income in a corporation, maybe you can switch to a different entity?

But before relying on these solutions, you need to counsel clients that there could there be a retroactive amendment or "technical correction"!

B. Sections 5 and 6 - Amending Minn. Stat. 291.03, subd. 1 Estate Tax Calculation Methodology.

ANOTHER MAJOR CHANGE: Read the language carefully, and remember “taxable gifts” means only those after June 30, 2013.

Effective for 2013 decedents, the Minnesota estate tax calculation stated in section 291.03, subd 1(a) is based on the newly revised definition of “Minnesota adjusted taxable estate”, so that gifts made after June 30, 2013 and within three years of death are brought back into the taxable estate, thereby causing such taxable gifts to be taxed at the estate tax rate. It is the value of the reported gift at time the gift was made that is brought back, NOT the value of the gifted property at date of death (so at least appreciation in the asset after the gift is not being taxed).

Note that Minnesota gift tax paid does NOT get brought back into the Minnesota adjusted taxable estate, though federal gift tax paid on gifts within 3 years of death would be included in federal “taxable estate” and therefore, within definition of Minnesota adjusted taxable estate. For very large gifts and estates, it appears this might create some small amount of aggregate tax savings.

Concomitantly, the tentative Minnesota estate tax calculated *by reference to the state death tax credit table* in section 291.03, subd 1(a) is reduced by (i.e. the estate is “credited” with) the amount of Minnesota gift tax paid on gifts within 3 years of death that are included in the Minnesota adjusted taxable estate and not already subtracted as qualified farm/small business interests. **For gifts made more than 3 years prior to death, the flat 10% gift tax paid turns out to be the real rate on those gifts--there is no “refund” if it turns out the donor’s estate was subject to an estate tax rate lower than 10%.**

BUT NOTE, the “unified credit” calculation [Subd. 1(b)] tentative tax does NOT get reduced by Minnesota gift tax paid.

For nonresidents, the tentative Minnesota estate tax calculated *by reference to the state death tax credit table* is also reduced by (i.e. the estate is “credited” with) a new subsection 291.03, subd. 1(c) credit for property in a pass-through entity that is taxed by another state (lesser of amount paid the other state, or the Minnesota estate tax attributable to the interest).

AGAIN NOTE, the “unified credit” calculation [Subd. 1(b)] tentative tax does NOT get reduced by this credit either!

The “unified credit table” calculation (291.03, subd 1(b)) was not changed by the new law. It typically applies to a taxable estate between \$1,000,000 – 1,093,775 range. It had the potential to cause a 41% marginal tax rate, and this can still happen under the new law (but remember, this is only occurring because the federal estate tax is LESS than the tax would have been under the state death tax credit table).

The unified credit table calculation is a limit designed to insure that the federal unified credit is fully used before any state death tax credit could be taken. So although this test does take into account ALL lifetime taxable gifts (without regard to 3 year rule), and takes into account any federal gift taxes paid, it doesn't have anything in it about Minnesota gift tax paid.

Most importantly, remember that the \$1 million federal exemption equivalent credit (\$345,800 in 2000) which is deducted in the unified credit calculation, and which is what constitutes what is often referred to as a "\$1 million Minnesota estate tax exemption," is NOT in the state death tax credit calculation of subd. 1(a), and is not a true exemption. You do not get to deduct \$1 million from Minnesota adjusted taxable estate and then use the state death tax credit table on the remainder. When we speak of funding a Credit Shelter Trust to the \$1 million level, we mean we are taking a marital (or occasionally, charitable) deduction large enough to reduce the sum of taxable estate and lifetime taxable gifts to \$1 million, so that the second test with its unified credit equivalent can be used to reduce tax to zero. Thus, if there are lifetime taxable gifts of \$1 million or more, whether or not within 3 years of death, there is no unified credit left to shelter any credit shelter trust disposition.

Finally, note that when gifts made within three years of death are pulled back into the Minnesota adjusted taxable estate, there is no basis step-up, since that is governed by federal tax law.

C. Section 3 - Amending Minn.Stat. 289A.10, subd.1 - Minnesota estate tax return filing requirement.

PERHAPS THE CHANGE AFFECTING THE MOST TAXPAYERS!

Effective for all 2013 decedents (so even those dying before this law was enacted), a Minnesota estate tax return is required if:

(1) a federal estate tax return is required to be filed (i.e. the taxable estate plus lifetime gifts exceed \$5.25 million in 2013); or

(2) the sum of the federal gross estate and federal adjusted taxable gifts made within three years of the date of the decedent's death exceeds \$1,000,000.

Note, this does not refer to "taxable gifts" as defined in the new Minnesota gift tax statute, nor is it necessarily the same as new definition of "Minnesota adjusted taxable estate" in Minn. Stat. section 291.005, subd. 1(4)(ii).

What does "federal adjusted taxable gifts" mean? It is not a defined term in Minnesota statutes. But the "unified credit table" limitation in section 291.03, subd 1(b) refers to "adjusted taxable gifts as defined in section 2001(b) of the Code," which in turn means ALL taxable gifts except those already included in the gross estate (usually by reason of some tax "string" that causes inclusion). The phrasing here is that only the taxable gifts made within three years of death are counted; i.e. in essence, such gifts are treated as still being part of the gross estate. This is a MAJOR change, because the former filing requirement only counted estate assets at

death, without regard to lifetime gifts, even deathbed gifts. This will require many more decedents' estates to file Minnesota estate tax returns, and makes "deathbed" gifting to avoid the filing requirement virtually impossible. [But it still works if decedent had \$1,005,000 gross estate, no lifetime gifts, but makes \$10,000 deathbed gift covered by annual exclusion]. This was probably the legislators' intention!

This change eliminates some of the cliff effects I identified in previous outlines, where only a few dollars of difference in lifetime gifts or assets at death could have very large tax effects. But at least one cliff still lurks here: for a decedent whose gross estate is under \$1 million, and who made taxable gifts that, together with the gross estate, would exceed \$1 million, a difference of one day in a decedent's date of death (the last day of the 3 year period, or the day after) could affect the filing requirement, and thereby trigger a tax of about \$32,300.

Note that federal gross estate already includes federal gift taxes paid on gifts made within 3 years of death (i.e. if gifts greater than the federal unified credit). This definition does NOT appear to bring back Minnesota gift taxes paid, even though it does bring back the actual gifts.

D. Estate Tax Calculator

The Department released a new version of its estate tax calculator on October 4, 2013. The link is:

http://www.revenue.state.mn.us/businesses/estate/Pages/estate_calculators.aspx

A major issue for practitioners is the interrelated calculations in computing the federal state death tax deduction, as part of the process of determining credit shelter trust amount, and marital and charitable deductions. It is not at all clear that commercial preparers of software for estate tax returns will be (or when they will be) modifying their software to deal with Minnesota's gift tax, or even if they do, when this will be ready. In estates with interrelated calculations, this could pose significant difficulties meeting deadlines.

E. Filing 2013 Estate Tax Returns of decedents dying early in 2013.

For some 2013 decedents, their estate tax returns are already due, but no 2013 forms have been issued. The Minnesota Department of Revenue's position is that taxpayers should make a good faith estimate of estate tax due, and send it in, **WITHOUT FILING A RETURN**. When the 2013 forms are ready, then the return should be filed. If you are in this situation, I suggest you call the Department to discuss the situation, confirm this instruction, and also you may wish to inquire when the 2013 form will be ready.

CONCLUDING COMMENTS on the new statutes.

1. The Minnesota gift tax and estate tax are not "unified", but they do intersect sometimes in interesting ways!

Gifts made more than 3 years before death are not brought back, but gifts within 3 years of death are treated as estate dispositions (marginal rate might be less than gift tax rate was!)

Rather than a \$2 million aggregate (“unified”) exemption, we have a potential \$1 million gift + \$1 million estate exemption, but the gift exemption must be used by donors who live more than 3 years after the gift. This seems like huge discrimination against the very elderly, or the terminally ill. It would be far preferable to have a unified state gift and estate tax, as Connecticut does.

2. The federal and Minnesota gift taxes are not “unified”.

The definition of “taxable gift” excludes certain things that are federal taxable gifts.

Minnesota gift tax is flat 10%, subject to adjustment if you die within 3 years of gift; federal gift tax may be higher or lower rate. The federal system has graduated rates.

Federal law hardly contemplates the existence of a state gift tax – There is no federal credit for gift taxes paid to a state (unlike estate or GST tax).

Federal gross estate includes (brings back) federal gift tax paid for gifts made within 3 years of death, but does not include state gift tax paid within 3 years of death.

3. A few things we don’t know:

a) Will there be a Minnesota gift tax apportionment rule? Is gift tax owed by a donor at time of death to be treated as a debt that reduces the residuary share? How is the extra estate tax in an estate, if any, caused by 3 year inclusion rule, allocated? Will we need amendments to the Minnesota estate tax apportionment statute, to include gift tax (especially on gifts within three years of death)? Can testator put specific provisions regarding apportionment in testamentary instruments? How should these be drafted?

b) Will Minnesota recognize “net gifts”, i.e. structuring a gift in which the donee agrees to pay the gift tax, so it reduces amount of the taxable gift.

c) Most important, how is the 3 year lookback to be interpreted?

d) Given the increase in capital gains rates, how do we create a mechanism to obtain the benefit of the Minnesota gift tax exclusion and estate tax exclusion (in case a surviving spouse dies within a few years after decedent) but still be able to deal with the prospect that if the spouse survives the decedent by a longer period, the higher capital gains tax may well outweigh the Minnesota estate and gift tax savings. At a minimum, we need a mechanism to free trustees to distribute property out of trusts to the spouse in order to get step-up in basis at death.

4. Are zeroed out GRATs the answer?

If, going forward, the major benefit of gifts is to transfer the benefit of future appreciation without transfer tax, and donor must live a period of time to do so, then maybe zeroed out GRATs are better, since they are “gifts” with a zero value. They can be reported on federal and Minnesota gift tax returns, but should not incur use of the lifetime exemption. The statute explicitly tells the Commissioner to follow IRC section 2702, which validates GRAT’s and tells us how to structure them to be in compliance!

5. Things we need to do.

a. Work out better technical language for a stand-alone unified gift and estate tax, for adoption by the Legislature, if as a policy matter that’s what they have decided to do.

b. Work on language for the Drafting Wills and Trusts in Minnesota forms book, to deal with the 3 year pullback and potentially increased taxes.

c. Review and suggest revisions to the estate tax apportionment rules, to see if gift tax needs to be worked into it, or create a separate apportionment statute.

d. Be alert to all the new issues that arise that I haven’t covered in this outline – I would welcome your emails as to new issues as they arise in your practice.

III. QUALIFIED SMALL BUSINESS/FARM PROPERTY - Minn. Stat. 291.03 Subds. 9 -10.

A. Introduction.

The qualified small business and qualified farm property, found at Minn. Stat., Section 291.03, Subd. 1, and Subds. 8 – 11, was originally enacted in the Special Session of the legislature held in July, 2011. In essence, the provision created an additional up-to-\$4 million deduction for the value of "qualified small business property" and "qualified farm property" passing to qualified heirs, for purposes of computing Minnesota estate tax on estates of decedents dying after June 30, 2011. It was based very loosely upon IRC section 2032A, with references to various federal and Minnesota statutes.

Technical changes were made to the law in the 2013 Omnibus Tax Act effective retroactively for estates of decedents dying after June 30, 2011.

B. Statutory language. The law is found in Minn. Stat., Section 291.03, Subd. 1, and Subds. 8 – 11. Below is the law with the changes.

Subd. 8. Definitions. (a) For purposes of this section, the following terms have the meanings given in this subdivision.

(b) "Family member" means a family member as defined in section 2032A(e)(2) of the Internal Revenue Code, or a trust whose present beneficiaries are all family members as defined in section 2032A(e)(2) of the Internal Revenue Code.

(c) "Qualified heir" means a family member who acquired qualified property ~~from~~ upon the death of the decedent and satisfies the requirement under subdivision 9, clause ~~(6)~~ (7), or subdivision 10, clause ~~(4)~~ (5), for the property.

(d) "Qualified property" means qualified small business property under subdivision 9 and qualified farm property under subdivision 10.

Subd. 9. Qualified small business property. Property satisfying all of the following requirements is qualified small business property:

(1) The value of the property was included in the federal adjusted taxable estate.

(2) The property consists of the assets of a trade or business or shares of stock or other ownership interests in a corporation or other entity engaged in a trade or business. ~~The decedent or the decedent's spouse must have materially participated in the trade or business within the meaning of section 469 of the Internal Revenue Code during the taxable ——— year that ended before the date of the decedent's death.~~ Shares of stock in a corporation or an ownership

interest in another type of entity do not qualify under this subdivision if the shares or ownership interests are traded on a public stock exchange at any time during the three-year period ending on the decedent's date of death. For purposes of this subdivision, an ownership interest includes the interest the decedent is deemed to own under sections 2036, 2037, and 2038 of the Internal Revenue Code.

(3) During the taxable year that ended before the decedent's death, the trade or business must not have been a passive activity within the meaning of section 469(c) of the Internal Revenue Code, and the decedent or the decedent's spouse must have materially participated in the trade or business within the meaning of section 469(h) of the Internal Revenue Code, excluding section 469(h)(3) of the Internal Revenue Code and any other provision provided by United States Treasury Department regulation that substitutes material participation in prior taxable years for material participation in the taxable year that ended before the decedent's death.

(4) The gross annual sales of the trade or business were \$10,000,000 or less for the last taxable year that ended before the date of the death of the decedent.

~~(4)~~(5) The property does not consist of cash or cash equivalents, publicly traded securities, or assets not used in the operation of the trade or business. For property consisting of shares of stock or other ownership interests in an entity, the amount value of cash or cash equivalents, publicly traded securities, or assets not used in the operation of the trade or business held by the corporation or other entity must be deducted from the value of the property qualifying under this subdivision in proportion to the decedent's share of ownership of the entity on the date of death.

~~(5)~~(6) The decedent continuously owned the property, including property the decedent is deemed to own under sections 2036, 2037, and 2038 of the Internal Revenue Code, for the three-year period ending on the date of death of the decedent. In the case of a sole proprietor, if the property replaced similar property within the three-year period, the replacement property will be treated as having been owned for the three-year period ending on the date of death of the decedent.

~~(6)~~ A family member continuously uses the property in the operation of the trade or business for three years following the date of death of the decedent.

(7) For three years following the date of death of the decedent, the trade or business is not a passive activity within the meaning of section 469(c) of the Internal Revenue Code, and a family member materially participates in the operation of the trade or business within the meaning of section 469(h) of the Internal Revenue Code, excluding section 469(h)(3) of the Internal Revenue Code and any other provision provided by United States Treasury Department regulation that substitutes material participation in prior taxable years for material participation in the three years following the date of death of the decedent.

(8) The estate and the qualified heir elect to treat the property as qualified small business property and agree, in the form prescribed by the commissioner, to pay the recapture tax under subdivision 11, if applicable.

Subd. 10. Qualified farm property. Property satisfying all of the following requirements is qualified farm property:

(1) The value of the property was included in the federal adjusted taxable estate.

(2) ~~The property consists of a farm meeting the requirements of agricultural land and is owned by a person or entity that is either not subject to or is in compliance with section 500.24, and was classified for property tax purposes as the homestead of the decedent or the decedent's spouse or both under section 273.124, and as class 2a property under section 273.13, subdivision 23.~~

(3) For property taxes payable in the taxable year of the decedent's death, the property is classified as class 2a property under section 273.13, subdivision 23, and is classified as agricultural homestead, agricultural relative homestead, or special agricultural homestead under section 273.124.

(4) The decedent continuously owned the property, including property the decedent is deemed to own under sections 2036, 2037, and 2038 of the Internal Revenue Code, for the three-year period ending on the date of death of the decedent either by ownership of the agricultural land or pursuant to holding an interest in an entity that is not subject to or is in compliance with section 500.24.

~~(4) — A family member continuously uses the property in the operation of the trade or business~~ (5) The property is classified for property tax purposes as class 2a property under section 273.13, subdivision 23, for three years following the date of death of the decedent.

~~(5)~~ (6) The estate and the qualified heir elect to treat the property as qualified farm property and agree, in a form prescribed by the commissioner, to pay the recapture tax under subdivision 11, if applicable.

Subd. 11. Recapture tax. (a) If, within three years after the decedent's death and before the death of the qualified heir, the qualified heir disposes of any interest in the qualified property, other than by a disposition to a family member, or a family member ceases to use ~~the qualified property which was acquired or passed from the decedent~~ satisfy the requirement under subdivision 9, clause (7); or 10, clause (5), an additional estate tax is imposed on the property. In the case of a sole proprietor, if the qualified heir replaces qualified small business property excluded under subdivision 9 with similar property, then the qualified heir will not be treated as having disposed of an interest in the qualified property.

(b) The amount of the additional tax equals the amount of the exclusion claimed by the estate under subdivision 8, paragraph (d), multiplied by 16 percent.

(c) The additional tax under this subdivision is due on the day which is six months after the date of the disposition or cessation in paragraph (a).

C. Definitions.

1. **Family Member.** The definition of "family member" was expanded to include or a *trust whose present beneficiaries are all family members as defined in section 2032A(e)(2) of the Internal Revenue Code*. A family member under 2032A(e)(2) includes an ancestor or spouse of the decedent, lineal descendant of the decedent or the decedent's spouse or parents, or spouse of a lineal descendant.

2. **Qualified Heir.** The definition of "qualified heir" was amended to mean a family member who acquired qualified property *upon the death of the decedent* opposed to *from the decedent*. This allows the transfer of the property from a trust to a trust or another family member.

D. Qualified Small Business Property.

1. **Property.** The property must consist of assets of a trade, business, share of stock or other ownership interest in a corporation or entity engaged in a trade or business. Cash, cash equivalent, publicly traded securities, or assets not used in the trade or business must be deducted proportionate to the share of the ownership interest.

2. **Ownership Interest.** Ownership interest was expanded by the technical changes to include *interests the decedent is deemed to own under I.R.C. § 2036, § 2037, and § 2038*.

1) **I.R.C. § 2036:** Value of transferred **Life Estate Interest** includes all interests of which decedent has made a transfer relating to:

(1) Possession, enjoyment of, right to vote on matters concerning, or right to income derived from the property, or

(2) Right to designate, alone or in conjunction with another, persons who may possess, use, or enjoy income derived from the property.

2) **I.R.C. § 2037: Reversionary Value** of gross estate includes value of all property held by the decedent and transferred by trust or otherwise, if:

(1) Possession or enjoyment of the property through ownership can only be obtained by surviving the decedent, **and**

(2) Decedent retains a reversionary interest in the property, valued immediately before decedent's death at > 5% of the property value.

- *A reversionary interest is the possibility that property transferred by the decedent may return to him or his estate, or may be subject to power of disposition by him. This does not include the possibility of income derived from the property.*

3) **I.R.C. § 2038:** Value of gross estate includes value from **Revocable Transfers** (*i.e., Revocable Trusts*) when:

(1) Decedent or another person, *except* in the case of a bona fide sale, retained the power to alter, amend, or revoke the transfer until the decedent's death, **or** where decedent relinquished this power in the preceding 3-year period ending on the date of decedent's death, **unless** the transfer occurred before 6/22/1936 and is otherwise not included in the above description.

(2) The power to alter, amend, revoke, or terminate shall be considered to exist on the date of decedent's death, even when the exercise of power is subject to notice not given, or when the power shall not take effect until after a term of years which has not yet expired.

3. Passive Activity Prohibition. Passive Activity is *defined in I.R.C. § 469(c) as any activity which:*

1) Involves the conduct of any trade or business in which the taxpayer does not **materially participate**.

2) Any rental activity (**except** for taxpayers in the real property business to whom over ½ of all services performed are real property trades, and said taxpayer performs over 750 hours of services during the taxable year in property trades or for a business in which the taxpayer materially participates).

4. Material Participation Requirement. The material participation requirement for Minnesota qualified small business property adopts the standards of § 469 of the Internal Revenue Code, for determining whether there was material participation or not.⁴ Section 469 of the Internal Revenue Code contains provisions on passive activity losses and credits allowed. It is not clear why, but the Minnesota legislature chose to use a definition of "material participation" which is used to govern passive losses, and not refer to § 1402(a)(1) which is the section dealing with self-employment taxes and is the section referred to for determining material participation under § 2032A.

5. The Section 469 Standard. Section 469(h)(1) of the Internal Revenue Code defines "material participation" by stating:

A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is (A) regular, (B) continuous, and (C) substantial.

Treasury Regulations interpreting section 469 provide that a taxpayer is considered to have "materially participated" if his or her activities satisfy at least one of seven specific tests. According to Treasury Regulation 1.469-5T, "an individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year, if and only if

1. The individual participates in the activity for more than 500 hours during such year, and the taxpayer owns an interest in the activity while performing the work.
2. The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year. This permits a small operation to qualify, when it could not under test (1) above.
3. The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

⁴ Minn. Stat. § 291.03, subd. 9(2) (2011)

4. The activity is a significant participation activity (within the meaning of paragraph (c) [of Regs. 1.469-5T] for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

5. The individual materially participated in the activity (determined without regard to this paragraph (a)(5) [of Regs. 1.469-5T] for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

6. The activity is a personal service activity (within the meaning of paragraph (d) [of Regs. 1.469-5T], and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

7. Based on all of the facts and circumstances (taking into account the rules in paragraph (b) [of Regs. 1.469-5T], the individual participates in the activity on a regular, continuous, and substantial basis during such year.⁵ This test requires at least 100 hours of activity during the year. Management activity cannot be taken into account unless no other person is compensated for management services and no other individual performs management services for more hours than the taxpayer. There is no definition of "management services."

Tests (5) and (6) do not seem applicable in the 2032A context.

6. Continuous Ownership. The decedent must have continuously owned the property for three years preceding the date of death of the decedent. An ownership interest was expanded by the technical changes to include *includes interests the decedent is deemed to own under I.R.C. § 2036, § 2037, and § 2038.*

Note: If decedent is a **sole proprietor**, and the property replaced similar property within the three year period, the new property is treated as having been owned for the three-year period ending on decedent's death.

7. Continuous Ownership after death of decedent. In the three-year period following the decedent's death, the business must refrain from passive activity **and** a family member of the decedent must materially participate in the business or trade.

E. Qualified farm property.

1. Compliance with Corporate Farm Statute (Minn. Stat. § 500.24.)

2. Property classification. The property must be classified for property tax purposes as Class 2A Property under Section 273.13 Subd. (23) in the year of the

⁵ Regs. § 1.469-5T

decedent's death AND as agricultural homestead, agricultural relative homestead, or special agricultural homestead under § 273.124 in the year of the decedent's death.

1) **Class 2A Property under Section 273.13 Subd. (23).** In essence, parcels or portions thereof of property consisting of agricultural land and buildings, including Class 2b property interspersed with Class 2a property, with a net class rate of 1% of market value, *unless* it is part of an agricultural homestead.

2) **Agricultural homestead.** See attached agricultural homestead determination chart.

3. **Continuous ownership.** The decedent must have continuously owned the property for three years preceding the date of death of the decedent. An ownership interest was expanded by the technical changes to include interests the decedent is deemed to own under I.R.C. § 2036, § 2037, and § 2038. See paragraph (C)(2) for discussion on I.R.C. § 2036, § 2037, and § 2038)

4. **Continuous Ownership three years following decedent's death.** Three years following the death of the decedent, the qualified heir must continually own the property as class Class 2A Property under Section 273.13 Subd. (23).

F. **Recapture Tax.** The estate and the qualified heir must elect to treat the property as qualified small business or farm property, and agree, in a form prescribed by the Commissioner of Revenue, to pay the recapture tax if applicable.

1. **Three year holding requirement.** If, within the earlier of three years of the date of the decedent's death or the death of the qualified heir, the qualified heir disposes of the interest and additional estate tax is imposed on the property.

2. **Disposition to family member allowed.** The qualified heir can dispose of the property to a family member without triggering the recapture tax.

3. **Election.** The estate and the qualified heir must elect to treat the property as qualified small business or farm property, and agree, in a form prescribed by the Commissioner of Revenue, to pay the recapture tax if applicable.

4. **Sole proprietor replacement property.** In the case of a sole proprietor, if the qualified heir replaced small business property excluded under the qualified small business exclusion with similar property, the qualified heir will not be treated as having disposed of the interest in the property.

5. **Recapture Tax.** The Minnesota statute sets the recapture tax rate at the top bracket, i.e., 16%. Thus, a failed election could end up costing more than twice as much in recapture tax as the original tax would have been if paid at the outset!

MINNESOTA REVENUE 2013 Estate Tax Return

2013 M706

For estates of a decedent whose date of death is in calendar year 2013

Check box if this is an amended return

Decedent's first name, middle initial		Last name		Decedent's Social Security number	
Last home address (street, apartment, route)				Date of death	
City		State	Zip code	Minnesota probate county and file number	
Executor's first name, middle initial		Last name	Executor's Social Security number		If filing under a federal filing extension enter the extended due date (mm/dd/yyyy) (attach IRS approval):
Name of firm (if applicable)		Executor's phone		Check if electing the qualified small business and farm property deduction (attach Schedule M706Q): <input type="checkbox"/>	
Address (street, apartment, route)		City	State	Zip code	Check if you received an extension for paying tax: <input type="checkbox"/>

If paying federal estate tax in installments, attach copy of IRS approval and check this box: Round amounts to the nearest whole dollar.

Estates of residents of Minnesota

1 Tentative Minnesota estate tax before deductions (determine from instructions, page 5) 1

2 Gross value of all real and tangible personal property located in other states (attach itemized list) .. 2

3 Federal total gross estate (from line 1 of federal Form 706) 3

4 Ratio of property in other states to total gross estate (divide line 2 by line 3, and round the result to five decimal places) 4

5 Multiply line 1 by line 4 5

6 Minnesota estate tax before credits (subtract line 5 from line 1). Skip lines 7-11 and continue with line 12 6

Estates of nonresidents of Minnesota

7 Tentative Minnesota estate tax before deductions (determine from instructions, page 5) 7

8 Gross value of all real and tangible personal property in Minnesota, including those within a pass-through entity (attach itemized list) 8

9 Federal total gross estate (from line 1 of federal Form 706) 9

10 Ratio of property in Minnesota to total gross estate (divide line 8 by line 9, and round the result to five decimal places) 10

11 Minnesota estate tax before credits (multiply line 7 by line 10) 11

Nonrefundable credits

12 Credit for Minnesota gift taxes paid (determine from instructions, page 5)..... 12

13 Nonresident decedent tax credit (determine from instructions, page 5)..... 13

14 Total nonrefundable credits. Add lines 12 and 13 14

Estate tax

15 Minnesota estate tax (subtract line 14 from line 6 if resident or from line 11 if nonresident) 15

16 Total payments, including any extension payments, made prior to filing this return 16

17 If line 15 is more than line 16, subtract line 16 from line 15 17

18 Penalties (determine from instructions, page 7) 18

19 Interest, if any, from: _____ to: _____ (complete worksheet on back) 19

20 **AMOUNT DUE.** Add lines 17, 18 and 19 20
Check payment method: check (attach payment voucher), or electronic (see Options, page 2)

21 **REFUND.** If your total payments are more than the sum of Minnesota estate tax, penalty and interest, subtract the amounts on lines 15, 18 and 19 from line 16 21

22 To have your refund direct deposited, enter the following. Otherwise, you will receive a check.

Account type: Routing number Account number (must be an account not associated with any foreign bank)

Checking Savings

I declare that this return is correct and complete to the best of my knowledge and belief.

Signature of executor Date Executor's phone I have appointed a power of attorney on the back of this form.

Signature of executor Date Signature of executor Date

Signature of preparer, other than executor PTIN Date Daytime phone

You must attach a copy of the federal Form 706, required schedules, death certificate and all supporting documentation.
Mail to: Minnesota Estate Tax, Mail Station 1315, St. Paul, MN 55146-1315

Type or Print
Estates of Minnesota Residents
Estates of Nonresidents
All Estates
Sign Here

2013 Estate Tax Return (continued)

Decedent's first name, middle initial, last name	Decedent's Social Security number	Executor's first name, middle initial, last name	Executor's Social Security number
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Interest Calculations

Worksheet for Determining Interest on Line 19

Interest accrues on any unpaid tax and penalty beginning nine months from the decedent's date of death.

1	Amount of tax not paid within nine months after the decedent's date of death	.....	1	_____
2	Unpaid penalty, if any, from line 18 on the front of this form	.....	2	_____
3	Unpaid tax and penalty on which interest will accrue (add step 1 and step 2)	.....	3	_____
4	Number of days that your payment of tax and/or penalty is late. If the days fall in more than one calendar year, you must determine the number of days separately for each year	.....	4	_____
				Year: 2013 Year: 2014
5	Divide step 4 by 365. Round the result to five decimal places	.....	5	_____
6	Multiply step 3 by the result in step 5 for each year	.....	6	_____
7	Interest rate in effect for the calendar year	.....	7	_____ 3% _____ 3%
8	Multiply step 6 by the interest rate in step 7 for each year	.....	8	_____
9	Add the amounts in step 8. Also enter the result on line 19 of Form M706	.....	9	_____

Appointee

Power of Attorney

You may designate another person to act on your behalf or perform any act you can perform with respect to the Minnesota taxes of the decedent's estate when dealing with the department. To designate power of attorney, provide the information below and check the box after your signature on the front of this form.

Note: The department does not send tax refunds to the designated appointee unless you make an election in writing. It is your responsibility to keep your appointee informed of your tax matters. If you want the department to send any and all notices, including tax refunds, directly to your appointee rather than you, attach Form REV184A, *Election for Power of Attorney*, to this form.

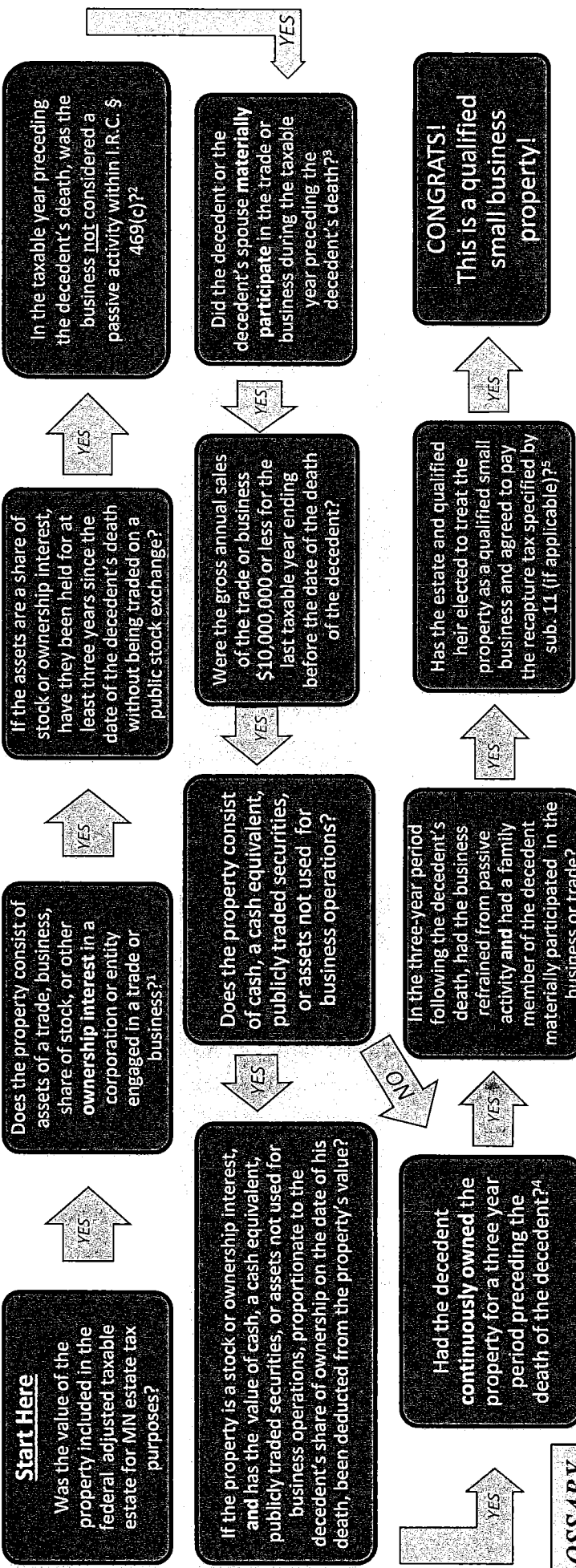
I, the executor (personal representative) of the decedent's estate, appoint the person named below as Attorney-in-Fact to represent the estate before the Minnesota Department of Revenue. The appointee is authorized to provide and receive private and nonpublic information regarding the Minnesota taxes of the estate, and to perform any and all acts that I can perform with regard to the state taxes of the estate, unless noted below.

Name of person (appointee) given power of attorney		Daytime phone	Fax number
Name of firm (if applicable)			
Address (street, apartment, route)		Expiration date (if a date is not provided, this power of attorney is valid until revoked in writing):	
City	State	Zip code	Check this box to revoke all powers of attorney previously filed by you in connection with the Minnesota taxes of the decedent's estate: <input type="checkbox"/>

Excluded Powers

I am excluding the following powers (please list):

QUALIFYING A SMALL BUSINESS PROPERTY UNDER M.S.A. § 291.03 SUBD. 9



GLOSSARY

¹ **Ownership Interest:** Ownership interest includes interests the decedent is deemed to own under I.R.C. § 2036, § 2037, and § 2038.

I.R.C. § 2036: Value of transferred Life Estate Interest includes all interests of which decedent has made a transfer relating to:

- 1) Possession, enjoyment of, right to vote on matters concerning, or right to income derived from the property, or
- 2) Right to designate, alone or in conjunction with another, persons who may possess, use, or enjoy income derived from the property.

I.R.C. § 2037: Reversionary Value of gross estate includes value of all property held by the decedent and transferred by trust or otherwise, if:

- 1) Possession or enjoyment of the property through ownership can only be obtained by surviving the decedent, and
- 2) Decedent retains a reversionary interest in the property, valued immediately before decedent's death at > 5% of the property value.

A reversionary interest is the possibility that property transferred by the decedent may return to him or his estate, or may be subject to power of disposition by him. This does not include the possibility of income derived from the property.

I.R.C. § 2038: Value of gross estate includes value from Revocable Transfers (i.e., Revocable Trusts) when:

- 1) Decedent or another person, except in the case of a bona fide sale, retained the power to alter, amend, or revoke the transfer until the decedent's death, or where decedent relinquished this power in the preceding 3-year period ending on the date of decedent's death, unless the transfer occurred before 6/22/1936 and is otherwise not included in the above description.
- 2) The power to alter, amend, revoke, or terminate shall be considered to exist on the date of decedent's death, even when the exercise of power is subject to notice not given, or when the power shall not take effect until after a term of years which has not yet expired.

² **Passive Activity:** Defined in I.R.C. § 469(c) as any activity which:

- 1) Involves the conduct of any trade or business in which the taxpayer does not materially participate (see note 3).
- 2) Any rental activity (except for taxpayers in the real property business to whom over 1/2 of all services performed are real property trades, and said taxpayer performs over 750 hours of services during the taxable year in property trades or for a business in which the taxpayer materially participates).

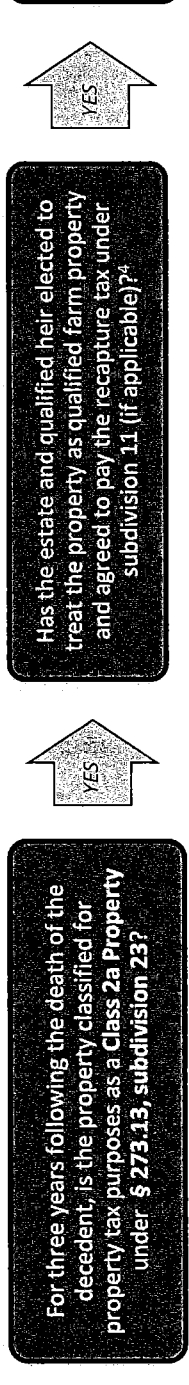
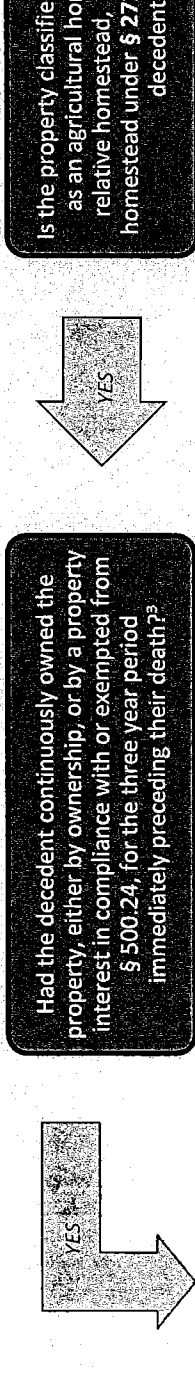
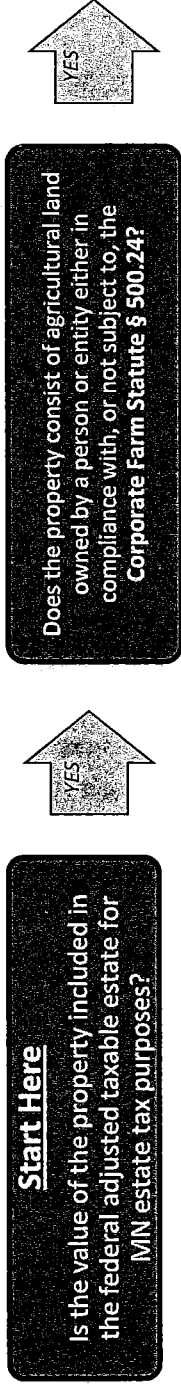
³ **Material Participation:** Defined in 26 U.S.C. § 469(h):

- 1) Taxpayer must be involved in the operations on a:
 - a) Regular, (b) Continuous, and (c) Substantial basis.
- 2) Interest in a limited partnership as a limited partner does not constitute material participation.
- 3) Any regulation substituting material participation in prior taxable years for participation in the 3 years following decedent's death is excluded
- 4) If interest is a C Corporation or Personal Service Corporation:
 - a) Only for a C Corporation, it must exhibit one of the following:
 - (i) At least one full-time employee managing business last year.
 - (ii) At least 3 full-time, non-owner, active employees last year.
 - (iii) Business deductions to taxpayer via 26 U.S.C. § 162 and § 404 must exceed 15% of the gross income for previous year.

⁴ **Note:** if decedent is a sole proprietor, and the property replaced similar property within the three year period, the new property is treated as having been owned for the three-year period ending on decedent's death.

⁵ **Qualified Heir:** means a family member (an ancestor or spouse of the decedent, lineal descendant of the decedent or the decedent's spouse or parents, or spouse of a lineal descendant) who receives property upon the death of the decedent. **Family Member:** includes a trust whose present beneficiaries are all family members.

QUALIFYING A FARM PROPERTY UNDER M.S.A. § 291.03 SUBD. 10



Is the property considered a Class 2a Property under §273.13, subdivision 23, in the year of the decedent's death?¹

Is the property classified for taxation purposes as an agricultural homestead, agricultural relative homestead, or special agricultural homestead under § 273.124 in the year of the decedent's death?²

CONGRATS!
The property is classified as a Qualified Farm Property!

GLOSSARY

¹**Class 2a Property (§ 273 .13, subd. 23):** Parcels or portions thereof of property consisting of agricultural land and buildings, including Class 2b property interspersed with Class 2a property, with a net class rate of 1% of market value, unless it is part of an agricultural homestead. See note 2.

²**Agricultural Homestead:** See attached agricultural homestead determination chart.

³**Ownership Interest:** Ownership Interest includes interests the decedent is deemed to own under I.R.C. § 2036, § 2037, and § 2038.

- I.R.C. § 2036: Value of transferred Life Estate Interest includes all interests of which decedent has made a transfer relating to:
1) Possession, enjoyment of, right to vote on matters concerning, or right to income derived from the property, or
2) Right to designate, alone or in conjunction with another, persons who may possess, use, or enjoy income derived from the property.

- I.R.C. § 2037: Reversionary Value of gross estate includes value of all property held by the decedent and transferred by trust or otherwise, if:
1) Possession or enjoyment of the property through ownership can only be obtained by surviving the decedent, and
2) Decedent retains a reversionary interest in the property, valued immediately before decedent's death at > 5% of the property value.
• A reversionary interest is the possibility that property transferred by the decedent may return to him or his estate, or may be subject to power of disposition by him. This does not include the possibility of income derived from the property.

- I.R.C. § 2038: Value of gross estate includes value from Revocable Transfers (i.e., revocable trusts) when:
1) Decedent or another person, except in the case of a bona fide sale, retained the power to alter, amend, or revoke the transfer until the decedent's death, or where decedent relinquished this power in the preceding 3-year period ending on the date of decedent's death, unless the transfer occurred before 6/22/1936 and is otherwise not included in the above description.
2) The power to alter, amend, revoke, or terminate shall be considered to exist on the date of decedent's death, even when the exercise of power is subject to notice not given, or when the power shall not take effect until after a term of years which has not yet expired.

⁴**Qualified Heir:** A family member who acquired qualified property from the decedent.

- *A Family Member consists of:
1) Ancestor of the decedent (parent, grandparent, etc.).
2) The Decedent's Spouse.
3) Lineal descendant of the decedent, the decedent's spouse, or the decedent's parents.
4) Spouse of any lineal descendant described above.
5) A trust whose present beneficiaries are all family members.

Election to Claim the Qualified Small Business and Farm Property Deduction 2012

2012 M706Q

To be completed by the executor of the estate with a date of death after June 30, 2011, and qualified heirs.

Type or Print

Decedent's first name, middle initial		Last name		Decedent's Social Security number	
Last home address (street, apartment, route)				Date of death (must be after June 30, 2011)	
City		State	Zip code	Minnesota probate county and file number	
Executor's first name, middle initial		Last name		Executor's Social Security number	
Name of firm (if applicable)				Executor's phone	
Address (street, apartment, route)		City	State	Zip code	

Part 1

Part 1 – Qualified Small Business Property Requirements

Complete Part 1 to determine if the estate meets the qualified small business property requirements. If the answer is "No" for any of the questions, the estate is not eligible to claim the small business property deduction.

- 1 Is the value of the property included in the decedent's federal adjusted taxable estate, which is after federal allowable deductions, including debts, expenses and bequests to a surviving spouse? 1 Yes No
- 2 Does the property consist of assets of a trade or business (or shares of stock or other ownership interests in a corporation or other entity that is engaged in a trade or business and is not publicly traded)? 2 Yes No
- 3 Did the decedent or the decedent's spouse materially participate in the trade or business during the taxable year that ended before the decedent's death? 3 Yes No
- 4 Did the trade or business have gross annual sales of \$10 million or less during the last taxable year that ended before the decedent's death? 4 Yes No
- 5 Did the decedent continuously own the property for the three-year period ending at the decedent's death? 5 Yes No

If you answered yes to all of the Part 1 questions, the estate may be eligible to claim the small business property deduction. Complete Part 3 to determine if the estate has qualified heirs.

Part 2

Part 2 – Qualified Farm Property Requirements

Complete Part 2 to determine if the estate meets the qualified farm property requirements. If the answer is "No" for any of the questions, the estate is not eligible to claim the farm property deduction.

- 6 Is the value of the property included in the decedent's federal adjusted taxable estate, which is after federal allowable deductions, including debts, expenses and bequests to a surviving spouse? 6 Yes No
- 7 Does the property consist 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? 7 Yes No
- 8 Was the property 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? 8 Yes No
- 9 Was the property classified for property tax purposes in the taxable year of death as class 2a property under M.S. 273.13, subd. 23? 9 Yes No
- 10 Did the decedent continuously own the property for the three-year period ending at the decedent's death? 10 Yes No

If you answered yes to all of the Part 2 questions, the estate may be eligible to claim the farm property deduction. Complete Part 3 to determine if the estate has qualified heirs.

Election to Claim the Qualified Small Business and Farm Property Deduction 2012 (continued)

Decedent's first name, middle initial, last name	Decedent's Social Security number	Executor's first name, middle initial, last name	Executor's Social Security number
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Part 4 – Agreement (Must be completed and signed by each and every qualified heir and the executor)

Heirs: All persons signing below agree and attest to the following:

I am a "family member" as provided by M.S. 291.03, subd. 8.

I am a "qualified heir" as provided by M.S. 291.03, subd. 8(c).

Each and every qualified heir who acquired the qualified property or an interest in the qualified property described on Line 1, Parts 5 and 6 is listed below.

If any qualified heir or family member disposes of any interest in the qualified property described on Line 1, Parts 5 and 6, other than by a disposition to a family member, during the three-year period following decedent's death, I am personally responsible for filing and paying the recapture tax equal to the amount listed on Line 4, Part 7, multiplied by 16%. The filing and payment due date is no later than six months from the date of the disqualifying disposition.

If a family member does not maintain the 2a classification for the qualified property described on Line 1, Part 6 for the farm property deduction or a family member does not materially participate in the operation of the trade or business describes on Line 12, Part 3 for the qualified property described on Line 1, Part 5 for the small business property deduction during the three-year period following decedent's death, I am personally responsible for filing and paying the recapture tax equal to the amount listed on Line 4, Part 7, multiplied by 16%. The filing and payment due date is no later than six months from the date of the disqualifying cessation of the trade or business

This schedule is correct and complete to the best of my knowledge and belief.

Name	Address	City	State	Zip code
Signature of qualified heir	Date	Social Security number	Phone number	
Name	Address	City	State	Zip code
Signature of qualified heir	Date	Social Security number	Phone number	
Name	Address	City	State	Zip code
Signature of qualified heir	Date	Social Security number	Phone number	
Name	Address	City	State	Zip code
Signature of qualified heir	Date	Social Security number	Phone number	

Part 4

Executor: I agree and attest to the following:

I am the executor of the decedent's estate.

Each and every qualified heir who acquired the qualified property or an interest in the qualified property described on Line 1, Parts 5 and 6 signed the agreement above.

If any qualified heir or family member disposes of any interest in the qualified property described on Line 1, Parts 5 and 6, other than by a disposition to a family member, during the three-year period following decedent's death, I am personally responsible for filing and paying the recapture tax equal to the amount listed on Line 4, Part 7, multiplied by 16%. The filing and payment due date is no later than six months from the date of the disqualifying disposition.

If a family member does not maintain the 2a classification for the qualified property described on Line 1, Part 6 for the farm property deduction or a family member does not materially participate in the operation of the trade or business describes on Line 12, Part 3 for the qualified property described on Line 1, Part 5 for the small business property deduction during the three-year period following decedent's death, I am personally responsible for filing and paying the recapture tax equal to the amount listed on Line 4, Part 7, multiplied by 16%. The filing and payment due date is no later than six months from the date of the disqualifying cessation of the trade or business

This schedule is correct and complete to the best of my knowledge and belief.

Name	Address	City	State	Zip code
Signature of executor	Date			

Attach separate sheets, if needed.

Election to Claim the Qualified Small Business and Farm Property Deduction for Qualified Small Business Property 2012 (continued)

Decedent's first name, middle initial, last name	Decedent's Social Security number	Executor's first name, middle initial, last name	Executor's Social Security number
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Part 5 – Deduction Calculation for Qualified Small Business Property

- 1** Value of assets. For each asset elected to be deducted from the decedent's Minnesota adjusted taxable estate as qualified small business property, provide a description, indicate the Schedule and item number from the Federal Form 706 where the asset is reported, and report the asset's fair market value at the valuation date.

Description of Asset	Federal Schedule and Item Number Where Reported	Fair Market Value At Valuation Date

Subtotal from additional sheets attached to this schedule, if any **1** _____
 Total value of assets **1** _____

- 2** Noneligible property. List property included on your Federal Form 706 and on line 1 above that is not eligible for the qualified small business deduction (see instructions).

Noneligible Property	Value Included in Federal Gross Estate	Amount Not Allowed in Deduction

Subtotal from additional sheets attached to this schedule, if any **2** _____
 Total amount not allowed in deduction **2** _____

- 3** Federal allowable deductions. Report allowable deductions that are related to the assets included on line 1 above and indicate the Schedule and item number from the Federal Form 706 where the allowable deduction is reported.

Description of Deduction	Federal Schedule and Item Number Where Reported	Amount Claimed as a Deduction

Subtotal from additional sheets attached to this schedule, if any **3** _____
 Total allowable deductions **3** _____

- 4** Add line 2 and line 3 **4** _____
5 Tentative Deduction. Subtract line 4 from line 1. If you are also claiming a deduction for qualified farm property, continue to Part 6. If not, continue to Part 7..... **5** _____

Part 5

Election to Claim the Qualified Small Business and Farm Property Deduction for Qualified Farm Property 2012 (continued)

Decedent's first name, middle initial, last name	Decedent's Social Security number	Executor's first name, middle initial, last name	Executor's Social Security number
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Part 6 – Deduction Calculation for Qualified Farm Property

1 Value of assets. For each asset elected to be deducted from the decedent's Minnesota adjusted taxable estate as qualified farm property, provide a description, indicate the Schedule and item number from the Federal Form 706 where the asset is reported, and report the asset's fair market value at the valuation date.

Description of Asset	Federal Schedule and Item Number Where Reported	Fair Market Value At Valuation Date

Subtotal from additional sheets attached to this schedule, if any _____
 Total value of assets **1** _____

2 Noneligible property. List property included on your Federal Form 706 and on line 1 above that is not eligible for the qualified farm property deduction (see instructions).

Noneligible Property	Value Included in Federal Gross Estate	Amount Not Allowed in Deduction

Subtotal from additional sheets attached to this schedule, if any _____
 Total amount not allowed in deduction **2** _____

3 Federal allowable deductions. Report allowable deductions that are related to the assets included on line 1 above and indicate the Schedule and item number from the Federal Form 706 where the allowable deduction is reported.

Description of Deduction	Federal Schedule and Item Number Where Reported	Amount Claimed as a Deduction

Subtotal from additional sheets attached to this schedule, if any _____
 Total allowable deductions **3** _____

4 Add line 2 and line 3 **4** _____

5 Tentative Deduction. Subtract line 4 from line 1. Continue to Part 7 **5** _____

Part 6

Election to Claim the Qualified Small Business and Farm Property Deduction 2012 *(continued)*

Decedent's first name, middle initial, last name	Decedent's Social Security number	Executor's first name, middle initial, last name	Executor's Social Security number
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Part 7 — Deduction Calculation for Qualified Small Business Property and Qualified Farm Property

- 1** Enter the amount from Part 5, Line 5 **1** _____
- 2** Enter the amount from Part 6, Line 5 **2** _____
- 3** Add line 1 and line 2 **3** _____
- 4 Deduction.** Enter the lesser of line 3 or \$4,000,000. Also, enter the amount on step 6 and step 20 of the "Worksheet to Determine Line 1," on page 4 of the M706 instructions.. **4** _____

Part 7

You must attach the following to the Form M706Q:

- Documentation demonstrating decedent's continuous ownership of the qualified property for the three-year period prior to decedent's death (deeds, titles, Federal Schedules K-1, etc.).
- If the deducted property is qualified small business property, a complete copy of the decedent's federal income tax return, schedules, and attachments for the three taxable years ending prior to the decedent's death (including the taxable year of death).
- If the deducted property is qualified farm property, a copy of the decedent's property tax statements for the taxable year of death.

Schedule M706Q Instructions 2012

Purpose of Schedule M706Q

Schedule M706Q allows the estate of a decedent dying after June 30, 2011 to make an election to deduct qualified small business or qualified farm property from the Minnesota adjusted taxable estate. The deduction cannot exceed \$4 million and qualified heirs must pay a recapture tax if a qualified heir fails to own the property or if a family member fails to use the property for a qualified use during the three years after the decedent's death.

Who Should File

An estate may be eligible for this deduction if:

- the decedent died after June 30, 2011;
- the estate is required to file Form M706;
- the value of the Minnesota adjusted taxable estate includes qualified small business or qualified farm property;
- for the small business property deduction, the estate and all qualified heirs agree that a family member will materially participate in the operation of the trade or business for three years following the decedent's death
- for the farm property deduction, the estate and all qualified heirs agree that a family member will maintain 2a property classification for three years following the decedent's death; and
- the estate and all qualified heirs agree not to dispose of any interest in the qualified property other than to a family member during the three years following the decedent's death.

When to File

File Schedule M706Q with Form M706.

Required Attachments

You must attach the following to Form M706Q:

- Documentation demonstrating decedent's continuous ownership of the qualified property for the three-year period prior to decedent's death.
- If the deducted property is qualified small business property, a complete copy of the decedent's federal income tax return, schedules, and attachments for the three taxable years ending prior to the decedent's death (including the taxable year of death).

- If the deducted property is qualified farm property, a copy of the decedent's property tax statements for the taxable year of death.

Assembly Required

See Form M706 instructions for how to assemble the required information.

Line Instructions

Part 1 - Qualified Small Business Property Requirements

The estate must complete the federal Form 706 and Minnesota Form M706 to determine if the value of the qualified property is included in the decedent's federal adjusted taxable estate. The federal adjusted taxable estate is after deductions, including debts, expenses and bequests to a surviving spouse.

Material participation is described in section 469 of the Internal Revenue Code. The existence of material participation is a factual determination that generally requires regular, continuous, and substantial involvement in the operations of the trade or business activity. A passive activity within the meaning of section 469(c) of the Internal Revenue Code does not constitute material participation.

If the estate answers "no" to any of the questions in Part 1, stop here: the estate is not eligible to claim the small business property deduction. If the estate answers "yes" to all questions in Part 1, the estate may be eligible to claim the small business property deduction. Continue to Part 3.

(M.S. 291.03, subd. 9)

Part 2 - Qualified Farm Property Requirements

The estate must complete the federal Form 706 and Minnesota Form M706 to determine if the value of the qualified property is included in the decedent's federal adjusted taxable estate. The federal adjusted taxable estate is after deductions, including debts, expenses and bequests to a surviving spouse.

Minnesota law, in general, bars corporations, limited liability companies, pension or investment funds, trusts, and limited partnerships from farming, owning, or leasing farmland in Minnesota. To meet the requirements of the qualified farm property deduction, the land cannot be owned by an entity that is prohibited from owning agricultural land under section 500.24 of Minnesota Statutes.

Class 2a agricultural land consists of parcels of property, or portions thereof that are agricultural land and buildings. Class 2a land may be homestead or non-homestead depending on ownership, occupancy, and active farming scenarios.

To meet the requirements of qualified farm property, the property must be classified as class 2a agricultural land. If the property has multiple property classifications and the county assessor can practically separate the acreage of each classification type, then only the acreage that is attributable to class 2a can be claimed for the farm property deduction.

To meet the requirements of qualified farm property, the property must be classified as the agricultural homestead, agricultural relative homestead, or special agricultural homestead. If the property has multiple homestead classification and the county assessor can practically separate the acreage of each classification type, then only the acreage that is attributable to the agricultural homestead, agricultural relative homestead, or special agricultural homestead can be claimed for the farm property deduction.

If the estate answers "no" to any of the questions in Part 2, stop here: the estate is not eligible to claim the farm property deduction. If the estate answers "yes" to all questions in Part 2, the estate may be eligible to claim the small business property deduction. Continue to Part 3.

(M.S. 291.03, subd. 10)

Part 3 - Qualified Heirs and Family Members Requirements

A "family member" means:

- an ancestor of the decedent (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.

A decedent's aunts, uncles, and cousins do not qualify as family members. A decedent's nieces or nephews, however, do qualify as family members.

A "qualified heir" means a family member who acquired qualified property upon the death of the decedent.

Continued

M706Q Instructions 2012 (continued)

Describe the trade or business, including the type of industry, and enter the six-digit NAICS code that best describes the business activities. To determine the appropriate NAICS code, go to <http://www.census.gov/eos/www/naics/index.html>. Enter a keyword to search the most recent NAICS list.

If a family member does not maintain the 2a classification for the qualified property for the farm property deduction or a family member does not materially participate in the operation of the trade or business for the small business property deduction during the three-year period following decedent's death, a recapture tax will be imposed.

If the qualified heirs dispose of any interest in the qualified property other than to a family member during the three years following the decedent's death, a recapture tax will be imposed.

The recapture tax is equal to 16% of the amount deducted by this election from the Minnesota adjusted taxable estate. The recapture tax and return are due no later than six months from the date of the disqualifying cessation of the trade or business or the disqualifying disposition of the qualified property.

(M.S. 291.03, subd. 11)

If the estate answers "no" to any of the questions in Part 3, stop here: the estate is not eligible to claim the small business or farm property deduction. If the estate answers "yes" to all questions in Part 3, the estate may be eligible to claim the small business or farm property deduction. Continue to Part 4.

Part 4 – Agreement

To make a valid election, the agreement must be completed and signed by each and every qualified heir who acquired the qualified property upon the death of the decedent. In addition, the executor of the estate must sign the agreement on behalf of the estate.

Parts 5 and 6 – Deduction Calculation

Value of Assets. Complete section 1 by entering a description of each asset that is elected to be deducted as qualifying property from the decedent's Minnesota adjusted taxable estate. Enter the schedule and item number from the federal Form 706 where the asset is reported. Then enter the fair market value of the asset at the valuation date. This is the value included in the Federal gross estate. If the estate is electing to deduct only a portion of an asset reported on the federal Form 706, enter the appropriate valuation percentage that qualifies for the deduction. Subtotal all amounts as line 1.

Non-eligible Property. For qualified small business property, complete section 2 by entering a description of any cash, cash equivalents, publicly traded securities, or assets not used in the operation of the trade or business. Cash equivalents are short-term securities that are liquid enough to be considered equivalent to cash. Examples include negotiable instruments, money market holdings, short-term government bonds or Treasury bills, marketable securities, commercial paper, and other like items. For assets entered above in section 1 consisting of shares of stock or other ownership interests in a business entity, the amount of cash, cash equivalents, publically traded securities, or assets not used in the operation of the trade or business held by the corporation or business entity must be entered in section 2 in proportion to the decedent's share of ownership of the corporation or business entity on the date of death.

For qualified farm property, complete section 2 by entering a description of any property other than class 2a agricultural land (real property) or non-homestead property included in the values entered above in section 1.

Subtotal all amounts as line 2.

Allowable Deductions. Complete section 3 by entering a description of the Federal allowable deductions that are related to the assets entered above in section 1, including:

- marital deduction,
- mortgages and liens held against the qualifying property,
- property tax payable on the qualifying property,
- expenses and costs taken as a deduction used to preserve the qualifying property, and
- appraisal fees.

Enter the schedule and item number from the federal Form 706 where the allowable deduction is reported. Subtotal all amounts as line 3.

Questions?

You can find forms and information, including answers to frequently asked questions and options for paying electronically, on our website at:

www.revenue.state.mn.us

Send us an email at:
BusinessIncome.tax@state.mn.us

Call us at:
651-556-3075
Weekdays, 8 a.m. to 4:30 p.m.
TTY: 711 Minnesota Relay

Or write to:
Minnesota Revenue
Mail Station 1315
St. Paul, MN 55146-1315