

**DEATH, ESTATE TAXES, AND LIQUIDITY NEEDS -  
THREE STRIKES ON THE FAMILY BUSINESS?**

**HOW TO PAY THE ESTATE TAX  
FROM THE CLOSELY HELD BUSINESS**

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### I. INTRODUCTION

#### A. Importance of Closely Held Businesses.

1. Closely held businesses are a major and important part of the United States economy. Almost 35 percent of the Fortune 500 companies are private businesses with two of the largest being Cargill and Mars.<sup>1</sup> In addition, private businesses create more than 75 percent of all new jobs, 60 percent of the national employment and 50 percent of the gross domestic product.<sup>2</sup>
2. The death of a private business owner foretells the death of the business in many instances. Only 30 percent of all privately owned businesses survive past the first generation. Although it is the goal of many business owners to transfer ownership of the business to future generations, only 12 percent of private businesses survive into the third generation, and a mere three percent are still in existence at the fourth generation and beyond.<sup>3</sup>
3. There are many reasons for the lack of survival of private business for future generations, including lack of succession planning, business failure, and inability to meet liquidity needs.<sup>4</sup> Lack of business succession planning exacerbates the liquidity needs at the death of a business owner.

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<sup>1</sup> Ronald C. Anderson and David M. Reeb, Founding Family ownership and Firm Performance: Evidence from the S&P 500.

<sup>2</sup>Financial Planning, November 1999.

<sup>3</sup>Boston Globe, May 4, 2003.

<sup>4</sup>Note: Are Estate Taxes Sounding the Death-Knell for High-Value Family-Owned Businesses? An Examination of the Jack Kent Cooke Estate and the Forced Sale of the Washington Redskins Football Franchise, 2000 Columbia Business Law Review 303.

Business succession planning can be described as 10 percent planning and 90 percent money.

**B. Internal Revenue Service 2003 Statistics Regarding Closely Held Businesses.**

1. The Statistics of Income Division of the Internal Revenue Service produces data files from samples of tax and information returns filed with the Internal Revenue Service. The Statistics of Income Division publishes information on the number of returns filed, the amount of tax collected, and other tax return information. In October 2004, the Statistics of Income Division released in Excel spreadsheet format a report entitled "Estate Tax Returns Filed in 2003; Gross Estate by Type of Property, Deductions, Taxable Estate, Estate Tax and Tax Credits, by Size of Gross Estate."<sup>5</sup>
2. The Statistics of Income report showed that approximately 66,000 estate tax returns were filed in 2003 and approximately 15 percent (9,500) of the tax returns listed as an asset stock in one or more closely held businesses. The Report also showed that those estates classified as the largest gross estates (greater than \$20 million) held a higher percentage of stock in a closely held business (50 percent of the estate tax returns for estates greater than \$20 million listed as an asset stock in a closely held business) than smaller estates. In addition, the Report showed that the closely held stock was approximately five percent of the gross estate for all estates, but the closely held stock constituted approximately 11 percent of the gross estate of estates greater than \$20 million.
3. Thus, it appears that for estate tax returns filed in 2003, the larger the estate, the more likely the estate will own a higher percentage of closely held stock. From a brief review of statistics for years before 2003, there is a similar pattern of ownership of closely held stock.

**C. Tax Obstacles to Transferring the Private Business to the Next Generation.**

1. Many owners of private businesses wish to transfer the ownership of the business to the next generation. To accomplish this goal, the owner (typically the parent) must minimize the transfer costs, including federal and state income, gift, estate, and generation-skipping transfer taxes. In addition, many owners of family businesses wish to retain control after the transfer. Often competing with these goals is the business owner's desire to treat the children equally. Meeting all of the owner's goals generally requires significant planning in advance of the transfer. Much has been

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<sup>5</sup>This Report can be found at [www.irs.gov/pub/irs-soi/03es01tp.xls](http://www.irs.gov/pub/irs-soi/03es01tp.xls).

written on the subject of estate planning for the private business owner and that subject will not be covered in this paper.

2. Because of the illiquid nature of a private business, federal and state estate and gift taxes present a serious obstacle to transferring the business to the next generation. The shortfall of sufficient liquid assets to pay the estate taxes incurred as a result of the transfer may necessitate a forced sale or liquidation of the business, thereby preventing the continuation of the business by the next generation.
3. With proper planning, the business owner may be able to overcome these obstacles while at the same time achieving the owner's goals regarding the control and ownership of the business.

D. **Liquidity Needs of Private Business Owner's Estate.**

1. For most private business owners, the business represents the most valuable, and usually the most illiquid, asset in the owner's estate. During the business owner's lifetime, the business is generally the primary vehicle of economic and emotional support for the business owner's family. As the primary asset of the owner's estate, the business will be the source of funds to pay estate taxes, debts, and administration expenses, as well as to pay for the support of the surviving spouse and other dependents.
2. Without proper planning, the business may have to be sold to meet liquidity needs. If this is the case, the sale may occur at the most inopportune time either because of external forces, such as a poor economy, or internal forces, such as lack of leadership, internal strife, and emotional duress.

E. **Extent of Estate Planning by Private Business Owners.**

1. Business owners spend time and money on estate planning to avoid or minimize estate taxes. According to one survey,<sup>6</sup> 92 percent of the surveyed business owners have a basic will while 86 percent have done estate planning beyond a basic will.<sup>7</sup> But, 45 percent of the surveyed business owners did not know the amount of estate tax liability their estates would face upon their deaths.

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<sup>6</sup>Astrachan and Tutterow, The Effect of Estate Taxes on Family Business: Survey Results, Family Business Review, vol. 9, no. 3, Fall 1996.

<sup>7</sup>Id., at page 306.

2. Private business owners spend resources on minimizing estate taxes. According to the same survey, the surveyed business owners spent an average of \$33,137 on estate planning.<sup>8</sup> The expenditures were divided among lawyers (\$16,113), accountants (\$14,632), and financial planners (\$2,392).
3. Because of the significant needs of private business owners for liquidity planning, private business owners represent an excellent opportunity for growth for the financial services industry.

## II. **PROCESS FOR ADVISING PRIVATE BUSINESS OWNERS ON MEETING LIQUIDITY NEEDS**

### A. **Determine Whether the Business Owner Will Be Subject to Estate Tax.**

1. The first step in advising a private business owner on meeting liquidity needs is to determine whether the business owner's estate will be subject to estate tax. Although this analysis sounds simple, it is a challenge for many reasons. First, as evidenced by the number of valuation cases on the Tax Court docket, it can be difficult to determine the valuation of business interests. In many instances, valuation of a closely held business can be more of an art and less of a science.
2. In addition, the 2001 Tax Act creates a great deal of uncertainty particularly if the business owner's taxable estate is between \$1,500,000 and \$3,500,000. With individuals with estates in this range, there may or may not be estate tax depending upon the year of death.<sup>9</sup>
3. The biggest uncertainty in determining whether the business owner's estate will be subject to estate tax is whether the estate tax will be repealed. President Bush has made it clear that a priority of his second term is fundamental tax reform and making permanent the tax cuts made by the 2001 Tax Act, including the repeal of the estate tax.<sup>10</sup> Because of the 2004

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<sup>8</sup>Id., at page 306.

<sup>9</sup>Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the applicable credit ranges from \$1,500,000 for individuals dying in 2005, \$2,000,000 for individuals dying in 2006, 2007, and 2008, and \$3,500,000 for individuals dying in 2009. For individuals dying in 2010, there is no estate tax and the law reverts back to pre-2001 law in 2011.

<sup>10</sup>Remarks of Samuel W. Bodman, Deputy Secretary of the Treasury, to the Tax Foundation Annual Conference, November 18, 2004.

election, the repeal of the estate tax may not be a “vote-counting” issue.<sup>11</sup> The issue will be determining the priority of tax relief. Because of the size of the deficits, it is unlikely that the President can obtain all of the tax relief he has mentioned (relief from the alternative minimum tax, elimination of the double taxation on dividends, social security reform, etc.). The President has announced that in December and January he will appoint a bipartisan panel to prepare recommendations on tax reform. The panel will submit its recommendations to Congress and Congress will debate the recommendations. Thus, it appears that tax reform will occur, if at all, in late 2005 or 2006. There will be many external events affecting the estate tax repeal debate that will occur before Congress acts, which makes it impossible to predict accurately what Congress will do.

4. Because of the significant uncertainty surrounding the repeal of the federal estate tax, the prudent practitioner will assume that the business owner will be subject to the estate tax. But, because of the possibility of significant reform or repeal, the prudent practitioner may be reluctant to suggest irrevocable planning involving the payment of gift tax. Until Congress acts and either repeals or reforms the estate tax, the business advisers should assume that a business owner with an estate in excess of \$3.5 million will be subject to the estate tax and plan accordingly.

**B. Recommend Estate Planning Techniques to Reduce Estate Tax Burden.**

1. After determining that the business owner may be subject to estate tax, the next step is for the business adviser to recommend estate planning techniques to reduce or eliminate the estate tax. The key techniques used to minimize federal wealth transfer taxes in connection with the transfer of a private business parallel those used for transfers of other forms of wealth. The most common techniques used for business owners to minimize federal transfer taxes are:
  - a. The business owner and the business owner’s spouse should structure their property holdings and estate plans to take advantage

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<sup>11</sup>Reconciliation bills are limited to the ten-year budget window unless there are 60 votes to waive the rule (the so-called “Byrd rule”). One Senatorial 2001 vote on estate tax repeal produced 44 votes against repeal. Four Democratic Senators who voted against repeal have been replaced by Republican Senators, Thomas Daschle, S.D. (John Thune), John Edwards, N.C. (Richard Burr), Bob Graham, Fl. (Mel Martinez), and Fritz Hollings, S.C. (Jim DeMint). Although some Senators who favor retaining the estate tax now reportedly favor repeal, it is unclear whether these Senators will change their votes.

of their applicable credit amounts and to shelter from taxation the balance of their assets through the marital deduction;

- b. The ownership of the business, as well as the choice of entity, should be structured to take advantage of valuation discounts;
  - c. The business owner should consider making lifetime gifts to reduce estate taxes;
  - d. The business owner should use leveraged estate planning techniques to increase the amount of tax-free transfers; and
  - e. The estate plan of the business owner should be structured to enable the personal representative to take advantage of post-mortem tax elections (sections 6166, 303 and 2032A).
2. The first step in estate planning for the business owner is to make sure that the business owner and the business owner's spouse have structured their property holdings and estate plans to take advantage of their applicable credit amounts and the marital deduction.
3. The next step is for the business owner to structure the owner's holdings so that the business owner's estate will be in a position to take advantage of valuation discounts. The valuation of an interest in a business for transfer tax purposes is not necessarily the proportionate value of the entire business. If structured properly, all transfers of business interests for federal transfer tax purposes should be of an amount less than liquidating and voting control. If the transferred interest does not carry liquidating and voting control, discounts for lack of control and minority interest may be applied to the transferred interest to determine the value for transfer tax purposes. These discounts can reduce significantly the transfer tax cost of business interests.
4. After the business has been structured so as to take advantage of discounts, the planner should encourage the business owner to make lifetime gifts to help reduce overall transfer taxes. Lifetime gifts offer several tax advantages to the donor. The gift tax annual exclusion allows individuals in 2005 to give up to \$11,000 (\$22,000 in the case of a married couple) annually to each family member or other beneficiary free of transfer taxes. Regardless of the size of the gift, any subsequent appreciation in the value of the property following the gift is also removed from the donor's estate and, consequently, is not subject to transfer taxation. By shifting income from the property away from the donor and to the donee, the donor's estate is not increased by the amount of the income generated by the gifted

property. The removal of this property from the business owner's estate can significantly reduce transfer taxes.

5. Despite the advantages of lifetime gifts, gifts do have certain disadvantages that must be considered. The donor's basis in the transferred property carries over to the donee although there is a basis adjustment for any gift taxes paid. On the other hand, if the property is transferred at the owner's death, the beneficiary receives a "stepped-up" basis equal to the property's fair market value at the date of death. If ultimate sale of the transferred property is anticipated, it is necessary to examine carefully the income tax consequences of a lifetime gift. If the value of the transferred property depreciates following the gift, the transfer tax savings may be increased.
6. With the decoupling of the estate and gift tax applicable credit amounts, it will be more important to use leveraged gift transactions in estate planning so as to increase the amount of tax-free transfers.<sup>12</sup> These techniques include: GRATs, installment sales to defective grantor trusts, intra-family installment sales, sales to family members for a private annuity, sales to family members for a self-cancelling installment promissory note, ESOPs, and redemptions. These techniques will not be covered in this paper.
7. There are several provisions of the Internal Revenue Code offering benefits to the estates of private business owners, including sections 2032A, 6166, and 303. Section 2032A involves valuing real property for federal estate tax purposes at the use value of the real property instead of the fair market value of the property. (This section is used predominantly with farmers and ranchers and will not be discussed in this paper.) Section 6166 is the deferral of the estate taxes attributable to a closely held business interest over a 14-year period. Section 303 allows the redemption of stock from a closely held business for an amount equal to the estate taxes and costs of administration. If certain requirements are met, each of these provisions offer significant estate tax savings. The ownership structure and the business owner's estate plan should be structured to enable the personal representative to take advantage of these postmortem tax elections.

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<sup>12</sup>For a discussion of estate planning techniques for private business owners, see Mezzullo, 809-2nd T.M., Estate Planning for Owners of Closely Held Business Interests.

C. **Using Life Insurance to Meet Liquidity Needs.**

1. An obvious and, in many instances, a practical means of providing liquidity for the business owner's estate is life insurance. Many business owners purchase life insurance on their lives with the insurance policies being owned by the business owner, the business, children, or irrevocable trusts.
2. Although life insurance can be an effective means of solving the liquidity needs of the estate of a private business owner, life insurance may not be available to every business owner. This paper will not cover using life insurance but focus on other techniques for meeting the liquidity needs of the private business owner.

D. **Scope of Paper.**

1. This paper will cover planning to meet the liquidity needs of the estate of the private business owner using funds from the private business. Specifically, this paper will cover:
  - a. Using section 6166 to defer the estate taxes attributable to an interest in a closely held business;
  - b. Obstacles in using section 6166;
  - c. Funding section 6166 payments with corporate distributions;
  - d. Funding section 6166 payments with redemptions under section 303;
  - e. An alternative strategy to section 6166, third party borrowing with an estate tax deduction for the interest payments;
  - f. The economics of Internal Revenue Code section 6166; and
  - g. Practical considerations in paying the estate tax from the closely held business.

### III. OVERVIEW OF SECTION 6166 - DEFERRAL OF ESTATE TAXES ATTRIBUTABLE TO A CLOSELY HELD BUSINESS

#### A. In General.

1. Under section 6166, a personal representative may elect to defer the estate taxes attributable to an interest in a closely held business and pay the taxes, after a four-year deferral, in ten annual installments. The interest rate on the unpaid tax is two percent on the tax attributable to the first \$1,170,000<sup>13</sup> (for estates of individuals dying in 2005, \$1,140,000 for individuals dying in 2004) of value of closely held business interests and 45 percent of the interest rate applicable to underpayments of tax (2.2 percent with an underpayment rate of five percent). Section 6166 does not reduce the estate taxes payable and the savings under section 6166 relate solely to the deferral of the payment of estate taxes and the bargain interest rate.
2. Other than the discretionary deferral of estate taxes available under section 6161 and the deferral of tax on remainder interests under section 6163, section 6166 is the only estate tax deferral available to taxpayers.

#### B. Legislative History of Section 6166.

1. In 1958, Congress provided the first deferral provisions for the estate tax attributable to closely held businesses by enacting section 6166. In the 1958 version, section 6166 provided a nine-year deferral for the estate tax attributable to closely held business interests if the business interests constituted more than 35 percent of the decedent's adjusted gross estate or 50 percent of the decedent's taxable estate. The 1958 version of section 6166 did not provide any bargain interest rate.
2. In 1976, Congress expanded the relief by designating the 1958 version of section 6166 as new section 6166A and enacting a new section 6166. The new section 6166 expanded the deferral by providing for a four-year period of interest payments followed by ten equal payments of the estate tax (a fourteen-year deferral period) if the business interests constituted more than 65 percent of the decedent's estate.<sup>14</sup> In addition, the 1976 version of section 6166 provided for a bargain interest rate of four percent for a portion of the estate tax.

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<sup>13</sup>Revenue Procedure 2004-71, Section 3.34. The amount of tax that can be deferred under section 6166 is subject to a cost of living adjustment.

<sup>14</sup>Gopman and McCawley, 832 T.M., Estate Tax Payments and Liabilities, page A-1.

3. In 1981, Congress, as a part of the Economic Recovery Tax Act of 1981, repealed section 6166A and reduced the percentage test of qualifying for section 6166. Under the 1981 version of section 6166, Congress changed the closely held business interest percentage test from 65 percent of the adjusted gross estate to 35 percent.
4. The Tax Reform Act of 1984 added section 6166(b)(8) dealing with the treatment of stock of any holding company that represents direct or indirect ownership and section 6166(b)(9) dealing with passive assets held by business entities. Both of these sections are discussed in more detail below.
5. The last significant change to section 6166 occurred in 1997 when Congress amended section 6601(j) to reduce the interest rates charged on the deferred tax and increase the amount of tax eligible for the reduced interest rate. In exchange for the lower interest rates, Congress amended sections 2053 and 163 to eliminate the estate and income tax deduction of the interest paid on the tax deferred under section 6166.
6. In 2001 Congress amended section 6166 to provide special rules for closely held business interests in qualifying lending and finance businesses and also amended the holding company rules.

C. **Section 6166 Issues.**

1. The most significant issues with section 6166 include:
  - a. What is the level of activity required for a business to qualify as a closely held business under section 6166;
  - b. How is a holding company and its subsidiaries treated under section 6166;
  - c. How does an estate maximize the benefits of section 6166 and redemptions under section 303 so as to avoid the acceleration of unpaid tax; and
  - d. Whether it is more economical to borrow from another source and deduct the interest payments rather than elect the lower interest rates and non-deductibility of interest under section 6166.
2. These issues are discussed in more detail below.

D. **Section 6166 Requirements.**

1. To be eligible for the deferral under section 6166, the decedent, the decedent's interest in the closely held business, and the decedent's estate must meet certain requirements.
  - a. The decedent must have been at death a citizen or resident of the United States.<sup>15</sup>
  - b. More than 35 percent of the decedent's adjusted gross estate must consist of an interest in a closely held business.<sup>16</sup>
  - c. The personal representative of the decedent's estate must make an election on a timely filed estate tax return.<sup>17</sup>

E. **Percentage Test.**

1. The benefits of section 6166 are available if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate.<sup>18</sup> The decedent's adjusted gross estate is defined as the decedent's gross estate less allowable deductions under section 2053 (debts, costs of administration, and other charges) and section 2054 (liens and mortgages).<sup>19</sup> Thus, costs of administration are deducted in determining the adjusted gross estate notwithstanding that costs of administration are claimed as income tax deductions on the estate's income tax return.<sup>20</sup>
2. The decedent's interests in two or more closely held businesses may be aggregated and treated as an interest in a single closely held business if 20 percent or more in value of each business is included in the decedent's estate. For purposes of meeting the 20 percent test, the surviving spouse's interest in the business is treated as included in the decedent's gross estate

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<sup>15</sup>Internal Revenue Code section 6166(a)(1).

<sup>16</sup>Internal Revenue Code section 6166(a)(1).

<sup>17</sup>Internal Revenue Code section 6166(d).

<sup>18</sup>Internal Revenue Code section 6166(a).

<sup>19</sup>Internal Revenue Code section 6166(b)(6).

<sup>20</sup>Technical Advice Memorandum 8203009.

if owned with the decedent as joint tenants, tenants by the entirety, or tenants in common.<sup>21</sup>

3. Certain gifts made within three years of the decedent's death are included in determining whether the 35 percent test is met.<sup>22</sup> This provision can provide both a benefit and a burden. If the client makes a gift of non-qualifying assets within three years that would be includable under section 2035(a), the client's estate may not qualify for the benefits of section 6166. On the other hand, if the client makes a gift of qualifying assets within three years, the client's estate may qualify for the benefits of section 6166.

#### IV. SECTION 6166 DEFINITION OF CLOSELY HELD BUSINESS

##### A. General Definition of Closely Held Business.

1. An interest in a closely held business is defined<sup>23</sup> to be:
  - a. An interest as a proprietor in a trade or business carried on as a proprietorship,
  - b. An interest as a partner in a partnership carrying on a trade or business, if
    - (1) 20 percent or more of the total capital interest is included in the decedent's gross estate, or
    - (2) the partnership has 45 or fewer partners,
  - c. Stock in a corporation carrying on a trade or business, if
    - (1) 20 percent or more of the voting stock of the corporation is included in the decedent's gross estate, or
    - (2) the corporation has 45 or fewer shareholders.
2. If the closely held business is a farm, the value of the residence and related improvements is eligible for section 6166 treatment if occupied on a

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<sup>21</sup>Internal Revenue Code section 6166(c).

<sup>22</sup>Internal Revenue Code section 2035(c)(2).

<sup>23</sup>Internal Revenue Code section 6166(b)(1).

regular basis by the owner, a lessee, or employees of the owner or lessee for the purposes of operating or maintaining the farm.<sup>24</sup>

3. In meeting the above numerical requirements, there are attribution rules available, which are discussed below.

**B. Trade or Business Test.**

1. In order for the federal estate taxes attributable to a decedent's interest in a closely held business to qualify for deferral under section 6166, the Internal Revenue Service takes the position that the closely held business must be engaged in an active trade or business as of the decedent's death. There have been several published rulings in this area, but none recently.<sup>25</sup> The Internal Revenue Service takes the position that the passive rental of real property is not an active trade or business and does not qualify for the benefits of section 6166.<sup>26</sup> From the private letter rulings discussed below, the Service has taken inconsistent positions where the individual rents land to a corporation or other entity in which the individual is an owner.
2. In dealing with farmers and ranchers, generally, the trade or business test is an issue in the following circumstances:
  - a. The net cash rental of farm real property;
  - b. A crop-sharing arrangement;
  - c. A family member managing the farm when the owner retires or becomes incompetent; and
  - d. Holding companies.

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<sup>24</sup>Internal Revenue Code section 6166(b)(3). Private Letter Ruling 9410011.

<sup>25</sup>See Rev. Rul. 75-365, 1975-2 C.B. 471; Rev. Rul. 75-366, 1975-2 C.B. 472; and Rev. Rul. 75-367, 1975-2 C.B. 472.

<sup>26</sup> See Rev. Rul. 75-367, 1975-2 C.B. 472, decided under section 6166A, a predecessor to section 6166.

C. **Trade or Business Test - Rental Real Property Without Duties.**

1. It is clear that a net cash lease arrangement of real property that calls for no participation on the part of the owner will disqualify the property for the benefits of section 6166.<sup>27</sup> In Private Letter Ruling 8020101, the Internal Revenue Service ruled that real property leased by a 97-year old to children with the children paying real property taxes and maintenance expenses did not qualify as a trade or business under section 6166. In Private Letter Ruling 8144012, the Internal Revenue Service ruled that the decedent's son was the agent of the decedent for purposes of determining whether the farm assets were used in a trade or business.
2. Real property that is subject to a crop-sharing arrangement should be a trade or business under section 6166. Revenue Ruling 75-366 provided that an individual is in the business of farming if he receives a rental based upon farm production rather than a fixed rental. If this is the case, the benefits of section 6166 should be available. There are several Private Letter Rulings that support Revenue Ruling 75-366.<sup>28</sup>
3. If the lease arrangement calls for activity on the part of the decedent, the real property may be a trade or business under section 6166.<sup>29</sup> A Federal District Court<sup>30</sup> ruled that a decedent's interest in farm land farmed under a sharecropping arrangement by a non-family member did not qualify as an interest in the closely held business. The Court's ruling was based on the finding that the decedent was not actively engaged in the operation of the farm business. The Court made this finding notwithstanding that the decedent was consulted on management matters and contributed a portion of the expenses.

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<sup>27</sup>Smith v. Booth, 87-2 USTC ¶ 13,731 (5th Cir. 1987), rev'g. 86-2 USTC ¶ 13,748.

<sup>28</sup>See Private Letter Rulings 8133015 and 8020142.

<sup>29</sup> See Private Letter Rulings 8601005, 8332025, 8314003, 8240054, 8229133, 8226156, 8218072, 8205026, 8145008, 8136022, 8134019, 8133022, and 8130057.

<sup>30</sup> Ronald C. Schindler, 87-2 USTC ¶ 13,735.

D. **Trade or Business Test - Property Rented to Corporation in Which Decedent Is an Owner.**

1. The typical planning device of separating the ownership of real property used in connection with an operating business from the operating business by using two separate corporations (or limited liability company, partnership or other pass-through entity) may disqualify the real property for the benefits of section 6166. The Internal Revenue Service has ruled for and against taxpayers in these circumstances and it is difficult to predict the Service's position.<sup>31</sup>
2. Revenue Ruling 75-367 is the only published ruling dealing with the issue of whether real property owned by a decedent and used by the decedent's corporation qualified under section 6166. In that Ruling, the decedent owned a corporation that built homes on land owned by both the corporation and the decedent. In addition, the decedent owned personally several buildings used by the corporation. The Internal Revenue Service ruled that the real property owned by the decedent but used by the decedent's corporation qualified for section 6166 deferral.
3. In Private Letter Ruling 200339001, the decedent owned three corporations. One corporation leased real property to the other two corporations. The leases did not require any services by the landlord corporation. The Internal Revenue Service ruled that the decedent's ownership of stock in the landlord corporation was a passive asset.<sup>32</sup>
4. In Private Letter Ruling 200006034, the Internal Revenue Service ruled that land and a building owned by the decedent and used by a corporation owned by the decedent qualified as an interest in a closely held business for purposes of section 6166. The Service concluded that the land and building were held for the overall operation and management of the corporation.
5. In Private Letter Ruling 8140020, the decedent owned real property that was leased to a corporation of which he was a substantial stockholder. The real property was the principal place of business of the corporation. Under the lease agreement, the corporation was responsible for all expenses,

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<sup>31</sup>Private Letter Rulings 200339001, 200006034, 8451014, 8140020, and 7917006.

<sup>32</sup>Chief Counsel Advice Memoranda 2003 39047 outlined the reasons the Internal Revenue Service had tentatively reached an adverse conclusion in a withdrawn Private Letter Ruling that appears to be the basis for this Technical Advice Memorandum.

maintenance, repairs, taxes and insurance. The Internal Revenue Service ruled that the real property was not a closely held business under section 6166 and, thus, the federal estate taxes attributable to the property could not be deferred.

6. In Private Letter Ruling 7917006, the Internal Revenue Service held that real property leased to the decedent's corporation was not considered eligible for section 6166 deferral. Private Letter Ruling 81400020 reached a similar result. In Private Letter Ruling 200339001, the Internal Revenue Service ruled that a corporation that rented property to corporations owned by the decedent did not qualify for section 6166 deferral.

E. **Trade or Business Test - Rental Real Property Business.**

1. Frequently, the personal representative of an estate of the owner of rental real property will be interested in the benefits of section 6166. Whether the estate of the owner will qualify for section 6166 will depend upon the decedent's activities with respect to the real property. As the following Private Letter Rulings will illustrate, the Internal Revenue Service has not drawn a bright line between what it defines as an active trade or business versus a passive asset. It is clear that passively owning real estate and collecting rents is a passive activity. It is not clear how much additional activity is necessary to convert the passive activity to a trader business that qualifies for deferral under Section 6166. One commentator has stated that Section 6166 "is not user friendly" with regards to real estate assets.<sup>33</sup> It would be helpful if the Internal Revenue Service would provide bright line test that could be used to determine what level of activities are necessary to qualify for estate tax deferral under section 6166.
2. Revenue Ruling 75-365 involved the issue of whether a real estate management office qualified as an interest in a closely held business for purposes of section 6166. In the facts in the Ruling, the decedent maintained a fully equipped office, collected rental payments on the properties, received payments on notes receivable, negotiated leases, made occasional loans, and contracted and directed the maintenance of the properties using outside vendors. Notwithstanding this level of activity, the Internal Revenue Service ruled that the decedent's business was not considered an active trade or business. Fortunately, the Service has backed off this position in later private letter rulings, but, unfortunately, the

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<sup>33</sup>Proposal by California Bar Taxation Section, Estate and Gift Tax Committee member Elizabeth Kohs on clarifying Internal Revenue Service Code Section 6166 and updating Revenue Ruling 75-365, 75-366, and 75-367 dated May 3, 2004.

Service has not issued any published rulings contrary to Revenue Ruling 75-365.

3. Private Letter Ruling 2003 40012 involved the issue of whether the decedent's interest in certain real estate qualified as an interest in a closely-held business for purposes of section 6166. The decedent owned and operated as a sole proprietor 109 rental on six parcels of real property. In addition, the decedent owned a 50 percent interest in 36 rental units and the decedent owned a membership interest in a limited liability company that held rental property. The decedent and his son, assisted by five part-time employees, performed all services in the management and maintenance of the rental properties. The activities included advertising vacant apartments, interviewing, screening and selecting prospective tenants, negotiating and executing leases, collecting rents, maintaining common areas, making ordinary plumbing and electrical repairs, purchasing appliances, supplies and equipment, and inspecting rental units. The decedent and his son routinely devoted up to 14 hours a day on week days and several hours on weekends for maintenance and management of the property. The Internal Revenue Service ruled that the decedent's interest in the properties and the limited liability company qualified as an interest in a closely-held business under section 6166.
4. In Private Letter Ruling 200114005, the Internal Revenue Service ruled that a sole proprietorship consisting of 82 rental units on 20 parcels of land qualified as an interest in a closely held business for purposes of section 6166. Under the facts of that Ruling, the decedent found tenants, negotiated leases, collected rents, and paid the expenses for the operation of the rental units. The decedent performed most of the repairs and employed others to perform those repairs that were beyond the decedent's capabilities.
5. In Technical Advice Memorandum 9801009, the Internal Revenue Service ruled that a decedent's interest in a corporation involved in the rental real estate business was an interest in a closely held business for purposes of section 6166. For the 29-year period before his death, the decedent was engaged in the real estate leasing and management business, and at some point, he formed a corporation to manage his rental properties. The decedent and his wife wholly owned the corporation, and the decedent continued to personally operate, manage, and maintain the properties on a full-time basis. Two months before the decedent's death, the decedent hired a company to help manage the properties due to his inability to do so. The Internal Revenue Service held that section 6166 was not intended to apply to activities involving the management of investment assets and indicated that the level of activity is the factor that distinguishes an active

business from mere passive ownership of income producing assets. The Service determined that the decedent's activities were more than an owner merely managing investments to obtain rents, and was instead similar to the level of activity in Revenue Ruling 75-366 and distinguishable from that of Revenue Ruling 75-365 and Revenue Ruling 75-367. As to the decedent's hiring of a management company, the Service said that it would be unreasonable to deny relief on that basis, because death is frequently preceded by a period of incapacity.

6. In Technical Advice Memorandum 9832009, the Internal Revenue Service ruled that the decedent's interest in several commercial real estate properties constituted an interest in a closely held business and in other properties the decedent's interest did not qualify. The Service based its rulings on the activities of the decedent and the services provided to the tenants.
7. In Private Letter Ruling 9621007, the Internal Revenue Service ruled that an estate may not elect to pay estate tax in installments under section 6166, because the decedent's real estate interests were not a trade or business. The decedent held the real estate interests as a tenant in common and through partnerships. The interests exceeded 35 percent of the adjusted gross estate. The decedent was an active participant in managing the business until ill health forced the decedent's daughter to replace him. Business activities included obtaining tenants, enforcing lease terms, resolving tenant complaints, collecting rent, paying bills, and overseeing repairs and improvements. In some cases many of those activities were assumed by the tenants. The Service concluded that the decedent's real estate interests were not interests in a closely held business under section 6166, even though the decedent might be considered to be operating a trade or business for purposes of other code sections. According to the Service, the decedent's activities fit squarely within the activities described in Revenue Ruling 75-365. The activities performed by the decedent and his daughter were merely those of an owner managing investment assets to obtain rents. Further, the services provided for the tenants were limited and a relatively small number of tenants occupy the assets.
8. In Technical Advice Memorandum 9635004, the Internal Revenue Service ruled that an estate may elect to pay in installments the estate taxes due on land owned by a decedent that was used by a partnership in the cattle ranching business. Most of the decedent's cattle ranching business was conducted by a partnership that was owned two-thirds by the decedent and one-third by his son. The decedent actively participated in all operations of the partnership. Two-thirds of land used in the cattle ranching business was owned outright by the decedent. Although the land was essential to

the operation of the partnership, it was never transferred to the partnership. Land owned outright by the son, also essential to the operation of the partnership, was never transferred to the partnership. Nevertheless, the partnership paid to maintain fences on the land, paid the real estate taxes, and paid for casualty and liability insurance. The Service concluded that the decedent's land qualified for the benefits of section 6166, reasoning that the decedent was carrying on the cattle ranching business both as a partner and as proprietor of a sole proprietorship. The land was essential to the overall operation of the decedent's cattle ranching business even though it was not owned by the partnership. According to the Service, the situation was distinguishable from the facts in Revenue Ruling 75-365 because the asset was used in the active business enterprise and produced income. The Service noted that income from the land depended on and arose out of the profitability of the cattle ranching enterprise, rather than a fixed rental fee.

9. In Technical Advice Memorandum 9634006, the Internal Revenue Service ruled that two corporations that developed and managed rental real property were engaged in carrying on a trade or business for the installment payment of estate taxes. The decedent owned 17.65 percent of the voting stock of one of the corporations and 38.7 percent of the other. One corporation developed and constructed rental real estate and the other managed rental properties. The Service ruled that both corporations were engaged in a trade or business under section 6166. The Service noted that one of the corporations provided substantial services to tenants such as maintaining common areas, providing water, heating, and sewer service, and disposing of garbage.
10. In Private Letter Ruling 8136022, the Internal Revenue Service ruled that the decedent's ownership in a corporation that managed rental real estate was an interest in a closely held business because the corporation was engaged in an active trade or business rather than in mere leasing of property. Under the facts of that ruling, the corporation provided extensive maintenance, operation, and repair services to tenants of the properties and, thus, was conducting an act of service enterprise.<sup>34</sup>
11. In Technical Advice Memorandum 9403004, the Internal Revenue Service ruled that the decedent's interest in ranch land did not qualify as an interest in a closely held business under section 6166(b). Accordingly, the estate may not elect to pay estate tax in installments. Citing Revenue Ruling 75-365, Revenue Ruling 75-366, and Revenue Ruling 75-367, the Service

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<sup>34</sup>The Internal Revenue Service ruled similarly in Private Letter Ruling 8145008 and 8240055.

stated that whether an estate should be permitted to elect under section 6166 should turn not on whether payment of the estate tax might require the estate to sell some income-producing assets, but on whether the estate's properties form a genuine, active business. The Service pointed out that ranch land, which was rented to ranch corporation B, was held as a passive income-producing investment. Accordingly, the decedent's interest in the ranch land did not qualify as an interest in a closely held business under section 6166(b).

12. Residential real property actively managed by a decedent and two employees qualified as an interest in a closely held business in Private Letter Ruling 8524037. Under the facts of that ruling, the decedent and two employees operate, maintain and repair the buildings and surrounding grounds.
13. In Technical Advice Memorandum 8601005, the Internal Revenue Service ruled that a decedent's interest in real property held in a partnership qualified as an interest in a closely held business notwithstanding that the partnership leased certain real property to a limited partnership in which the decedent also had an interest.
14. In Private Letter Ruling 9602017, the Internal Revenue Service allowed a section 6166 election for estate taxes attributable to real property owned by a partnership and several corporations that owned commercial and residential rental real property. The basis of the ruling was that the companies were going business concerns with active agents and not merely holders of passive assets.
15. In Gettysburg National Bank<sup>35</sup> the District Court held that a decedent's estate was entitled to the benefits of section 6166 because the decedent was closely involved in both the management of the corporation and the leasing of farm real property to the corporation.

F. **Trade or Business Test - Activities of Agent.**

1. As owners of farm real property become elderly, frequently management of the farm is given to family members or third parties. The question becomes whether this is detrimental to section 6166. Private Letter Ruling 8144012 addressed this issue. In that Ruling, the decedent was in failing health for some time before her death. The decedent's son took over the operation of her farm and received all proceeds and made all farm

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<sup>35</sup>DC Pa, 92-2 USTC ¶ 60,108,

payments. The Internal Revenue Service ruled that the farm was actively managed by the decedent's son acting on behalf of the decedent. Therefore, the decedent was a proprietor in an active trade or business and the benefits of section 6166 were available.

2. Private Letter Ruling 8134018 reached the same result where a bank handled the decedent's property under a general power of attorney.

G. **Section 6166 Attribution Rules.**

1. There are several attribution rules in section 6166. Property owned, directly or indirectly, by or for a corporation, partnership, estate or trust is considered as owned proportionately by or for its shareholders, partners or beneficiaries.<sup>36</sup> Stock or a partnership interest held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common is treated as owned by one shareholder or one partner.<sup>37</sup> Stock and all partnership interests held by the decedent or by any member of the decedent's family (within the meaning of section 267(c)(4)) shall be treated as owned by the decedent.<sup>38</sup> Certain non-readily tradable stock owned by related parties can be treated as includable in determining the value of the decedent's gross estate.<sup>39</sup>
2. The attribution rules for non-readily tradable stock are complex. Non-readily tradable stock is defined as stock for which there is no market on a stock exchange or in an over-the-counter market.<sup>40</sup> In addition, the attribution rules are available only if the personal representative elects the benefits of section 6166(b)(7). If the personal representative so elects, then all such stock and partnership interests held by the decedent or by any member of his family (within the meaning of section 267(c)(4)) shall be treated as included in determining the value of the decedent's gross estate. Under section 267(c)(4) stock owned by the decedent's brothers, sisters, spouse, ancestors and lineal descendants are automatically treated as owned by the decedent. Pursuant to this attribution rule, the stock owned by

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<sup>36</sup>Internal Revenue Code section 6166(b)(2)(C).

<sup>37</sup>Internal Revenue Code section 6166(b)(2)(B).

<sup>38</sup>Internal Revenue Code section 6166(b)(2)(D).

<sup>39</sup>Internal Revenue Code section 6166(b)(7).

<sup>40</sup>Internal Revenue Code section 6166(b)(7)(B).

members of the decedent's family is treated as owned by the decedent for purposes of meeting the 20 percent test under section 6166(b).

3. By making the election under section 6166(b)(7), the personal representative foregoes the benefit of the two percent interest rate (and is left with the Internal Revenue Service general underpayment interest rate) and the deferral period is cut back from 15 years to 10 years.<sup>41</sup> Because of these restrictions, there is limited benefit to this election.

#### H. **Holding Company Rules.**

1. The Internal Revenue Service has consistently taken the position that a corporation that has as its sole asset stock of another corporation is not a closely held business under section 6166.<sup>42</sup> In Technical Advice Memorandum 8134012, the decedent owned stock in a corporation that owned all of the outstanding stock of five subsidiaries. The Internal Revenue Service ruled that the decedent's stock in the personal holding company did not qualify as an interest in a closely held business under section 6166.
2. A planning technique to minimize liability is to place assets used in an active trade or business in separate entities with the entities owned by a holding company. The Tax Reform Act of 1984 added section 6166(b)(8) that allows the portion of stock of a holding company that directly or indirectly owns stock in a closely held active trader business to be considered stock in the business company for purposes of section 6166. Before the holding company stock may qualify for section 6166 treatment, several requirements must be met. First, the interest that is held by the holding company must meet the general rule of section 6166(b)(1)(C) requiring that a closely held business have 45 or fewer shareholders or the decedent owned 20 percent or more of the corporation's voting stock. Second, the value of the business interest held by the holding company must exceed 35 percent of the value of the decedent's adjusted gross estate. Last, the personal representative must elect the benefits of section 6166(b)(8).
3. If an election is made under section 6166(b)(8), the favorable two percent interest rate of section 6601(j) and the five-year deferral of principal

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<sup>41</sup>Internal Revenue Code section 6166(b)(7)(A).

<sup>42</sup>See Technical Advice Memoranda 8219007 and 8134012 and Private Letter Rulings 8448006 and 8130175. R.E. Moore (DC) 87-2 USTC ¶ 13,741.

payments under section 6166(a)(3) are not available. If this election is made, the stock in any subsidiary entities is not considered a passive asset for purposes of excluding passive assets from the benefits of section 6166.<sup>43</sup>

4. The holding company structure presents numerous issues some of which have not been answered. What is the level of activity required by a subsidiary in order to qualify as a closely held business under section 6166? Are intra-company loans considered passive assets for purposes of section 6166(b)(9)? Because section 6166(b)(8) uses the term “company” in describing personal holding entities, is the application of section 6166(b)(8) limited to corporate entities? (Although it is not clear from the statutory language, section 6166(b)(8) should also apply to partnerships and limited liability companies.<sup>44</sup>)
5. Section 6166(b)(9)(B)(iii) provides another exception that will allow a holding company that conducts an active trade or business to qualify for deferral under section 6166. If a parent corporation -
  - a. Owns 20 percent or more in value of the voting stock of another corporation or the corporation has 45 or fewer shareholders, and
  - b. Eighty percent or more in value of the subsidiary corporation is attributable to assets used in carrying on a trade or business,
  - c. Then the holding company and subsidiaries that meet the above requirements shall be treated as one corporation for purposes of section 6166(b)(9)(B)(ii) (the subsidiary stock shall not be considered a passive asset).<sup>45</sup>

I. **Deferral Not Available for Passive Assets.**

1. The benefits of section 6166 are limited to business interests that conduct an active trade and business. Passive assets held by an interest in an entity conducting a trade or business are excluded in determining whether the estate qualifies for the benefits of section 6166 and the amount of estate tax

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<sup>43</sup>Internal Revenue Code section 6166(b)(9)(B)(ii).

<sup>44</sup>Gopman and McCawley, 832 T.M., Estate Tax Payments and Liabilities, page A-11.

<sup>45</sup>Gopman and McCawley, 832 T.M., Estate Tax Payments and Liabilities, page A-12

eligible for deferral.<sup>46</sup> A passive asset is defined as “any asset other than an asset used in carrying on a trade or business.”<sup>47</sup>

2. Stock in another corporation is considered a passive asset unless the stock is treated as being held by the decedent by reason of an election under section 6166(b)(8) and the stock meets the requirements of section 6166(a)(1) of exceeding more than 35 percent of the decedent’s adjusted gross estate.<sup>48</sup> The Internal Revenue Service has held that proceeds of life insurance on an owner’s life are passive assets notwithstanding that the policy was collateral on business loans.<sup>49</sup>

## V. THE MECHANICS OF THE SECTION 6166 ELECTION

### A. Election.

1. The election under section 6166 is made by attaching to a timely filed estate tax return a notice of election.<sup>50</sup> Notwithstanding that reasonable cause exists for the late filing of an estate tax return, the benefits of section 6166 are not available on a late filed estate tax return.
2. Under Regulation section 20.6166-1(b), the notice of election<sup>51</sup> should contain the following information:
  - a. The decedent's name and taxpayer identification number;
  - b. The amount of tax that is to be paid in installments;
  - c. The date selected for the payment of the first installment;
  - d. The number of annual installments in which the tax is to be paid;

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<sup>46</sup>Internal Revenue Code section 6166(b)(9).

<sup>47</sup>Internal Revenue Code section 6166(b)(9)(B)(i).

<sup>48</sup>Internal Revenue Code section 6166(b)(9)(B)(ii).

<sup>49</sup>Technical Advice Memorandum 8848002.

<sup>50</sup>Internal Revenue Code section 6166(d).

<sup>51</sup>An example of an election under section 6166 can be found in Gopman and McCawley, 832 T.M., Estate Tax Payments and Liabilities, Worksheet.

- e. The properties shown on the estate tax return that constitutes a closely held business interest (identified by schedule and item number); and
  - f. The facts that form the basis for the personal representative's conclusion that the estate qualifies for payment of the estate tax in installments.
- 3. If the notice of election does not state the amount of tax to be paid in installments, the date selected for payment of the first installment, or the number of installments, the election is presumed to be for the maximum amount so payable and for payment thereof in ten equal installments, the first of which is due on the date that is five years after the date prescribed in section 6166(a) for payment of the first installment of the deferred estate tax.<sup>52</sup>
  - 4. It is preferable that the notice of election be executed by the personal representative. If the attorney for the estate in all matters executes the notice of election, it may be a valid election under section 6166 notwithstanding that the attorney had no power of attorney on file with the Internal Revenue Service.<sup>53</sup>

**B. Judicial Review of Denial of Section 6166 Election.**

- 1. After an election under section 6166 has been filed, the Internal Revenue Service will review the election to determine whether it is in accord with the requirements of section 6166. If the Internal Revenue Service determines that the election is in accord, no notice is issued. Thus, a personal representative should assume that the election is acceptable if not advised to the contrary.
- 2. Where it appears after examination that an election under section 6166 does not meet the section 6166 requirements, the personal representative will be given the opportunity of an appeals conference. If the personal representative loses at appeals, there was no provision for judicial review of the decision before 1997. The Taxpayer Relief Act of 1997 added section 7479 that authorizes the Tax Court to issue declaratory judgments with the respect whether a section 6166 election may be made or whether the extension has ceased to apply.

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<sup>52</sup>Reg. Section 20.6166-1(b).

<sup>53</sup>Private Letter Ruling 8124050.

3. If an estate elected deferral under section 6166, the estate was at a disadvantage in attempting to gain access to federal district court or the Court of Federal Claims because of the necessity to pay the estate tax before the taxpayer can sue for a refund. Congress cured this problem in 1998 with the addition of section 7422(j) which allows an estate that has made a section 6166 election to file an estate tax refund claim in federal district court or the Court of Federal Claims before the entire estate tax has been paid.

C. **Amount of Tax Deferred and Interest Rates.**

1. The maximum amount of tax that may be paid in installments under section 6166 is determined by the following formula:

$$\frac{\text{Net Federal Estate Tax Payable}}{\text{Tax Payable}} \times \frac{\text{Closely Held Business Amount}}{\text{Adjusted Gross Estate}}$$

2. The estate tax attributable to the first \$1,170,000 value of closely held business interest (indexed for inflation) will bear interest at the rate of 2 percent.<sup>54</sup> The interest rate on the balance of the estate tax extended under section 6166 bears interest at a rate equal to 45 percent of the interest rate applicable to underpayments of tax.<sup>55</sup> In both instances, the interest is compounded daily.<sup>56</sup> The 55 percent reduction in interest occurred in 1997 when Congress eliminated the estate and income tax deduction for interest paid on estate taxes deferred under section 6166. Notwithstanding that the estate tax rate at the time of the reduction was 55 percent and the estate tax rate has decreased since 1997, Congress has not adjusted the reduction in interest rate.<sup>57</sup>

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<sup>54</sup>Internal Revenue Code section 6601(j).

<sup>55</sup>Internal Revenue Code section 6601(j)(1)(B).

<sup>56</sup>Internal Revenue Code section 6622(a).

<sup>57</sup>For decedents dying before 1998, the interest rate on the unpaid tax was four percent on the first \$1,000,000 of closely held business amount. The interest rate on the balance of the tax deferred was the Internal Revenue Service general underpayment interest rate. Revenue Procedure 98-15, 1998-4 I.R.B. 25 sets forth the steps to be followed to take advantage of the new section 6166 lower interest rates on the deferred payment of estate taxes for those individuals who died before January 1, 1998.

3. If the closely held business amount is in excess of \$1,170,000, the Internal Revenue Service prorates the two percent interest rate and 45 percent of the general underpayment interest rate.<sup>58</sup> Under this position, it is not possible to pay down the amount of estate tax attributable to the closely held business amount in excess of \$1,170,000 with the two percent interest rate applicable. It is possible, however, to elect section 6166 treatment for only \$1,170,000 worth of closely held business amount and thereby avoid the higher interest rate. This would only be beneficial if the personal representative can borrow the excess portion of the estate taxes from a third party on more beneficial terms.
4. Before 1998, the applicable credit amount reduced the estate tax eligible for the bargain four percent (now two percent) interest rate. Because of changes made by the Taxpayer Relief Act of 1997, the increase in the applicable credit amount does not reduce the estate tax to which the two percent interest rate applies.
5. If the time for payment of estate tax is extended under section 6166 of the Internal Revenue Code and a deficiency is assessed after the estate has timely made one or more annual interest payments, at what rate does interest accrued on unpaid interest that should have been paid on each past annual interest payment date? Because interest is part of the tax under section 6601(a), the Internal Revenue Service ruled in Revenue Ruling 89-32<sup>59</sup> that interest accrues at the prevailing rate under section 6601(e). Moreover, the prevailing rate accrues from the date the interest should have been paid under section 6166(f)(1) if the return had shown the correct tax liability. The Service noted that this ruling clarifies and amplifies Revenue Ruling 67-161.<sup>60</sup>

D. **Election in Case of Deficiency.**

1. If there is a deficiency in tax after examination by the Internal Revenue Service and the estate qualifies under section 6166, the personal representative may elect to pay the deficiency in installments.<sup>61</sup> This election is available notwithstanding that the personal representative did not make an election when the return was filed. This election is not

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<sup>58</sup>Internal Revenue Code section 6601(j)(3).

<sup>59</sup>1989 C.B. 307.

<sup>60</sup>1967-1 C.B. 342.

<sup>61</sup>Internal Revenue Code Section 6166(h).

available if the deficiency is due to negligence, intentional disregard of rules and regulations or fraud with intent to evade tax.<sup>62</sup> The election must be made not later than 60 days after request for payment of the deficiency.<sup>63</sup>

2. The deficiency is prorated to the installments that would have been due if an election had been timely made when the estate tax return was filed.<sup>64</sup> If the personal representative made a protective election under section 6166 when the return was filed, the entire amount of the deficiency may be deferred under certain circumstances.
3. Revenue Ruling 81-294 sets forth several examples that illustrate the amount due when installment payments are recomputed because of deficiencies, over-payments and changes in the ratio of the value of an interest in a closely held business to the value of the estate. The Service ruled in technical advice that an election to pay estate tax in installments under section 6166 does not mean that the entire tax is deemed paid with the final installment, and section 6511(b)(2) limits refunds to tax actually paid within the two years before the refund claim.<sup>65</sup>

## VI. ACCELERATION OF DEFERRED TAX

### A. General Rules Applicable to Acceleration of Deferred Tax.

1. A distribution, sale, exchange or other disposition of 50 percent or more of the value of decedent's interest in the closely held business will accelerate all unpaid tax deferred under section 6166.<sup>66</sup> Note that it is 50 percent or more in value of the interest in closely held business as of the date of the decedent's death.<sup>67</sup> A mere change in form is not construed to be a disposition. Thus, a sole proprietorship may be incorporated without

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<sup>62</sup>Internal Revenue Code Section 6166(h)(1).

<sup>63</sup>Internal Revenue Code Section 6166(h)(2).

<sup>64</sup>Internal Revenue Code Section 6166(h)(3).

<sup>65</sup> Technical Advice Memorandum 9828002.

<sup>66</sup>Internal Revenue Code section 6166(g).

<sup>67</sup>Private Letter Ruling 8113120.

accelerating the unpaid tax.<sup>68</sup> But, the issuance of corporate debentures in the incorporation of a sole proprietorship is considered a disposition.<sup>69</sup> The exchange of estate assets for an interest as a limited partner in a limited partnership is not a disposition.<sup>70</sup>

2. A withdrawal of 50 percent or more of the value of the closely held business will also accelerate the unpaid tax.<sup>71</sup> Under certain circumstances, a redemption under section 303 is not considered a disposition or withdrawal if the proceeds are used to pay the estate tax on or before the date the next installment is due.<sup>72</sup> This issue is discussed in more detail later in this paper.
3. A liquidation of a corporation that is subject to a section 6166 election may be a disposition. To the extent the corporate assets continue to be used in the same trade or business, the unpaid federal estate tax should not be accelerated.<sup>73</sup> If the liquidation results in a distribution of assets to stockholders so that the stockholders will conduct separate businesses, there is a disposition under section 6166 and the unpaid tax may be accelerated.<sup>74</sup>
4. Although transfer of property to a beneficiary does not accelerate the payment of unpaid tax deferred under section 6166, a subsequent transfer by the beneficiary does accelerate payment.<sup>75</sup> As long as the closely held business is transferred to a family member (within the meaning of section

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<sup>68</sup>See Rev. Rul. 66-62, 1966-1 C.B. 272; Private Letter Rulings 8108090; 8103066; 8105063; 7724045; 7721043; 7807104; 7825029; and 7929055.

<sup>69</sup>Private Letter Ruling 8220119.

<sup>70</sup>Private Letter Ruling 8131030. Other asset for asset exchanges are permitted if the newly acquired asset is used in the same business as the asset exchanged. Private Letter Rulings 8326052, 8304032, 8248102, 8138068, and 7825029.

<sup>71</sup>Reg. section 20.6166-3(d).

<sup>72</sup>Rev. Rul. 72-188, 1972-1 C.B. 383.

<sup>73</sup>Rev. Rul. 66-62, 1966-1, C.B. 272. Private Letter Rulings 8213075, 8108090 and 8103066.

<sup>74</sup>Private Letter Ruling 8131031.

<sup>75</sup>Reg. section 20.6166-3(e)(1).

267(c)(4)), the death of a beneficiary during the deferral period no longer accelerates the unpaid tax.<sup>76</sup>

5. If there is any undistributed net income of an estate, the undistributed income must be paid before the due date of the next installment payment to avoid acceleration.<sup>77</sup>
6. The Internal Revenue Service ruled in Revenue Ruling 89-4<sup>78</sup> that the sale to a nonqualified heir, undertaken to allay impending foreclosure, was not a disposition of an interest in the closely held farming business for purposes of section 6166(g)(1)(A). The Service cited the statute's underlying purpose and ruled that the sale to the nonqualified heir, undertaken to allay impending foreclosure, will not be treated as a disposition of an interest in the closely held farming business for purposes of section 6166(g)(1)(A).
7. In Private Letter Ruling 200043031, the Internal Revenue Service ruled that a proposed restructuring of a sole proprietorship into a limited liability company was not an event giving rise to acceleration of tax under section 6166.

**B. Acceleration of Tax and Redemptions under Section 303.**

1. Section 303 permits a redemption by a corporation of stock owned by a deceased stockholder to the extent of death taxes (including interest), funeral expenses, and administration expenses with respect to the estate of the deceased stockholder without the redemption being treated as a dividend. Section 303 can allow distributions from the corporation with minimum income tax consequences if: (i) a corporation is taxed as a C corporation, (ii) the corporation will be the source of cash for the payment of estate taxes and costs of administration, and (iii) stock in the corporation is to be distributed to family members or trusts for their benefit. Section 303 is discussed in detail later in this paper.
2. There is a time restriction on the availability of a redemption under section 303.<sup>79</sup> In general, a redemption must be made within 90 days of the expiration of the statute of limitations for the assessment of federal estate

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<sup>76</sup>Internal Revenue Code section 6166(g)(1)(D).

<sup>77</sup>Internal Revenue Code section 6166(g)(2).

<sup>78</sup>1989 C.B. 298.

<sup>79</sup>Internal Revenue Code Section 303(b)(1)(A).

taxes (or approximately four years from date of death) to qualify for the benefits of section 303. If the redemption is made outside four years after the date of the decedent's death, section 303 is available only to the extent of the lesser of the aggregate of the amounts that remain unpaid immediately before the redemption, or the aggregate of the amounts that are paid during the one-year period beginning on the date of the redemption.<sup>80</sup>

3. To obtain the maximum benefit from section 6166, the deferral period must be maximized. But this creates problems with a redemption under section 303 and the four-year time limitation. In general, the maximum benefits under section 6166 can be obtained if there are a series of redemptions. The first redemption should occur within four years of the decedent's death in the amount of the death taxes, interest, funeral expenses and costs of administration that have been paid up to the time of the redemption. As each installment is paid under section 6166, there would follow a redemption under section 303.<sup>81</sup>
4. One pitfall that the practitioner must be cautious about is the acceleration of deferred estate taxes under section 6166 because of a redemption under section 303. As pointed out above, there is an acceleration of the unpaid federal estate taxes deferred under section 6166 if more than 50 percent is withdrawn from the closely held business. Section 6166(g)(1)(B) provides a safe harbor with a redemption under section 303 if there is paid an amount of tax equal to the value of property and cash withdrawn from the corporation. It should be noted, however, that the value of the closely held business amount under section 6166 is reduced relating back to the date of the decedent's death. This means that an earlier disposal of a portion of the corporation that was within the 50 percent safety zone may no longer be within the safety zone.<sup>82</sup>
5. Revenue Ruling 86-54, modifying Revenue Ruling 71-188, provides an explanation of the application of sections 303 and 6166 when shares of stock are redeemed and an election to pay the estate tax in installments is made.

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<sup>80</sup>Internal Revenue Code Section 303(b)(4).

<sup>81</sup>Private Letter Ruling 8204129 involves a series of redemptions under section 303 and the effect on a section 6166 election.

<sup>82</sup>See Reg. section 20.6166 A-3 (d)(2); Rev. Rul. 86-54, I.R.B. 1986-15, 44, April 14, 1986; and Rev. Rul. 72-188, 1972-1 C.B. 383.

C. **Acceleration of Tax and Failure to Pay Installment of Unpaid Tax.**

1. Regulation section 20.6166(c), which provides that the failure to pay any installment of tax accelerates the payment of the unpaid tax, was held invalid in Delguzzi v. United States.<sup>83</sup> In light of Delguzzi, the Internal Revenue Service issued Revenue Ruling 82-120.<sup>84</sup> Under that Ruling, the failure to pay any installment of tax does not accelerate the payment of the unpaid tax for any decedent dying before December 31, 1981.
2. The failure to pay any unpaid tax within six months from the date the late payment is due will accelerate the payment of the unpaid tax.<sup>85</sup> If the payment of the late interest and principal is made within six months of the due date, there will be no acceleration, but the two percent interest rate will be lost with respect to the late payment, and a penalty of five percent per month is assessed on the late payment.

VII. **MISCELLANEOUS SECTION 6166 MATTERS**

A. **TPT Credit and Section 6166.**

1. The amount of estate tax deferred under section 6166 affects the computation of the credit for tax on prior transfers available under section 2013. The first limitation of the credit is the amount of the federal estate tax attributable to the transferred property in the transferor's estate. The Internal Revenue Service will not allow the full credit under section 2013 until the taxes due on the transferor's estate are paid. Thus, deferral in the transferor's estate of federal estate taxes under section 6166 will decrease the first limitation.
2. The Internal Revenue Service will allow a claim for refund to be filed as each payment in the transferor's estate is made under section 6166.<sup>86</sup> Interest will be paid from the due date of the return on any overpayment resulting from the increase in the credit for tax on prior transfers resulting from installment payments made by the transferor's estate.

B. **Charitable Deduction and Section 6166.**

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<sup>83</sup>80-2 USTC ¶ 13,364 (W.D. Wash. 1980).

<sup>84</sup>1982-1 C.B. 203.

<sup>85</sup>Internal Revenue Code Section 6166(g)(3).

<sup>86</sup>Technical Advice Memorandum 8301007.

1. The Internal Revenue Service has raised the issue of the estate tax charitable deduction under section 2055 for a residuary charitable bequest and the effect of an election to defer federal estate taxes under section 6166. The Internal Revenue Service takes the position that the estate tax charitable deduction must be reduced by an estimate of the maximum amount of interest that will be payable on federal estate taxes deferred under section 6166.<sup>87</sup>
2. In Revenue Ruling 82-6, the decedent had given the residue of the estate to charity and provided by will that all debts, expenses and taxes were to be paid from the residuary estate. The personal representative of the decedent's estate elected under section 6166A to defer the estate taxes attributable to a closely held business owned by the decedent. Because the interest payable on the federal estate tax deferred under section 6166A was a cost of administration to be paid from the residuary estate, the Internal Revenue Service ruled that the residuary charitable bequest must be reduced by an estimate of the maximum amount of interest that would be payable on the deferred federal estate taxes.
3. Although Revenue Ruling 82-6 arose under section 6166A (which is no longer available), the Ruling provides that it is applicable as well to an election under section 6166.

## VIII. LIEN TO SECURE THE SECTION 6166 DEFERRED ESTATE TAX

### A. Section 6166 Lien.

1. A personal representative has personal liability for unpaid estate tax to the extent the personal representative distributes assets to the beneficiaries.<sup>88</sup> Because the general estate tax lien extends for a period of ten years from the decedent's death and the section 6166 deferral period can last up to 14 years, an election under section 6166 results in the creation of a lien under section 6324A in favor of the United States on all section 6166 property.<sup>89</sup>
2. A personal representative who seeks to be discharged from personal liability from the unpaid estate tax may either post a bond under section

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<sup>87</sup>Rev. Rul. 82-6, 1982-1 C.B. 137.

<sup>88</sup>Internal Revenue Code section 6324(a)(2).

<sup>89</sup>Section 6166 lien property is defined in section 6324A(b) as property expected to survive the deferral period and were designated in the section 6166 election agreement.

2204 (general fiduciary discharge) and section 6165 or elect to place a lien on the section 6166 property. The equity in the property pledged must exceed the amount of tax due plus interest. The Code of Federal Regulations sets forth the requirements for creation of the lien, which requires consent of the parties who hold an interest in the property pledged.<sup>90</sup> When the lien is filed, the lien serves as collateral to secure the unpaid portion of the deferred estate tax liability.

**B. Treasury Inspector General Report on Estate Tax Collection Process.**

1. In March 2000, the Treasury Inspector General for Tax Administration issued a Final Audit Report - The Internal Revenue Service Can Improve the Estate Tax Collection Process. In the Report, the Inspector General found that the United States was owed \$1.4 billion of deferred estate taxes under section 6166 and of this amount \$1.3 billion was not secured by liens. The Report also found \$177 million in overdue tax balances involving 187 defaulted section 6166 elections that were not secured with bonds or liens. In addition, the Internal Revenue Service had written off as uncollectible 252 estates with defaulted installment agreements, totaling \$50 million, that did not have liens or bonds.
2. The Report recommended that the Internal Revenue Service secure liens at the time of the approval of the section 6166 election. The Internal Revenue Service has been implementing this recommendation.
3. The Treasury Inspector's concern was highlighted in the bankruptcy case *IRS v. Skiba (In re Roth)*, W.D. Pa. , Adv. No. 03-1171. In that case, an estate had elected to pay the estate taxes attributable to the shares of stock in an automobile dealership in installments under section 6166. The personal representative of the decedent's estate entered into an agreement subjecting the shares of stock to a estate tax lien under section 6324A in favor of the Internal Revenue Service. The automobile dealership went bankrupt and the Internal Revenue Service claimed status as a secured creditor. The Bankruptcy Court held that the Internal Revenue Service's claim for unpaid estate taxes under section 6166 amounted to a general unsecured claim because the Internal Revenue Service was limited to the terms of the lien agreement. Under the agreement, the Internal Revenue Service was limited to its security in the shares of stock and was an unsecured creditor as to the decedent's assets.

**C. The Internal Revenue Manual Provisions Regarding Section 6166.**

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<sup>90</sup>Code of Federal Register 301.6324A-1.

1. Section 5.5.6.1 of the Internal Revenue Manual is a section in Part 5, Collection Process entitled “Estate Tax Installment Cases” and covers section 6166 bonds and liens. According to the Manual, the Internal Revenue Service has these options to secure payment of the estate tax deferred under section 6166:
  - a. Require the estate to furnish a performance bond with a face value up to double the amount being deferred, or
  - b. Allow the estate to substitute the filing of a special lien (Form 668J) pledging their right, title, and interest to specific property to the government.
2. Although the Federal Register lists approximately 100 acceptable bonding companies, one Estate Tax Attorney with the Internal Revenue Service stated that she was not aware of any bond ever having been written for an estate that elected section 6166. A copy of the standard notice that is now or will be distributed to personal representatives making a section 6166 election is attached.
3. As long as there is any unpaid federal estate tax, there will be a lien on the property and the personal representative will have personal liability for the unpaid tax.<sup>91</sup> Section 6324A provides a procedure whereby the personal representative may be relieved of personal liability. The personal representative must file an agreement and designate property over which there will be a section 6166 lien. In Technical Advice Memorandum 8147009, the Service ruled that the District Director has the authority to issue a certificate of discharge under section 6325 if the property remaining subject to the lien is at least double the amount of the unsatisfied liability under section 6166.

## IX. PLANNING FOR SECTION 6166

### A. Lifetime Planning for Section 6166.

1. If the client wants the benefits of section 6166 for the client’s estate, lifetime planning involves either increasing the closely held business interests or decreasing the non-business assets in the client's estate. As a first step, the client should review all business assets and interests in businesses owned by the client to determine whether the asset will qualify

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<sup>91</sup>Section 6901.

as a trade or business. An example of a problem encountered by many clients is where the real estate used in connection with a trade or business is owned by the client or an entity outside the operating business entity and is leased to the operating business entity. As shown above, the value of the real estate may not qualify as a trade or business resulting in a failure of the client's estate to meet the percentage tests of section 6166(a)(1). There are two solutions to this problem, transfer the real estate to a business entity that conducts a trade or business (which may create an asset protection issue) or place maintenance duties on the real estate entity that will qualify the real estate entity as a trade or business. (A list of questions asked by an Internal Revenue Service Estate Tax Attorney during a recent examination of an estate tax return is attached.)

2. A simple method of decreasing the non-business assets in the client's estate is to gift non-business assets, but the effect of section 2035(d)(4) must be considered. Section 2035(d)(4) requires that the 35 percent test of section 6166(a)(1) must be met with and without gifts made within three years of death being included in the decedent's gross estate. Thus, death bed gifts of non-business assets will not assure qualification under section 6166.
3. Some popular estate planning techniques may affect the eligibility of the business owner's estate for section 6166. For example, a sale of business interests to an irrevocable trust structured as a grantor trust is a popular estate planning technique for owners of closely held business interests. This technique, however, may disqualify the owner's estate for the benefits of section 6166. Because the promissory note issued by the irrevocable trust will be the asset in the owner's estate and not the underlying business interest, the owner's estate may not meet the percentage test under section 6166(a)(1).

**B. Post-Mortem Planning for Section 6166.**

1. Post-mortem planning for section 6166 involves primarily making sure that the benefits of section 6166 are not lost, thus accelerating all unpaid tax. The key is not to have any unintentional acceleration of deferred death taxes. In the event of a sale of the closely held business, there should be a cash down payment equal to at least the unpaid death taxes that will be accelerated.
2. In Chief Counsel Advice Memorandum 200141013, the issue was whether an estate can obtain a refund of a portion of the estate tax paid when the estate filed an extension request (Form 4768) which preceded the filing of the estate tax return and the making of an election under section 6166. In the CCA, the Internal Revenue Service took the position that

notwithstanding section 7422 (which created an exception to the full payment rule), the estate can obtain a refund until there has been an overpayment of the entire estate tax liability. Thus, the personal representative must be careful in not overpaying the estimated tax liability less the amount of the estimated deferred estate taxes under section 6166.

3. If the estate does not meet the percentage test, a protective election should be made.

## X. **OBSTACLES TO SECTION 6166**

### A. **Obstacles Created by Statute.**

1. Some of the obstacles to obtaining the benefits of section 6166 are created by the statute itself. These obstacles include the following.
  - a. Section 6166 has a “cliff” 35 percent requirement (34 percent does not qualify any portion of the estate for deferral, while 35 percent qualifies 35 percent of the estate tax for deferral).
  - b. Only active businesses will qualify for section 6166 deferral.
  - c. The rules regarding holding companies are not clear.
  - d. The rules regarding multiple levels of tiered entities are not clear.
2. These obstacles create uncertainty which will not be resolved without Congressional action or published rulings.

### B. **Business Obstacles.**

1. Although the restrictions under section 6166 are less onerous than most businesses could obtain from a commercial lender, the bonding and lien requirement may present issues in some instances. The lien will decrease the borrowing capabilities of the business and may make lenders and non-involved owners nervous.
2. Another obstacle is the variable interest rate on the portion of the deferred tax in excess of the two percent portion. Although the interest rate is 45 percent of Internal Revenue Service’s underpayment rate, the rate is variable during the term of the loan. Although some taxpayers may be able to obtain a fixed rate loan, it is doubtful that commercial lender would make a fixed rate loan for a 14-year term.

## XI. FUNDING SECTION 6166 PAYMENTS WITH CORPORATE DISTRIBUTIONS

### A. Corporate Distributions.

1. If the closely held business is an interest in a corporation and is the contemplated source of payment for the deferred tax, care must be taken in structuring distributions from the corporation to the payor of the estate tax. If the distribution does not qualify as one of the exceptions to dividend treatment, the distribution will be subject to dividend treatment and taxed. Although the tax on qualified dividends is at the lowest level in decades, the income tax will increase the amount of funds necessary to pay the deferred estate tax.
2. Section 316(a) defines a dividend for tax purposes to be any distribution of property made by a corporation to its shareholders out of the corporation's earnings and profits accumulated after February 28, 1913 (the date the first federal income tax was imposed after adoption of the Sixteenth Amendment to the United States Constitution), or earnings and profits of the taxable year, without regard to the amount of earnings and profits at the time the distribution was made.
3. Section 316(a) sets forth an irrebuttable presumption that every corporate distribution to a shareholder with respect to the shareholder's stock is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits.
4. To the extent the corporation does not have earnings and profits, a distribution to a shareholder with respect to the shareholder's stock is treated as a return of capital to the shareholder and applied against and in reduction of the adjusted basis of the shareholder's stock.<sup>92</sup> If the distribution is greater than the adjusted basis of the shareholder's stock, the excess is treated as gain from the sale or exchange of property (and thus capital gain assuming the stock is a capital asset).<sup>93</sup> The key to whether a distribution is a dividend is whether the corporation has earnings and profits. Thus, the determination of earnings and profits is very significant.
5. The tax definition of a dividend is not the same as the definition of a dividend for state law purposes. Although a corporate distribution may

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<sup>92</sup>Internal Revenue Code section 301(c)(2).

<sup>93</sup>Internal Revenue Code section 301(c)(3).

impair the capital of the corporation or is otherwise unlawful under state law, such a distribution may be a dividend under section 316(a).

**B. Redemptions of Stock under Section 302.**

1. Section 302(a) provides that a redemption of stock shall be treated as an exchange (and thus any gain or loss on the exchange would be eligible for capital gain or capital loss treatment) if it comes within one of the following categories:
  - a. A redemption that is not essentially equivalent to a dividend under section 302(b)(1);
  - b. A redemption that is substantially disproportionate under section 302(b)(2);
  - c. A redemption that completely terminates the shareholder's interest under section 302(b)(3); and
  - d. A redemption concerning certain railroad corporations under section 302(b)(4).
2. Any redemption not coming within one of the above categories (or within section 303, a redemption to pay death taxes) is treated as a distribution under section 301 and taxed as a dividend to the extent of the corporation's earnings and profits.<sup>94</sup>

**C. Stock Attribution Rules under Section 318.**

1. In connection with any redemption transaction under section 302, the rules of constructive ownership of stock under section 318 must be considered.
2. Under the family attribution rules of section 318(a)(1), an individual is deemed to own all stock owned (directly or indirectly) by the individual's spouse (other than a spouse who is legally separated under a divorce or separate maintenance decree), children, grandchildren, and parents. A legally adopted child is treated as a child by blood. There is no double attribution under the family attribution rules. Thus, stock owned by a brother is attributed to his parents but not reattributed from the parents to a sister of the shareholder.

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<sup>94</sup>Internal Revenue Code section 302(d).

3. Under the entity to beneficiary attribution rules under section 318(a)(2), stock owned (directly or indirectly) by a partnership or an estate is deemed to be owned proportionately by its partners or beneficiaries. Stock owned (directly or indirectly) by a trust (other than a grantor trust) is deemed to be owned by the beneficiaries in proportion to the actuarial interests of the beneficiaries in the trust. Stock owned (directly or indirectly) by a trust of which a person is considered the owner under sections 671-677 (grantor trust rules) is deemed to be owned by the person considered the owner. Stock owned (directly or indirectly) by a corporation is deemed owned proportionately by a shareholder if the shareholder owns more than a 50 percent interest in the corporation.
4. Under the beneficiary to entity attribution rules of section 318(a)(3), stock owned (directly or indirectly) by partners or beneficiaries is deemed to be owned by the partnership or estate. Stock owned (directly or indirectly) by the beneficiaries of a trust is deemed to be owned by the trust, except stock owned by a contingent beneficiary whose interest in the trust is less than 5 percent (actuarially determined) is not attributed to the trust. Stock owned (directly or indirectly) by a shareholder owning 50 percent or more in value of a corporation is deemed to be owned by the corporation.
5. Under the option attribution rules of section 318(a)(4), a person who has an option to acquire stock is deemed to own the stock subject to the option.

**D. Complete Termination of Shareholder's Interest under Section 302.**

1. A redemption will be treated as an exchange (and thus eligible for capital gain or loss treatment) if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.<sup>95</sup> In order to qualify for complete termination, the shareholder's proprietary interest in the corporation must be completely terminated by the redemption.
2. A redemption can qualify as a complete termination notwithstanding the corporation pays for the redeemed stock in installments over a period of years. Problems can arise, however, where there is a possibility of reacquiring the redeemed stock upon default (such as under a pledge agreement), or where the term of payment is unreasonably long.
3. Because it is necessary that the shareholder completely terminate the shareholder's interest in the corporation, careful attention must be paid to the attribution rules of section 318. If all of the stock actually owned by

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<sup>95</sup>Internal Revenue Code section 302(b)(3).

the shareholder is redeemed by the corporation but stock owned by members of the shareholder's family is deemed to be owned by the shareholder under the attribution rules, there is no complete termination unless the family attribution rules are waived by the redeeming shareholder. For example, father owns 25 percent of the stock of Brookdale Corporation and son owns 75 percent. Brookdale Corporation redeems father's stock. Because son's stock is deemed owned by father, father does not have a sale of his stock (and capital gain treatment) unless he waives the family attribution rules.

4. Section 302(c)(2) provides for the waiver of the family attribution rules under Section 318. To waive the family attribution rules, the redeeming shareholder must:
  - a. Retain no interest in the corporation (including an interest as an officer, directly or employee), other than as a creditor;
  - b. Not acquire any interest in the corporation within 10 years from the date of the redemption (other than by inheritance); and
  - c. Notify the Internal Revenue Service of any interest in the corporation is acquired within the 10-year period.
5. It is important to note that section 302(c)(2) waives only the family attribution rules, not the entity-beneficiary or option attribution rules. Section 302(c)(2)(c) allows an entity (such as an estate or trust to waive the family attribution rules only when the entity member (partner or beneficiary) owns the stock constructively by virtue of section 318(a)(1). If the member directly owns the stock, section 302(c)(2)(c) does not apply and attribution to the entity cannot be waived.

E. **Substantially Disproportionate Redemption under Section 301(b)(2).**

1. If a redemption is substantially disproportionate, the redemption will qualify for sale or exchange treatment and will not be taxed as a dividend. There are two requirements for a redemption to qualify as substantially disproportionate. The first requirement is referred to as the 50 Percent Test. Immediately after the redemption the shareholder must own (directly and indirectly) less than 50 percent of the total combined voting power of all classes of outstanding stock entitled to vote. The second requirement is referred to as the 80 Percent Test. The percentage of outstanding voting stock owned by the shareholder after the redemption must be less than 80 percent of the shareholder's percentage of such ownership before the

redemption (and, in addition, the shareholder's ownership of common stock, whether voting or nonvoting, must meet the 80 percent test).

2. The protection of section 302(b)(2) is not available if the redemption is part of a series of redemptions that in the aggregate is not substantially disproportionate with respect to the shareholder.

**F. Redemption Not Essentially Equivalent to a Dividend under Section 302(b)(1).**

1. Section 302(b)(1) provides that a redemption may be treated as a sale of the redeemed stock if the redemption is not essentially equivalent to a dividend. Regulation section 1.302-2(b) provides that the question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend depends upon the facts and circumstances of each case. Because of the lack of certainty in connection with whether a redemption comes within the purview of section 302(b)(1), this section is rarely used as a planning device. Rather, the utility of section 302(b)(1) is in the situation where a redemption has already been made and does not come within one of the exceptions set forth above.
2. Regulation section 1.302-2(b) provides that one of the facts considered in making a determination of whether a redemption is not essentially equivalent to a dividend is the constructive stock ownership of the shareholder under section 318(a). This view was adopted by the United States Supreme Court in U.S. v. Davis.<sup>96</sup>

**G. Conclusion Regarding Corporate Distributions to Fund Section 6166 Payments.**

1. Because of the corporate tax rules applicable to distributions, it will be difficult for an estate to obtain funds from a corporation free of income taxes. If the distribution does not come within one of exceptions listed above, the distribution will in all likelihood be taxable to the estate as a dividend. In determining the income tax liability associated with dividend distributions, the shareholder's basis in the stock is not relevant. Accordingly, the fact that the estate's basis in stock includable in the decedent's estate received a basis adjustment at the decedent's death is not relevant if the distribution is taxed as a dividend.

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<sup>96</sup>397 U.S. 301 (1970).

2. The Jobs and Growth Tax Relief Reconciliation Act of 2003 lowered the federal income tax rate on qualified dividends to 15 percent (or 5 percent for taxpayers in the two lowest tax brackets). Although the income tax rate on dividend income is lower than it has been in decades, the income tax will increase the amount of corporate distribution necessary to pay estate taxes.
3. If the corporate distribution qualifies as a redemption under section 303, the distribution qualifies for sale and exchange treatment notwithstanding that the redemption does not meet any of the exceptions under section 302. Because of the adjustment to basis as a result of the decedent's death, the redemption should be tax-free and will minimize the amount of corporate distribution necessary to pay estate taxes.

## XII. REDEMPTIONS TO PAY DEATH TAXES -- SECTION 303

### A. Section 303 Redemptions Are Exceptions to Dividend Treatment.

1. An effective technique to obtain funds on a tax efficient basis from a corporation taxed as a regular corporation is a redemption that qualifies under section 303. Unless one of the exceptions under section 302(b) is met, a redemption of a portion of stock owned by a stockholder will result in a dividend and ordinary income treatment to the extent of the corporation's earnings and profits.<sup>97</sup> Section 303 permits a redemption by a corporation of stock owned by a deceased stockholder to the extent of death taxes (including interest), funeral and administration expenses with respect to the estate of the deceased stockholder without the redemption being treated as a dividend. The attribution rules of section 318 do not apply to a redemption under section 303.
2. Assuming an individual owns 100 percent of a corporation, upon the individual's death it may be possible to redeem part of the stock the individual owned, which in effect would be a tax free withdrawal from the corporation. Without section 303, a redemption under these circumstances would be taxed as a dividend to the extent of the corporation's earnings and profits.
3. With a redemption under section 303, the stock has received a step-up in basis for income tax purposes equal to the value as of the decedent's death (or alternate valuation date, if elected). Assuming the redemption is made shortly after death, there should be little or no capital gains tax paid by the

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<sup>97</sup>Internal Revenue Code section 301.

party making the redemption. If there is any appreciation from the date of the decedent's death (or the alternate valuation date) to the date of the redemption, any gain will be taxed as a capital gain.

**B. Requirements of Section 303.**

1. The shares of stock redeemed must be included in the decedent's gross estate. Stock created after the death of the decedent can qualify if the new stock has a basis determined by reference to the basis of the stock that was included in the decedent's estate.<sup>98</sup> A recapitalization would generally satisfy the requirements of this provision. Stock held in a revocable trust that is included in the decedent's gross estate meets this requirement.
2. The value of the shares of the corporation that are includable in the decedent's estate must exceed 35 percent of the decedent's gross estate less deductions allowable under sections 2053 (debts, costs of administration, and other charges) and 2054 (losses).<sup>99</sup> Allowable deductions under section 2053 and 2054 are expenses that could have been claimed on the decedent's estate tax return notwithstanding that such expenses were deducted on the fiduciary income tax return.<sup>100</sup> No redemption is permitted for the amount of the decedent's debts, but only for death taxes (including interest), funeral and administration expenses.<sup>101</sup> The family or widow's allowance is not considered an administration expense.<sup>102</sup>
3. If the decedent has stock of two or more corporations that are included in the decedent's gross estate, the stock of both corporations may be combined to meet the 35 percent test. At least 20 percent of the value of the outstanding stock in each corporation must be included in the decedent's gross estate before the stock of the two corporations can be combined to meet the 35 percent test. In addition, certain stock jointly owned by the decedent and the decedent's spouse and the community property interest of the surviving spouse are deemed to be included in the decedent's gross estate for the purpose of meeting the 20 percent test.

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<sup>98</sup>Internal Revenue Code section 303(c).

<sup>99</sup>Internal Revenue Code section 303(a)(2).

<sup>100</sup>Rev. Rul. 56-449, 1956-2 C.B. 180.

<sup>101</sup>Internal Revenue Code section 303(a).

<sup>102</sup>Majerus v. Coyle, 254 F. Supp. 214 (N.D. Ill. 1966).

4. A redemption under section 303 is available to the extent that the interest (in the estate) of the stockholder making the redemption is reduced by the payment of the estate tax, funeral expenses or administration expenses.<sup>103</sup> Thus, the surviving spouse or trustee holding stock that qualified for the federal estate tax marital deduction cannot redeem the stock under section 303.

C. **Maximum Amount of Redemption.**

1. A tax free redemption under section 303 cannot exceed the amount of death taxes and interest (federal and state), funeral expenses and administration expenses. It is not necessary that the estate or the stockholder use the proceeds from the redemption to pay the death taxes, funeral expenses or administration expenses.
2. Any redemption in excess of the section 303 amount will be examined under the rules of section 302. If the redemption does not meet the exceptions set forth in section 302(b), the redemption will be accorded ordinary income treatment to the extent the corporation has earnings and profits.

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<sup>103</sup>Reg. Section 1.303-2(f) and (g).

D. **Timing of Redemption under Section 303.**

1. Regulation Section 1.303-2(g) provides that if there are multiple redemptions, section 303 is applied to the first redemption. The timing of multiple redemptions is very significant. For example, assume the decedent owned 100 percent of the stock of Corporation X and 50 percent of the stock of Corporation Y. (The other 50 percent of the stock of Corporation Y is owned by an unrelated third party.) Assume that Corporation Y redeems all of the decedent's stock. Later, Corporation X redeems 25 percent of the decedent's stock, which is equal to the amount allowable to be redeemed under section 303. Section 303 will be applied first to the redemption by Corporation Y, notwithstanding that the redemption would be tax free as a complete termination under section 302(b)(3). The redemption by Corporation X will not be accorded section 303 treatment and the redemption proceeds may be taxable as a dividend. If the redemption by Corporation X had been before the redemption by Corporation Y, both redemptions may have been tax free.
2. A redemption under section 303 must be made within the following time limitations:
  - a. Within 90 days of the expiration of the statute of limitations for the assessment of federal estate taxes (or approximately four years from date of death);
  - b. If there is a deferral of estate taxes under section 6166, the redemption must be within the time period for paying the unpaid tax;
  - c. If a redemption is made more than four years after the decedent's death, under section 303(b)(4) the redemption is limited to the lesser of:
    - (1) The section 303 amount that has not been paid; or
    - (2) The section 303 amount that is paid during the one-year period beginning on the date of the redemption.

E. **Relationship of Sections 303 and 6166.**

1. There is no acceleration of unpaid estate taxes deferred under section 6166 if the estate pays an amount of tax on or before the date of the next installment equal to or greater than the amount received from the section 303 redemption. If this is done, however, the closely held business amount

under section 6166 is reduced relating back to the date of the decedent's death. This means that an earlier disposal of a portion of the closely held business that was within the 50 percent safety zone may no longer be in the safety zone.<sup>104</sup>

2. Generally, a series of redemptions will produce the optimum benefits of sections 6166 and 303. To obtain the maximum dollar benefit from section 6166, the deferral period must be maximized. But this creates problems with a redemption under section 303 and the four-year time limitation. In general, the maximum benefits under section 6166 can be obtained if there are a series of redemptions. The first redemption should occur within four years of the decedent's death and be in the amount of the death taxes, interest, funeral expenses and costs of administration that have been paid up to the time of the redemption. As each installment is paid under section 6166, there would follow a redemption under section 303. Private Letter Ruling 8204129 involves a series of redemptions under section 303 and the effect on a section 6166 election.
3. One pitfall that the practitioner must be cautious about concerns acceleration of the unpaid federal estate taxes under section 6166 with a redemption under section 303. As pointed out above, there is an acceleration of the unpaid federal estate taxes deferred under section 6166 if more than 50 percent is withdrawn from the closely held business. Section 6166(g)(1)(B) provides a safe harbor with a redemption under section 303 if there is paid an amount of tax equal to the value of property and cash withdrawn from the corporation. It should be noted, however, that the value of the closely held business amount under section 6166 is reduced relating back to the date of the decedent's death. This means that an earlier disposal of a portion of the corporation that was within the 50 percent safety zone may no longer be within the safety zone. See Reg. section 20.6166 A-3 (d)(2); Rev. Rul. 86-54, I.R.B. 1986-15, 44, April 14, 1986; and Rev. Rul. 72-188, 1972-1 C.B. 383.
4. Revenue Ruling 86-54 provides an explanation of the application of sections 303 and 6166 when shares of stock are redeemed and an election to pay the estate tax in installments is made. This ruling modified Revenue Ruling 72-188.

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<sup>104</sup>Reg. Section 20.6166A-3(d)(2). Rev. Rul. 72-188, 1972-1 C.B. 383.

F. **Conclusion.**

1. Through careful pre- and postmortem planning, it is possible to defer the estate tax under section 6166 and to fund the installment payments through redemptions under section 303. Section 6166 provides a low interest loan to pay the estate tax but care must be taken in obtaining corporate distributions free of income tax liability. Redemptions under section 303 can solve the income tax issue and if structured properly can avoid an acceleration of the deferred estate tax.
2. This combination strategy of a deferral of estate tax under section 6166 and a series of redemptions under section 303 can assist in solving a difficult problem for the illiquid estate.

XIII. **THE ECONOMICS OF ESTATE TAX DEFERRAL**

A. **Deductibility of Interest Incurred to Pay Estate Tax.**

1. Section 2053(a)(2) allows a deduction for administration expenses that are allowable by the law of the jurisdiction in which the estate is being administered. Regulation section 20.2053-3(a) provides that expenses actually and necessarily incurred are expenses “in the collection of assets, payments of debts, and distribution of property to the persons entitled to it.” If the loan is not necessary to the proper administration of an estate, interest on the loan is not deductible as an administration expense.<sup>105</sup>
2. Regulation section 20.2053-1(b)(3) prohibits a deduction taken upon the basis of a vague or uncertain estimate. That Regulation states: “If the amount of a liability was not ascertainable at the time of final audit of the return by the District Director and, as a consequence, it was not allowed as a deduction in the audit, and subsequently the amount of liabilities ascertained, relief may be sought by a petition to the Tax Court or a claim for refund.”
3. Interest on loans incurred by an estate to pay its estate tax obligation in a single payment have been held to constitute a deductible administration expense, even though the estate could have elected to pay the tax in installments under section 6166 pursuant to the terms of the stock

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<sup>105</sup>In Rupert . United States, M.D. Pa., No. 1:CV-03-0421 (October 22, 2004), the Court held that an estate did not provide factual details to support a finding that a loan incurred to pay the estate taxes attributable to lottery winnings was necessary to the administration of the estate.

restriction agreement.<sup>106</sup> In Private Letter Ruling 200020011, the Internal Revenue Service ruled that interest attributable to a loan obtained from a commercial lender to pay off federal estate taxes deferred under section 6166 is deductible as an administration expense under section 2053(a)(2).

4. In Revenue Ruling 84-75,<sup>107</sup> the personal representative had borrowed funds to pay the estate tax so as to avoid a forced sale of estate assets. The Internal Revenue Service found that the loan was reasonably and necessarily incurred in administering the estate, therefore the interest incurred on the loan was deductible as a cost of administration under section 2053(a)(2). Because the estate's payments on the loan could be accelerated, however, the amount of interest to be paid by the estate was uncertain. The Service ruled that interest could only be deducted after the interest accrued and any estimate of future interest was not deductible.
5. If the interest on the unpaid estate tax is taken as an estate tax deduction, the Internal Revenue Service will only allow the deduction as the interest is paid.<sup>108</sup> To deduct the interest on unpaid estate tax on the estate tax return, the personal representative must file amended returns claiming the interest as the interest was paid. The amended returns must be filed within the applicable statute of limitations, which is three years from the date of filing or two years from the date of payment of estate tax.<sup>109</sup> If interest is paid after the applicable statute of limitations, the estate cannot obtain a refund of estate tax.

**B. Nondeductibility of Section 6166 Interest Payments.**

1. When the Taxpayer Relief Act of 1997 reduced the interest rate to two percent and 45 percent of the general underpayment rate, the Act also eliminated the deductibility of the interest for both federal estate and income tax purposes. For decedents dying before December 31, 1997, however, the interest on the unpaid estate tax may be used as a deduction on the estate tax return or as a deduction on the fiduciary income tax return. Thus, for decedents dying before December 31, 1997, it is necessary to file an amended estate tax return as each interest payment is made. Technical Advice Memorandum 8022023 sets forth the procedure for protecting the

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<sup>106</sup>See McKee, T.C., CCH P. 13,058.

<sup>107</sup>1984-1 C.B. 193.

<sup>108</sup>Bailly Estate v. Com'r, 81 T.C. 246 (1983); Rev. Rul. 80-250, 1980-2 C.B. 278.

<sup>109</sup>Internal Revenue Code section 6511.

right to partial abatement of the tax assessed based on a recomputation of the tax as interest is paid and claimed as a deduction on federal Form 706.

2. The issue for many taxpayers will be whether the lower interest rate under section 6166 is more economical than borrowing from a third party and deducting the interest as an estate tax deduction under section 2053. In the present economic environment (the November 2004 underpayment interest rate is 5.0 percent) and the underpayment interest rate is decreased by 55 percent notwithstanding that the maximum estate tax rate is 48 percent, section 6166 should be more attractive to most taxpayers than third party borrowing. Some taxpayers may prefer third party borrowing so as to avoid the section 6166 lien requirements.
3. Commissioner v. Hubert<sup>110</sup> held in a plurality decision that the marital and charitable bequest were not required to be reduced by reason of administration expenses (such as interest payments on unpaid estate taxes) paid from income generated by the assets allocated to those bequests. Regulations have been issued addressing the Hubert issue.<sup>111</sup>

#### XIV. ALTERNATIVE STRATEGY: THIRD PARTY BORROWING WITH ESTATE TAX DEDUCTION FOR INTEREST PAYMENTS

##### A. General Description.

1. Electing the benefits of section 6166 is not the only long-term borrowing options available to the personal representative of a business owner's estate. Another option available to the personal representative is borrowing from a third party, including borrowing from an entity controlled by the decedent's estate or beneficiaries.
2. A personal representative of a business owner's estate may prefer not to elect the benefits of section 6166, but to borrow funds from a third party to pay the federal estate tax. Borrowing from a third party may allow the personal representative to deduct the interest payment as a cost of administration under section 2053(a)(2). It may be possible to structure the loan arrangement so that the entire interest payment over the term of the loan can be deducted as a cost of administration when the estate tax return is filed. This technique is based on the Tax Court memorandum decision in Estate of Graegin.

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<sup>110</sup>520 U.S. 93 (1997).

<sup>111</sup>T. D. 8846, 1999-52 I.R.B. 679.

**B. Estate of Graegin.**

1. Estate of Graegin v. Commissioner<sup>112</sup> involved the deductibility of a balloon payment of interest due upon the maturity of a loan incurred to pay Federal estate taxes. The issue was whether the interest was a deductible administration expense under section 2053(a)(2). The assets in Mr. Graegin's estate consisted primarily of stock in a closely held corporation. After payment of state inheritance taxes and other expenses, the estate had \$20,000 of liquid assets remaining. Rather than sell the stock in the closely held corporation, the estate borrowed funds (approximately \$200,000) from a wholly-owned subsidiary of the closely held corporation to pay the estate taxes. The term of the promissory note evidencing the loan was 15 years and the interest rate was 15 percent simple interest (equal to the prime rate on the date of the loan). All principal and interest of the loan was to be repaid in a single balloon payment at the end of the term and the loan agreement contained a prohibition against early repayment. (The 15-year term was selected because it was the life expectancy of the income beneficiary of the trust.) The estate requested and obtained the approval of the local probate court for the personal representatives to enter into the loan. The estate deducted the amount of the single-interest payment due upon maturity of the note (\$459,491) on the federal estate tax return as a cost of administration. The Internal Revenue Service disallowed the interest expense on the basis that the expense was not actually incurred and was unlikely to occur because the relationship of the parties made the repayment of the loan uncertain. The estate pursued the deduction in Tax Court.
2. The Tax Court found that the amount of interest on the promissory note was not vague but was capable of calculation and that the parties intended to pay the loan on a timely basis. For that reason, the Tax Court held that the entire amount of the interest on the note was deductible as a cost of administration under Section 2053(a)(2).

**C. The Position of the Internal Revenue Service Post Graegin.**

1. The Internal Revenue Service issued a Litigation Guideline Memorandum dated March 14, 1989 in response to Graegin. In the Memorandum, the Service repeated its position that interest on indebtedness was deductible as an administration expense if the indebtedness is incurred to enable the estate to pay taxes due without selling non-liquid estate assets at a forced

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<sup>112</sup>T. C. Memo. 1988-477.

sales price. In order to be deductible, the interest must be certain to be paid, and the amount must be subject to reasonable estimation. Because the loan in Graegin was found by the Tax Court not to be uncertain, the Internal Revenue Service stated that the result in Graegin was not inconsistent with the arguments advanced by the Service.

2. In the Litigation Guideline Memorandum, the Internal Revenue Service raised additional arguments to challenge a situation similar to Graegin. First, the loan must be bona fide and financing between related entities is subject to stricter scrutiny than arms' length dealings. If the underlying loan arrangement is not bona fide, there can be no deduction allowed for the interest on the debt. In the Memorandum, the Service mentioned another factor to be examined, the treatment by the lender of the interest. The related lender should accrue interest income so that the tax treatment is consistent between the lender and the borrower. Also, the Service stated that the transaction must have substance and unusual financing techniques, such as unsecured loans, high rates of interest, and loans with long terms should have close scrutiny especially if less expensive lending alternatives are available from third party sources.

D. **Rulings by the Internal Revenue Service.**

1. Private Letter Ruling 199903038 involved a request for a ruling that a deduction may be claimed on a federal estate tax return for the total amount of interest that would be paid over the term of an installment loan. The loan was from a commercial bank and would provide for annual payment of both interest and principal over a specified term of years not to exceed seven years at a fixed rate of interest. The note also provided that principal and interest may not be prepaid. The Service ruled that the deduction may be claimed on the estate tax return for the entire amount of post-death interest provided the expenses were necessarily incurred in the administration of the estate (which was a factual determination on which the Service did not rule). The favorable ruling was conditioned on the estate obtaining approval for the proposed transaction from the appropriate local court.
2. Private Letter Ruling 199952039 reached a similar result.

E. **Recent Unpublished Ruling by the Internal Revenue Service.**

1. In an unpublished Technical Advice Memorandum recently discussed at a meeting of the Estate and Gift Tax Committee of the American College of Trust and Estate Counsel, the Internal Revenue Service disallowed interest on a Graegin-style note executed by a partnership making a loan to the estate owning the partnership interest. The facts in that Technical Advice Memorandum are as follows. The decedent formed a limited partnership and contributed assets to the partnership in exchange for a two percent general partnership interest and a 97 percent limited partnership interest. The decedent died 5 ½ years after formation of the partnership. The decedent's estate consisted primarily of the decedent's 97 percent interest in the limited partnership. Approximately 57.6 percent of the partnership assets consisted of publicly traded stocks, bonds, and cash. The remaining partnership assets consisted primarily of real property (17.5 percent) and installment sale notes (24.7 percent).
2. Under the decedent's will, the residue of the decedent's estate, which included the decedent's limited partnership interest, was to be distributed to separate trusts for the benefit of his two children. One of the decedent's children and a third party were personal representatives of the decedent's estate. Before the filing of the estate tax returns, the personal representatives and one of his children, as a general partner of the partnership, executed a promissory note with the estate as the borrower and the partnership as the lender. The promissory note matured 10 years from the date of the note. Prepayment of principal and interest was prohibited by the terms of the note. The Estate's 97 percent limited partnership interest was pledged as security pursuant to a separate security agreement for the payment of the note. The interest rate was one percent above the prime interest rate. The Technical Advice Memorandum mentioned that the average interest rate for 15 year mortgage loans was two percent less than the prime interest rate at the time of the loan. On the federal estate tax return, the personal representatives claimed a cost of administration deduction under section 2053(a) for the amount of the interest payable over the 10-year term of the loan.
3. In the Technical Advice Memorandum, the Internal Revenue Service disallowed the interest deduction for the following reasons. First, the Service did not believe that the loan was necessary to the administration of the estate. Because the partnership held substantial liquid assets, and the child was a co-executor of the estate and a general partner of the partnership, the child could force the partnership to distribute liquid assets to the estate with which to pay the estate taxes. The Service stated there was clearly no fiduciary restraint on the child's ability to access the

partnership funds. Because the same parties stood on all sides of the transaction, the partnership assets were readily available for the purposes of paying the estate tax. In addition, the Service believed it was questionable whether the estate would actually make the payments in accordance with the terms of the promissory note. In addition, if the estate did make the payments, there would be no change in the economic position of the parties involved. Accordingly, the Internal Revenue Service disallowed the interest expense.

4. A copy of the Technical Advice Memorandum is attached.

## XV. PRACTICAL CONSIDERATIONS WITH SECTION 6166 PAYMENTS AND SECTION 303 REDEMPTIONS

### A. Have A Backup Plan.

1. It is dangerous to assume that the business owner's estate will meet the section 6166 requirements. There are too many variables for a client to rely on the deferral of estate taxes under section 6166 with one or more section 303 redemptions to fund the installment payments as the single strategy for funding the estate tax. The client's non-business assets may increase significantly and the client's estate will not meet the 35 percent test of section 6166. In addition, relying on section 6166 and section 303 may prevent the client from undertaking other estate planning techniques which could reduce the overall estate tax burden.
2. For these reasons, it is wise to have a backup plan in case the client's estate will not meet the requirements of section 6166 and section 303.

### B. Be Careful in Net Cash Leasing Real Property to Operating Business.

1. Eligibility for the benefits of section 6166 requires that the business interest conduct an active trade or business. If real property owned by the decedent is rented (even to an operating business owned by the decedent) and the decedent does not conduct any business activities, the real property may not qualify for section 6166 treatment.
2. There are many good business and tax reasons for real property not to be owned by an operating business. Because rental property with no activity does not qualify as a closely held business interest for purposes of section 6166, the client should consider restructuring the lease activities so as to qualify for the benefits of section 6166. One approach is to place duties on the real estate owner under the terms of the lease so as to qualify the real property as an active trade or business.

C. **Structure Real Estate Entities as Active Businesses.**

1. This issue is similar to the issue discussed above. There are many levels of activity in real estate development companies. If the real estate entity does not conduct any business (only collects rent from passive leases and does not have any employees), the business interest will not qualify as a closely held business interest under section 6166.
2. One approach is to not use outside rental agents but to have employees handle all real estate activities. Another alternative is to place duties on the real estate owner under the terms of the lease so as to qualify the real property as an active trade or business.

D. **Holding Companies and Tiered Entities Present Special Problems.**

1. Because of the lack of clarity of the rules under section 6166 dealing with holding companies and tiered entities, the planner must carefully review the ownership structure and activities of each entity involved so as to have certainty as to the eligibility of each entity for section 6166 deferral. In addition, intra-company debt should be reviewed to determine whether the debt will be classified as passive assets and not eligible for section 6166 deferral.
2. Hopefully, Congress and the Internal Revenue Service will act to provide clarity to these rules.

E. **Consider a Third Party Loan Structured as a Graegin Note.**

1. As an alternative to a deferring the estate tax under section 6166, the personal representative of the business owner's estate should consider a third party loan structured as a Graegin promissory note with a balloon payment loan with a fixed interest rate and a prohibition against prepayment. This approach should allow the personal representative to deduct as a cost of administration the full amount of the interest payment over the term of the loan. By deducting the interest payment as a cost of administration, the federal estate tax liability will be reduced up front.
2. If the personal representative borrows the funds from an entity controlled by the personal representative or beneficiary, the Internal Revenue Service may challenge the deductibility of the projected interest costs. To avoid

this risk, the personal representative may want to borrow the funds from a commercial lender.<sup>113</sup>

F. **Conclusion.**

1. There are many wealthy individuals with interests in closely held businesses. Upon the business owner's death, the personal representative is faced with the challenge of raising the necessary funds to pay the estate taxes attributable to the closely held business. Notwithstanding there is discussion about the repeal of the estate tax, the prudent planner should assume there will be a liquidity need for those clients with estates in excess of \$3.5 million, but the prudent planner should be reluctant to put in place irrevocable plans involving the payment of gift tax.
2. Upon the business owner's death, the personal representative has several options available to fund the payment of estate taxes attributable to the closely held business. If the business owner's estate meets certain requirements, one option available is the deferral of estate taxes under section 6166. There are several issues associated with section 6166, including the lack of clear rules as to what is an active trade or business, particularly with real estate entities, what constitutes a passive asset, particularly with tiered entities, the section 6166 lien on the business assets, and the variable interest rate over the 14-year deferral period.
3. Another option available to the business owner's estate is a third party loan. If the promissory note evidencing the loan prohibits prepayment of the loan, it may be possible to deduct all of the interest payable over the term of the loan on the federal estate tax return as a cost of administration. This reduces the interest cost of the loan by the present value of the current deduction at the marginal estate tax rate. If an entity controlled by the decedent or a beneficiary makes the fixed rate term loan to the business owner's estate, the Internal Revenue Service may challenge the deductibility of the interest.
4. Regardless of the funding arrangement, the personal representative must plan how to fund the deferred tax or loan payments. If the closely held business is a corporation taxed as a regular corporation, the personal representative must be careful in planning distributions from the

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<sup>113</sup>One commentator has suggested using variable-rate demand notes as a strategy to allow the personal representative to enter into a fixed-rate third-party loan so that interest will be deductible in full on the estate tax return. Markstein, Limited Partnerships, 2003 Institute on Estate Planning §904.2.

corporation. Unless the distribution comes within one of the exceptions set forth in the Internal Revenue Code, a distribution from the corporation will be taxed as a dividend. One exception to a distribution treated as a dividend is a distribution to pay estate taxes under section 303.

5. Because liquidity can create significant issues, it is important that the planner consider and investigate all of the options for the payment of the estate tax attributable to a closely held business. Once the personal representative has selected the appropriate option, it is important that the planner monitor the implementation so as to avoid adverse income and estate tax consequences.