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Estate Planning for the Closely Held Business

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<u>Estate Planning for the Closely Held Business</u>

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First. Introduction and Overview

I. Introduction

A. Importance of Closely Held Businesses to United States Economy

Family owned businesses are a major part of the United States economy, making up 80 to 90 percent of all businesses in North America and contributing significantly (in excess of $5 trillion) to the United States Gross Domestic Product.[1] In a study of the companies making up the S& P 500, one study found that one-third of these companies have deep family connections.[2] These families are heavily invested in the family business, and, on average, 69 percent of the family's total wealth is invested in the family enterprise. Because of the large, concentrated investment, family businesses operate in unique and efficient ways, including looking to the long term future of the business and the reputation of the family. The study also found that family businesses generally out-perform non-family businesses, posting a 6.65 percent greater return on assets than non-family businesses.[3]

The death of a closely held business owner often foretells the death of the business. Only 30 percent of all privately owned businesses survive past the first generation.[4] 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.[5] There are many reasons for the lack of survival of closely held business of future generations including lack of succession planning, business failure, and inability to meet liquidity needs (some of which is caused by the federal transfer tax laws). Business succession planning can be described as 10 percent planning and 90 percent money.

[1] J.H. Astrachan and M.C. Shanker, "Family Businesses' Contribution to the U.S. Economy: A Closer Look," Family Business Review, September 2003.

[2] Anderson, Ronald C., Mansi, Sattar A. and Reeb, David M., "Founding Family Ownership and the Agency Cost of Debt" (hereinafter "Anderson, Mansi, Reeb Study"). Available as SSRN: http://ssrn.com/abstract=303864. The study defined a "deep family connection to be the family responsible for starting the company was still heavily invested in the company, and has, on average, 18 percent of company equity.

[3] Anderson, Mansi, Reeb Study.

[4] Raymond Institute/MassMutual, American Family Business Survey, 2003.

[5] Id.

B. Internal Revenue Service 2007 Statistics Regarding Closely Held Businesses

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 2009, the Statistics of Income Division released a report entitled "Estate Tax Returns Filed in 2008; Gross Estate by Type of Property, Deductions, Taxable Estate, Estate Tax and Tax Credits, by Size of Gross Estate."[6]

The Statistics of Income report showed that approximately 38,000 estate tax returns were filed in 2008 and approximately 20 percent (7.372) 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 (590 returns had a closely held business out of 1,178 returns filed or approximately 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 nine percent of the gross estate for all estates, but the closely held stock constituted approximately 18 percent of the gross estate of estates greater than $20 million. Thus, it appears that for estate tax returns filed in 2008, the larger the estate, the more likely the estate will own a higher percentage of closely held stock. From a review of statistics for years before 2008, there is a similar pattern of ownership of closely held stock.

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

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

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[6] SOI Tax Stats - Estate Tax Statistics Filing Year 2008 can be found at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=210646,00.html and http://www.irs.gov/pub/irs-soi/08es01fy.xls.

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. 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. Extent of Estate Planning by Private Business Owners to Meet Estate Liquidity Needs

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. 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.

Business owners spend time and money on estate planning to avoid or minimize estate taxes. According to one survey,[7] 92 percent of the surveyed business owners have a basic will while 86 percent have done estate planning beyond a basic will.[8] Forty-five percent of the surveyed business owners, however, did not know the amount of estate tax liability their estates would face upon their deaths. 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.[9] The expenditures were divided among lawyers ($16,113), accountants ($14,632), and financial planners ($2,392). 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.

There are several provisions of the Internal Revenue Code offering benefits to the estate of a closely held business owner, including sections 303, 2032A, 2057, and

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[7] Astrachan and Tutterow, The Effect of Estate Taxes on Family Business: Survey Results, Family Business Review, vol. 9, no. 3, Fall 1996.

[8] Id., at page 306.

[9] Id., at page 306.

6166. Section 303 provides an income tax benefit by allowing the transfer of assets from a closely held business for an amount equal to the federal and state estate taxes and costs of administration. Section 2032A provides an estate tax benefit by valuing real property (generally farm real property) for federal estate tax purposes at the use value of the real property instead of the fair market value of the property. Until section 2057 terminated in 2003, section 2057 provided an estate tax benefit by excluding $675,000 in value from certain family businesses. Section 6166, the installment payment provision, provides an estate tax benefit by allowing the installment payment of the federal estate taxes attributable to a closely held business interest over a 14-year period at a bargain interest rate.[10] If certain stringent requirements are met, each of the above provisions can offer relief to the estate of a closely held business owner.

II. Process for Advising Private Business Owners on Meeting Liquidity Needs

A. Determine Whether the Business Owner's Estate Will Be Subject to Estate Tax

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. In addition, the 2001 Tax Act and the pending return to pre-2001 Tax Act legislation has created a great deal of uncertainty, particularly if the business owner's taxable estate is between

[10]For estates of individuals dying in 2010, there is no estate tax. For estates of individuals who died in 2009, the interest rate on the unpaid tax is two percent on the tax attributable to the first $1,330,000 of value of closely held business interests. This amount is referred to by the Internal Revenue Service as the "2-percent portion" and is indexed for inflation. The two percent interest rate applies to the first $598,500 of estate taxes, and the balance of the tax is subject to interest at 45 percent of the rate applicable to underpayment of tax (1.8 percent with an underpayment rate of four 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. In 2011, the pre-2001 Tax Act rules will be reinstated, unless Congress acts on estate tax reform. For more information on the impact of the repeal of the estate tax and the return of pre-2001 law, see http://www.mcguirewoods.com/estatetax.

$2.0 million and $3.5 million. With individuals with estates in this range, there may or may not be estate tax depending upon the year of death.[11]

The biggest uncertainty in determining whether the business owner's estate will be subject to estate tax is the status of future estate tax reform legislation. There will be many external events affecting the estate tax repeal debate that may occur before Congress acts, which makes it impossible to predict accurately what Congress will do.

Because of the significant uncertainty surrounding the federal estate tax, the prudent financial advisor will assume that the business owner will be subject to estate tax. Because of the possibility of significant reform or repeal, however, the prudent advisor may be reluctant to suggest irrevocable planning involving the payment of gift tax. Until Congress acts, prudent advisers should assume that a business owner with an estate in excess of $1.0 million will be subject to the estate tax and plan accordingly.

B. Recommend Estate Planning Techniques to Reduce Estate Tax Burden

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:

- Each of the business owner and the business owner's spouse should structure his or her property holdings and estate plans to take advantage of his or her applicable credit amounts and to shelter from taxation the balance of the assets through the marital deduction;

- The ownership of the business, as well as the choice of entity, should be structured to take advantage of valuation discounts;

- The business owner should consider making lifetime gifts to reduce estate taxes;

- The business owner should use leveraged estate planning techniques to increase the amount of tax-free transfers; and

[11] Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (referred to as the "2001 Tax Act"), for individuals dying in 2010, there is no estate tax, and in 2011 the law reverts back to pre-2001 law.

- The estate plan of the business owner should be structured to enable the personal representative to take advantage of post-mortem tax elections (Internal Revenue Code sections 6166, 303 and 2032A).

The first step in estate planning for the business owner is to make sure that each of the business owner and the business owner's spouse has structured his or her property holdings and estate plans to take advantage of the applicable credit amounts and the marital deduction. 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.

After the ownership of 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 2010 to give annually up to $13,000 ($26,000 in the case of a married couple) 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 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.

Despite the advantages of lifetime gifts, gifts do have certain disadvantages that must be considered. The donor's basis in the transferred property for income tax purposes 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 (or the applicable valuation date if alternate valuation is elected). 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. 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.[12] These techniques include: GRATs,

[12]For a discussion of estate planning techniques for private business owners,

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-canceling installment promissory note, ESOPs, and redemptions. These techniques will not be covered in this paper.

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 offers significant estate tax savings. The ownership and the business owner's estate plan should be structured to enable the personal representative to take advantage of these postmortem tax elections.

C. Using Life Insurance to Meet Liquidity Needs

An obvious and, in many instances, a practical means of providing liquidity for the private business owner's estate is life insurance. Many private business owners purchase life insurance on their lives with the insurance policies being owned by the business owner, the business, children, or irrevocable trusts. 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 (the owner may not be insurable, the cost may be prohibitive, or the owner may not "believe" in insurance).

D. Using Charitable Planning to Reduce Liquidity Needs

For owners of closely held business with an interest in supporting non-profit or charitable organizations, the use of charitable planning techniques may significantly reduce overall liquidity needs of the estate, thereby reducing the pressure on the business following the business owner's death. A properly structured charitable lead trust may generate a significant deduction for the estate and allow the family capital to remain in tact for future generations.

E. Section 6166 and the Deferral of Estate Taxes Attributable to a Closely Held Business

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see Mezzullo, 809-2nd T.M., Estate Planning for Owners of Closely Held Business Interests.

Using section 6166, a closely held business owner may successfully defer the estate taxes attributable to an interest in a private business. Deferring estate taxes using this technique is not without obstacles and careful planning is required. In addition to corporate distributions, a business owner may consider funding deferred estate tax payments with corporate stock redemptions under section 303. An alternative strategy to section 6166 involves third party borrowing with an estate tax deduction for the interest payments.

F. Scope of Paper

This paper will cover planning to meet the liquidity needs of the estate of the private business owner using funds from the private business.

- The first section contains an overview of the importance of closely held businesses in our economy and the transfer tax challenges facing the closely held business owner.

- The second section will address estate planning with life insurance for the closely held business owner. The paper will discuss the most efficient way for a business owner to structure the ownership of life insurance to allow for continued family ownership of the business interests. The paper will not address corporate owned life insurance, split-dollar insurance arrangements, or life insurance in the context of buy-sell agreements.

- The third section will address charitable planning techniques available to reduce the liquidity needs in the estate of a closely held business owner.

- The fourth section will address Internal Revenue Code section 6166 and the deferral of estate taxes attributable to a closely held business.

Second. **<u>Estate Planning with Life Insurance for the Closely Held Business Owner</u>**

I. The Importance of Life Insurance in Estate Planning

A. Reasons for purchasing life insurance

The reasons for purchasing life insurance are as varied as the financial circumstances of individuals and families. However, for most people, the reasons fall into one or more of the following categories:

- <u>Income Replacement</u>. Life insurance can be used to provide for the support and education of a spouse and descendants in the event of an individual's unexpected death and the loss of his or her salary.

- <u>Liquidity</u>. Individuals also purchase life insurance to provide liquidity at death. Liquidity might be needed for support purposes, even though the individual owns significant assets, because those assets are illiquid, such as real estate or closely held business interests. An individual whose estate consists largely of illiquid assets also needs liquidity to provide for the payment of estate taxes.

- <u>Estate Tax Replacement</u>. Some people prefer to fund the payment of estate taxes through insurance proceeds, even though their estate is relatively liquid, because of a desire not to erode the estate through the tax payments.

- <u>As an Investment</u>. Life insurance that meets applicable statutory requirements is exempt from income tax, including income tax on any "inside build-up" of cash value under the policy. As a result, life insurance products may compare favorably to alternative investments, notwithstanding the commissions and administrative costs that are deducted from premium deposits. Life insurance also may be an attractive investment because it will provide a fixed, known amount of funds at death, regardless of when death occurs.

An owner of a closely held business has the particular need for liquidity, addressed above. Because the value of the business will generate a significant tax liability, insurance proceeds may be necessary to pay that liability.

B. Types of Life Insurance Products

The most basic type of policy is term insurance. It consists of coverage for a particular period in return for payment of a specified premium. Term insurance, in one form or another, is often a component of all of the more complex types of insurance products, such as whole life, variable life, universal life, and private placement insurance. These types of insurance can best be described as various ways of adding an investment vehicle onto pure insurance coverage.

The type of policy selected by a closely held business owner will depend largely on availability of cash flow to pay premiums and the anticipated timing and amount of cash needs at the owner's death.

C. Term Insurance

A term life insurance policy may be renewable or nonrenewable. If the policy is renewable, the insurance company guarantees that it will renew the policy for another term without requiring the insured to undergo a medical examination at that time. Term policies may also be convertible, which means that the owner can convert the term policy to a cash value type of insurance, such as whole life or universal life.

Renewable term policies may be renewed every year, or they may be renewable for periods of five or 10 years, but they sometimes last as long as 15 or 20 years.

D. Whole Life Insurance

Whole life insurance policies generally provide insurance protection while accumulating cash value in the investment portion of the policy. The premium, at least during the early years of the policy, is much larger than the premium would be for a term policy with equivalent protection. The investment portion is not paid to the beneficiary in addition to the policy's death benefit. Rather, it gives the policy value if it is surrendered during the insured's life. Ordinarily, the premium remains level during the life of the insured. In addition, the insurance coverage, or a portion of it, is guaranteed by the issuer. The cash value buildup of a whole life policy is tax deferred. It is taxed only if withdrawn from policy, and not taxed at all if it is received in the form of death benefit proceeds.

Some whole life policies also pay dividends to the owner of the policy in an amount determined by the issuer's investment earnings, the death benefits that the issuer has paid to all policyholders during the relevant earnings period, and other expenses that it has incurred during that period. The dividends may be taken in cash, used to pay premiums, left to accumulate, or used to purchase additional insurance.

E. Variable Life Insurance

Variable life is similar to whole life insurance, except that the investment portion of the variable life premium goes into one or more funds that the insured or the owner of the policy chooses, where it grows tax deferred. Thus, the investment risk is shifted from the insurance company to the policyholder.

Dividends on variable life policies are rare and are based only on the mortality and expense experience of the issuer, and not the investment experience.

F. Universal Life Insurance

Universal life insurance combines term insurance with a savings account. The premium goes into an accumulation fund on which the company pays interest, but from which it also deducts money to pay for the term insurance part of the policy. The deduction is referred to as a mortality charge. The company also deducts an amount for expenses. The insurance company provides an annual account that itemizes the mortality charges, expenses, and investment credits of the policy, which allows the policyholder the flexibility of increasing or decreasing both the face value and the premium.

A universal variable life policy is similar to a standard universal life policy, except that with universal variable life, the insured is not limited to current-interest-rate investments.

G. Private Placement Insurance

Some insurance companies offer a private placement variable life insurance product to certain investors in which the cash value account is invested in one or more funds managed by an outside investment manager. Private placement insurance thus offers the level of investment sophistication and flexibility that many very wealthy clients demand, and in a form in which earnings can accumulate tax free. The investment portion of a private placement policy is frequently paid in the form of a single premium of at least $1 million, but sometimes as much as $10 million or $20 million, or even more.

Even though the owner may be able to borrow from the policy or make tax-free withdrawals to the extent of the owner's investment, many private placement polices are treated as modified endowment contracts, in which distributions from the account to the owner during life, including loans, will be treated as ordinary income first and as recovery of the owner's investment second. IRC § 72(e)(3).

H. Second-to-Die Policies or Survivorship Insurance

The second-to-die policy is a contract whereby any type of insurance policy provides coverage for two lives and is payable to the designated beneficiaries only upon the death of the last to die of the two lives.

Because such policies are not payable until the death of the survivor, the premiums are significantly less than premiums on single life coverage.

I. Split-Dollar Insurance

The split-dollar arrangement is not a type of policy but rather an arrangement by which the ownership and payment of premiums are split between an employer and an employee and may be used with any of the various types of policies available. It is discussed further later in these materials.

II. Selecting and Evaluating Life Insurance Products

A. Selecting a Life Insurance Company

Even when investment is not one of the purposes for purchasing life insurance, the prospective purchaser of a policy should nevertheless view the purchase as an investment with the company issuing the policy.

Like any careful investor, the business owner should make a thorough inquiry into the company or companies being considered. Among the factors that should be considered in selecting an insurance company are:

- Its investment performance and the level of risk of its investments;
- Its mortality experience among its policyholders;
- The percentage of insurance business lost from lapsing policies other than because of a death claim; and
- The ratio of expenses to premiums.

Information to help a prospective purchaser evaluate insurance companies with respect to these factors is available from state regulators, independent private rating services, and the annual reports of the companies.

B. Investment Performance and Risk

The ability of an insurance company to invest its funds will impact its ability to pay benefits under an insurance policy, the amount of cash value accruing to the insured's benefit, and the length of time that the owner will have to pay premiums before the policy will support itself.

The primary reason for recent financial problems in the insurance industry has been the high concentration of companies' investment portfolios in junk bonds and commercial real estate mortgages. The high yields of these investments helped support extraordinary internal rates of return on policies, but ultimately the riskiness of investments caught up with the companies, with disastrous results for policy holders.

A prospective purchaser should examine the historical investment performance of the insurance company, looking not only at the level of return being obtained by the company, but also the stability of return and the risk level in the company's investment portfolio. Rating services can provide information on the mix of an insurance company's investments and the mix of investment grades (AAA, AA, etc.) in the company's bond portfolio.

When considering actual policy illustrations, the prospective purchaser should be sure to ask about the yield assumption being used for projecting future cash values, etc. The yield should be consistent with both the company's historical investment performance and current market conditions. For example, an illustration assuming a 10 percent internal rate of return is suspect if current market rates of return are not above 7 percent. Even when the yield appears consistent and realistic, it is often useful to ask for a projection for the policy using a more conservative interest rate. This lets the prospective purchase see what policy performance would be if investment results are less than expected.

C. Other Factors

- Mortality Experience. A life insurance company that is less selective in issuing policies will experience a higher mortality rate among its policy holders. This will result in higher costs to the company and less favorable performance for its insurance products.

- Lapse Ratio. The lapse ratio measures the percentage of insurance business lost through lapses of policies (other than through a death claim). A low level of lapses indicates a larger base of insured individuals over which to spread operating expenses and mortality risk. It also means better cash flow for investments.

- Expenses. The ratio of expense to premiums for a company measures the percentage of premiums needed to pay expenses. The lower the ratio, the more available for allocation to other accounts like reserves and policy dividends.

- Diversification. Particularly for large coverages, it may be wise to consider using two or more insurance companies to underwrite the policies. In effect, the purchaser who does this is diversifying his insurance investment and spreading the risk.

D. Financial Analysis of Life Insurance Products

The various approaches to making a financial analysis of a life insurance policy, all of which are subject to error to the extent that they are based upon assumptions, include:

- Analysis of the total cash value available to the policyholder as of a particular date, subtracted from the total premiums that will have been paid by that date;

- A method that takes into account the time value of money as applied to the numbers provided by the previous method;

- An analysis of how much of the future value of the premium stream, at an assumed interest rate, is retained by the insurance company upon termination of the contract;

- An analysis of an index based on the assumption that the policy will continue in force, with the cash value of the policy not available to the policy owner and dividends and five-percent interest on those dividends available to the policy owner in participating policies; an analysis of an index based on the assumption that the cash surrender value of the policy and any termination dividend at policy termination will be available, along with the dividends and interest earnings;

- Mathematically analyzing the policy as the equivalent of a combination of decreasing term insurance and a savings fund; and

- A complex analysis based on the premise that the protection provided by a policy is not the full face amount of the policy but rather the face amount minus its cash surrender value.

Policy illustrations, which contain projections as to the face amount of the policy, premium, guaranteed cash value, and dividends, are a useful source of information for the financial analysis of a life insurance policy. However, illustrations can be especially unreliable with respect to interest-sensitive and investment-sensitive whole life, universal life, and variable life policies. It is also important to know the yield assumptions used in the projections of cash values and other investment factors.

III. Estate Tax Treatment

A. Estate Tax Treatment of Insurance Proceeds

Under Section 2042 of the Code, the gross estate includes the proceeds of life insurance on the life of the decedent to the extent that:

- The proceeds are received by the executor of the decedent's estate (IRC § 2042(i)); or

- The proceeds are received by other beneficiaries and, with respect to policy, the decedent possessed “any incidents of ownership, exercisable either alone or in conjunction with any other person." IRC § 2042(2).

B. Incidents of Ownership

The term "incidents of ownership" is not limited to ownership of the policy in the technical legal sense. It also includes the right of the insured to alter the economic benefits of the policy, such as the power to change the beneficiary, to surrender or cancel the policy, to revoke an assignment, to pledge the policy for a loan, and to obtain from the insurer a loan against the surrender value of the policy. IRC § 2038(a).

In determining whether a decedent held incidents of ownership with respect to a policy, the terms of the insurance contract govern, even if under the circumstances the decedent was unable to exercise those incidents of ownership. The term "incidents of ownership" also includes a reversionary interest in the policy or its proceeds, whether such interest arises by the express terms of the policy or instrument or by operation of law, but only if the value of the reversionary interest, immediately before the death of the decedent, exceeds five percent of the value of the policy. IRC § 2042(2).

If the insured is trustee of a trust holding a policy on the insured's life, the incidents of ownership held by the insured as trustee will ordinarily cause the life insurance proceeds to be included in the insured's estate. However, the mere possession of fiduciary powers with respect to a policy on one's own life is not an incident of ownership, as long as those powers cannot be exercised for the insured's personal benefit, where the insured was not the transferor of the policy and did not provide any of the consideration for its purchase.

A closely held business owner will remain subject to the three-year rule (IRC § 2035) after assigning his or her rights in a group term policy to an irrevocable trust if his or her corporation still possesses ownership rights in the group term policy.

IV. Irrevocable Life Insurance Trusts

A. Benefits of Irrevocable Life Insurance Trusts

Because the proceeds of life insurance that is owned by the insured or payable to the insured's estate are includible in the insured's gross estate for federal estate tax purposes, removing life insurance proceeds from the estate of the insured has long been an important estate planning goal. One of the best techniques to accomplish this is to transfer the policy to an irrevocable trust.

If the transfer is done properly, the trustee of the trust will become the owner of the policy and will receive the proceeds at the insured's death, without diminution by estate tax.

The trust can provide a vehicle for managing the insurance proceeds for the beneficiaries, specifically the proceeds can be used to provide liquidity to an estate. The trustee can act to purchase the closely held business interest from the estate following the owner's death. The estate benefits from the liquidity and can pay the estate tax. The closely held business interest is held intact and managed by the trustees for the benefit of the named beneficiaries. While the trust terms can be structured to distribute interests to the beneficiaries outright, long-term trusts provide additional creditor protection for beneficiaries and allow the business owner to plan for multiple generations and potentially avoid generation-skipping transfer tax as discussed below.

B. Characteristics of Irrevocable Life Insurance Trusts

Life insurance can be held in almost any type of irrevocable trust. A typical irrevocable insurance trust funded with a policy or policies on the life of the grantor will provide initially for the creation of a single trust for the benefit of some combination of the insured's spouse, children, and other descendants. The trustee will pay the insurance premiums either out of other assets initially transferred to the trust and income therefrom or using annual gifts made specifically by the insured to cover the premium payments.

<u>Provision During Life of the Insured</u>. During the lifetime of the insured, the trustee should be given standard investment and trust administration powers, including the power to make discretionary distributions to the trust beneficiaries. Some draftspersons make the mistake of not including any distribution powers during the life of the insured, assuming that there is nothing to distribute if the trust holds only a life insurance policy. This greatly restricts the trustee, who should always have the option to distribute the policy or convert it to cash and distribute the proceeds if it no longer makes sense to have the insurance held in a trust.

It is particularly important that the trustee have powers with respect to any insurance policies held by the trust, including the power to borrow against the cash value of the policy, to elect the treatment of policy dividends (e.g., accumulate in the policy or pay out to the trustee as they accrue), and to sell or transfer any policy, in short, any power that the insured, as owner, would have with respect to the policy.

If *Crummey* withdrawal rights are being used to make contributions qualify for the gift tax annual exclusion, the trust should also contain provisions allowing the policy value itself to be available to the beneficiaries for withdrawal.

Administering the Insurance Proceeds. At the insured's death, after the insurance proceeds are received, those proceeds can be retained in a single trust—as is often the case if the surviving spouse is a beneficiary—or be divided among separate trusts for children. An endless number of options for structuring such trusts are available, just as there are for structuring trusts in a testamentary estate plan. For example, if the trust instrument creates separate trusts for the grantor's children, each child can be given a broad, nontaxable power of appointment, thereby permitting him or her to decide whether to vest the property in his or her children (the grantor's grandchildren) or to continue the assets in trust for the benefit of younger generations.

Life insurance also can be used to fund a so-called dynasty trust, which is established to last for a number of generations. Insurance is often used to fund dynasty trusts because of the leverage that it provides. That is, the insurance policy can be transferred and maintained at a relatively low cost, thus using a minimal amount of the insured's exemption from the generation-skipping transfer (GST) tax. If the transferor uses the GST exemption to fully exempt from GST tax all transfers to the trust (such as transfers to pay premiums), the insurance proceeds will be exempt when received. Thus, the proceeds can be sheltered from GST tax so long as they remain in the trust. A dynasty trust can be maintained as a one-pot trust or it can be divided into separate trusts for each child's family or for each descendant.

C. Trustee Provisions

Any trust instrument that is drafted in anticipation of the trust holding life insurance should clearly authorize the trustee to invest part or all of the trust assets in life insurance. A well-drafted trust will contain broad authorization to invest in a variety of different life insurance products. In addition, the trustee should be given clear authority to exercise all ownership rights with respect to the policy.

Life insurance is not generally associated with active trustee management. In a typical irrevocable insurance trust, the trustee's activities are usually limited to purchasing the policy (or accepting an existing policy from the grantor), paying the annual premiums, and sending any *Crummey* notices that may be required.

Nevertheless, the trustee's actions, or inaction, can expose the trustee to potential liability. Indeed, there have been a number of situations in which a trustee's actions have been questioned or a trustee has been threatened with litigation in regard to the purchase of an insurance policy (even though the grantor was the dominant party in making the selection) or the decision to retain, terminate, or convert, or the failure to convert, a policy.

For these reasons, it may be advisable to exonerate the trustee from liability for purchasing and retaining life insurance and for the exercise or nonexercise of ownership rights with respect to the policy.

The trustee also could ask for trustee indemnification provisions. For example, the trustee could obtain letters from the settlor or trust beneficiaries or both approving the investments in insurance and indemnifying the trustee from any claims that might be brought against the trustee as a consequence of those investments. However, the indemnity feature is one of uncertain enforceability. In addition, either an exoneration or an indemnity for a willful or grossly negligent breach of trust probably is not enforceable because it would be contrary to public policy.

The possible exposure to liability also suggests that the trustee should undertake periodic reviews of the policy and the issuing insurance company to determine if the particular policy remains an appropriate investment for the trust. The trust instrument should permit the trustee to exchange, convert, or cash in the policy so that the trustee has authority to change to another policy if circumstances warrant. Another approach, especially if there is a corporate fiduciary, is to permit the trustee to rely upon the advice of an outside advisor, such as an insurance agent or financial advisor, in making the decision to purchase an insurance policy or to continue to hold an insurance policy.

The trustee also could obtain "comfort letters" from the insurance agent or other advisors or from the insured, indicating continued approval of the insurance investments. Although none of these indicia of approval would excuse a knowing breach of trust, they may provide a record of an appropriate level of inquiry on the part of the fiduciary as to whether the investment is prudent and continues to be in accordance with the purposes of the trust. A letter from the insurance agent confirming that the policy continues to perform well, that the insurance company is not in financial trouble, and that available policy elections are being made properly is certainly a worthwhile document to have in the file.

D. Lifetime "Bail-Out" Provisions

As previously suggested, an important provision for an irrevocable insurance trust is a flexible distribution power during the life of the insured that can be used to terminate the trust if changes in the tax laws or other circumstances make it no longer desirable to retain the life insurance in trust. Such a “bail-out” provision can be in the form of a distribution provision subject to a nonascertainable standard (as previously discussed), or a trust termination provision that permits the trustee to terminate the trust if it no longer is economical to administer. Neither of these powers should be exercisable by a trustee who is also a beneficiary.

These provisions are especially important with the impending sunset of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the “2001 Tax Act”), and the uncertainty as to the whether, or how much, estate tax will be due upon an business owner’s death.

E. Savings Clause

It is common for irrevocable insurance trusts to contain a savings clause that applies if any policy proceeds are included in the insured's estate for federal estate tax purposes. In this case, the trust instrument can provide that those proceeds will be distributed to the insured's estate (or a revocable living trust, if applicable), where they presumably can be funneled to a marital deduction bequest that will defer the estate taxes. Or, the proceeds could be allocated directly to a marital trust created under the irrevocable trust agreement. These savings clauses are particularly important if the insured is transferring a preexisting policy to the trust.

If an insured transfers an interest in a life insurance policy within three years of death, the policy proceeds will be included in the insured's gross estate under IRC § 2035(a). Thus, an insured who transfers a previously issued policy to an irrevocable insurance trust must live for at least three years after the transfer. If the insured dies during the three-year period, the savings clause will help to minimize taxes.

F. Powers of Appointment

Because the trust is irrevocable and thus cannot be changed to reflect changing circumstances in the family, or even changes in the tax laws, it is important to maintain maximum flexibility in the trust instrument.

Flexibility can be built into the trust instrument by providing lifetime or testamentary powers of appointment that permit one or more beneficiaries to alter the future beneficial provisions of the trust. As is the case when drafting any trust, these powers can be drafted broadly or narrowly depending on the client's goals and willingness to leave planning decisions to a spouse or descendants.

G. Fiduciary Powers to Amend

Another way to provide flexibility in an irrevocable insurance trust is to include a power of amendment or trust protector provision. For many years, practitioners in the United Kingdom and other English common-law jurisdictions, as well as practitioners in tax-haven jurisdictions, have used the concept of a "trust protector" to provide added flexibility to an irrevocable trust.

The trust protector's fiduciary role is to modify the terms of the trust when necessary or appropriate to carry out the grantor's intent and may be limited to such things as removing and replacing trustees or moving the situs of the trust. Or, the trust protector's power of amendment may be extremely broad, encompassing an ability to change the dispositive terms of the trust or transfer the property to an entirely new trust.

The grantor can give this power of amendment to one of the trustees or to a separately appointed fiduciary, or committee of fiduciaries, who will act independently of the trustees. At a minimum, the power of amendment can permit the fiduciary to address tax or other legal changes that affect administration of the trust and to correct ambiguities that might otherwise require court construction. A power of amendment is a powerful tool, and it can be misused in the wrong hands. It must be carefully defined, and the person or persons designated to exercise it must be carefully selected.

H. Selection of Trustees

As the preceding discussion indicates, the administration of an irrevocable life insurance trust does require some affirmative oversight by the trustee even during the life of the insured. However, if the trust holds only one or more insurance policies, the trustee's activities and obligations will be limited.

For this reason, many business owners select a family member or other individual to act as trustee, at least during the insured's life. A corporate fiduciary named to act during the life of the insured will have to satisfy itself that it can fulfill its fiduciary obligations for the minimal fee that the trust settlor invariably will expect to be charged.

Because the trustees of the trust may be directed by the business owner to purchase the closely held business interests, a business owner should carefully select the fiduciaries charged with overseeing the business. A family member may serve a valuable role in understanding the inter-personal dynamics of individual beneficiaries and distribution decisions, and a corporate fiduciary may be suited to serve as an administrative trustee. Neither, however, may be have the acumen to make the necessary business decisions to keep the enterprise active.

In many ways, the trustees selected to oversee the business interests must step into the shoes of the business owner. If the business has a board of directors, the trustee, as the owner of the business interest, will elect the directors. If there is no board, the trustee will select the officers and manger to run the company. For this reason, the business owner may wish to select trusted advisors – legal, tax, and financial advisors – familiar with the operations and history of the business to serve as trustees.

While long-term and trusted employees of the business will be a valuable source of knowledge to the family and the trustees, those employees may not, depending on the circumstances, have a role as trustee. The trustees tasked with making decisions with respect to the business interest must take a long-term view of the enterprise to ensure that the directors and officers and managers are performing up to industry standards. The business owner may with to include standards by which the trustees, directors, officers, and managers must meet or be faced with removal by the beneficiaries.

The diagram below shows a potential structure of ownership of a closely held enterprise, following the business owner's death:

Closely Held, Inc.
Governance

Trustees of the Insurance Trust
Owners of Interest in Closely Held, Inc.

<u>Standards of Performance</u>

If company performance lags comparable public company performance for…
- o 8 quarters,
- o 12 quarters, or
- o 16 quarters

…then a predetermined number of Trustees of the Insurance Trust can be replaced by family members/beneficiaries of the Insurance Trust.

Elect

Directors
Closely Held, Inc.

<u>Standards of Performance</u>

If company performance lags comparable public company performance for…
- o 4 quarters,
- o 8 quarters, or
- o 12 quarters

…then a predetermined number of Directors can be replaced by the Trustees of the Insurance Trust.

Elect

Officers
Closely Held, Inc.

<u>Standards of Performance</u>

If company performance lags comparable public company performance for…
- o 2 quarters,
- o 4 quarters,
- o 6 quarters, or
- o 8 quarters

…then a predetermined number of Officers can be replaced by the Board of Directors.

Control

Closely Held, Inc.

<u>Measurements of Company Performance</u>

The following measures of company performance may be relevant for the Trustees, Directors, and Officers Standards of Performance:
- o Revenue/Earnings
- o Gross Profit
- o Net Income to Shareholders
- o Expansion and Growth

V. Funding the Irrevocable Life Insurance Trust

There are two ways in which an irrevocable insurance trust can be funded with a life insurance policy. The simplest way is for the trust to purchase the policy as initial applicant, owner, and beneficiary. This avoids any possible inclusion of the policy proceeds in the insured's estate pursuant to the three-year rule of IRC § 2035.

The second way is to transfer an existing policy to the trust. In order to make such a transfer, several steps must be taken. The initial owner of the policy must send to the insurance company a completed change of owner form, and the trustee of the trust, as new owner, must send a completed change of beneficiary form (in practice, these two "forms" are sometimes separate sections of a single form provided by the insurance company) along with a certificate of trust form, showing the name and date of the trust and the name of the trustee. The insurance company usually also requires that a copy of the trust agreement be provided.

If an existing policy that has cash value is transferred to the trust, the transfer of the policy will be considered a gift for gift tax purposes. Therefore, when the change of ownership forms are sent to the insurance company, the insured should also request that the company provide IRS Form 712, Life Insurance Statement, which will indicate the value of the policy that is transferred to the trust. The completed Form 712 is then used to prepare the federal gift tax return, Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, that will be due on April 15 of the year following the transfer of the policy to the trust. IRC § 6075(b).

Before the grantor makes contributions to the trust (to pay premiums (for example), the trustee should establish a checking account in the trustee's name. Any contributions then will be placed in the account, and any distributions from or payments by the trust will be paid from that account. It may not be necessary to open such a checking account if an insurance policy is the only asset of the trust and the premiums will be paid directly to the insurance company by the insured. However, the observance of this formality may be advisable in order to support a showing that the trust is a separate entity not controlled by the insured.

A. Tax Reporting on Trust Income

If a trust is funded exclusively with life insurance, there generally will be no taxable income to report. Life insurance companies normally will request a federal identification number for the trust purchasing the policy. If the trustee does obtain a number, the trustee either will have to file income tax returns or respond to annual inquiries from the IRS asking for returns.

If the trust has an interest-bearing account through which premium payments are made, it may have taxable income to report.

In many situations, the tax reporting can be kept simple because the trust will be a grantor trust for income tax purposes, and the income can be reported directly on the personal tax return of the grantor of the trust.

If the trust states that trust income and principal can be used to pay premiums on life insurance on the life of the grantor or the grantor's spouse (as typically is the case) and the trust actually owns a policy, then it will be a grantor trust under IRC § 677(a)(3).

In addition, if the grantor's spouse is a discretionary beneficiary of trust income or principal, the trust will be a grantor trust under IRC § 677(a)(1).

If the trust is a grantor trust, the trustee can choose to report all income under the social security number of the grantor, rather than obtaining a separate taxpayer identification number for the trust. See Treas. Reg. § 1.671-4(b). Many institutions and individuals are not aware that this option is available to any grantor trust, regardless of who is acting as trustee. They may think that old rules, that allowed use of the grantor's social security number only if the grantor is trustee, are still in effect. The IRS changed these rules in 1995.

B. Moving a Policy to a New Trust

The trustee of an irrevocable life insurance trust holding an insurance policy with undesirable terms is limited in its options as to how to move the policy to a trust with more advantageous terms.

The problem is that if the policy is simply purchased by another trust, a transfer for value would occur and this would subject the proceeds when received to income tax under IRC § 101(a)(2).

The transfer for value rules provide that the proceeds of life insurance will not be subject to the general exemption from income tax if the policy is transferred for consideration. In that case, the policy is treated like any other capital asset and the proceeds subject to income tax to the extent they exceed the purchaser's basis. There are five types of transfers that are not treated as transfers for value:

- a transfer where the transferee's basis is determined by reference to the transferor's basis (most typically a transfer by gift);
- a transfer to the insured;
- a transfer to a partner of the insured;
- a transfer to a partnership in which the insured is a partner; and

- a transfer to a corporation in which the insured is a shareholder or officer.

There are three common ways in which an insurance policy can be moved out of an irrevocable trust without creating a transfer for value.

First, the insured could purchase the policy from the trust. The problem with this option is that the insured now owns the policy and, unless it is re-transferred at least three years before the insured's death, it will be includable in the insured's estate.

The second option is to create a new irrevocable trust and have the new trust and the insured form a partnership. The new trust or the partnership then would purchase the policy. Of course, this involves the added burden of forming and administering a partnership. Most practitioners advise that the partnership should have assets other than just cash or the insurance policy to give it legitimacy.

The third option, if the initial trust is a grantor trust, is to create a new trust that is also a grantor trust for income tax purposes. The new trust would purchase the policy from the original trust. Because the new trust is a grantor trust, the purchase is treated for income tax purposes as if the insured had purchased the policy from the original trust, pursuant to Revenue Ruling 85-13, 1985-1 C.B. 184, which provides that a transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. Therefore, the purchase of the policy by the grantor trust would not be a transfer for value.

VI. Paying the Premiums: Gift Tax Issues and Permanent Funding for the Irrevocable Life Insurance Trusts

Although transfer tax issues are not unique to irrevocable trusts designed to hold life insurance, a number of special issues do arise, including the method of making premium payments; the availability of gift splitting between the donor and his or her spouse for contributions to the trust, particularly if the spouse is also a beneficiary of the trust; the use of *Crummey* powers of withdrawal for qualifying premium payments for the gift tax annual exclusion; and the gift tax consequences to the beneficiary holding a *Crummey* power that arise upon the lapse of the power.

A. Payment of Premiums

Except in rare situations, such as with a single-premium universal life policy, once a life insurance policy is transferred to a trust, premiums must continue to be paid. The premiums may be paid in several ways. The donor can add sufficient funds to the trust each year to cover the annual premium payments. Alternatively, the donor can make a large initial gift of property to the trust, which the trustee can draw from to cover future premium payments. It is also permissible for someone other than the trustee, such as the donor, to make premium payments directly to the insurance company from nontrust assets. Such direct premium payments will, nevertheless, be treated as gifts to the trust, referred to as a "constructive gift", for gift tax purposes. IRC § 2511(a).

A business owner may wish to continue to make premium payments directly to the insurance company after transferring a life insurance policy to an irrevocable trust. The trust instrument should contemplate this possibility and make clear that a direct payment of a premium is considered a transfer to the trust that gives rise to *Crummey* powers of withdrawal. Nevertheless, the business onwer should be strongly encouraged to make actual cash transfers to the trust and allow the trustee to make the premium payments. This will help eliminate any appearance that the trustee is simply acting as the insured's agent. It also will help prevent the IRS from questioning whether there was adequate property in the trust to satisfy the *Crummey* powers during the period that such powers could be exercised.

Many clients will loan money, either from the business or from personal funds, to the trust using low-interest (AFR) loans. While this can provide short-term liquidity to the trust to allow it to purchase and initially maintain the insurance, it can often sink the technique in the long-term. Without adequate and independent funding, the trustees will continue to borrow funds and be obligated to repay the loans from the proceeds of the insurance at the business owner's death, leaving little in the trust for purchasing the business interest.

Some policies provide that, after a certain number of years when the annual increase in the cash value of the policy and/or policy dividends has reached a sufficient level, cash-value additions or dividends, or both in combination, may be used to cover the premium payments. This eliminates the need to make additional premium payments to the trust (or directly to the insurance company on behalf of the trust). The use of cash-value additions or dividends to cover premium payments does not constitute gifts to the trust for gift tax purposes.

Even before premium payments vanish, there may be additional methods of relieving the donor, or the donor's employer, from the need to continue making premium payments. If the trust has assets other than the policy, those assets, or the income on those assets, may also be used to pay premiums. If permitted by the policy, the trust may also borrow against the cash value of the policy and use the proceeds to pay premiums.

B. Gift-Splitting Under IRC § 2513

An insured can treat gifts made to an irrevocable insurance trust as made one-half by his or her spouse, with the spouse's consent. IRC § 2513. This allows use of the unified credit of both spouses and, if applicable, the gift tax annual exclusions of both. This will allow the business owner to double the gifts to the trust and reduce any loan balances, but he or she must attend to the gift splitting rules if and when the spouse serves as trustee of the trust or is named as beneficiary under the trust.

C. Using Crummey Powers to Make Annual Exclusion Gifts

Neither the transfer of an insurance policy to an irrevocable trust nor the payment of premiums on the policy will qualify for the gift tax annual exclusion unless the trust instrument contains provisions that give one or more of the trust beneficiaries a present interest in the transfers. IRC § 2503(b), Treas. Reg. §25.2503-3(a), and Treas. Reg. §25.2503-3(c), Example (2). Provisions that grant a present interest in transfers to the trust typically take the form of what are called "*Crummey* powers," named after the court decision that confirmed the effectiveness of such provisions. Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968).

A *Crummey* power is a limited duration, usually noncumulative, power of withdrawal granted to a trust beneficiary. The power gives the beneficiary the right to immediate possession of that part of the property transferred to the trust that is subject to the power. The *Crummey* power usually applies both to the initial contribution to the trust and to subsequent contributions. This right of immediate possession transforms all or part of each gift to the trust into a gift of a present interest for gift tax purposes. The requirements for valid *Crummey* powers are discussed in the following paragraphs.

Notice of Withdrawal Right. The trust instrument should require the trustee to give notice to each *Crummey* power beneficiary of each contribution to the trust that gives rise to withdrawal rights. In order for the *Crummey* power to be valid, the beneficiary must have actual knowledge of the withdrawal right and a reasonable opportunity to exercise it. Although it does not appear that written notice is required, questions of proof suggest that written notice is the better practice.

The IRS has ruled privately that a single notice at the time of the initial contribution to the trust that set out the premium amounts to be contributed in the future and the dates of contribution constituted adequate "continuing notice" of the withdrawal rights. Letter Ruling 8121069. It appears that some practitioners follow this practice. It does, however, give the IRS a greater opportunity to question the adequacy of notice.

The IRS has ruled privately that an advance waiver of notice by the beneficiaries (that is, a statement waiving future notices of contributions) is ground for denying an annual exclusion for those future contributions. See Technical Advice Memorandum 9532001. It is not clear whether the 1995 technical advice memorandum was intended to override the 1981 letter ruling, but it suggests that it may be risky to rely on a single continuing notice.

Time Period for Exercise of Withdrawal Right. No rule explicitly states how much time a beneficiary must have to exercise a withdrawal right. Typically, the beneficiary is given 30 to 60 days.

The Tax Court has approved a 15-day exercise period. See Estate of Cristofani v. Comm'r, 97 T.C. 74 (1991) (acq. in result, Action on Decision 1992-09, 1992-1 C.B. 1.

Availability of Sufficient Property for Withdrawal. So long as a gift to the trust subject to *Crummey* powers is in the form of cash, and the cash is retained until the powers lapse, no questions arise concerning the actual ability of the beneficiaries to exercise their withdrawal rights. In an irrevocable insurance trust, however, the gift may consist of a life insurance policy itself.

In addition, the insured, instead of contributing cash to the trust for premium payments, may make those payments directly to the insurance company (thereby making a constructive gift to the trust). Therefore, the only trust asset is the life insurance policy. In such cases, there may be a question concerning the validity of the *Crummey* powers. The IRS has ruled that the *Crummey* power will be effective if it is clear that the withdrawal right could be satisfied with any trust assets, including the life insurance policy itself, or if the trustee has the authority and ability to raise cash by selling assets or borrowing funds.

If the trust contains only term insurance, however, there may be no realistic source for satisfying a withdrawal right and the IRS could challenge any claimed annual exclusions if funds are not actually placed in the trust for an appropriate period of time prior to being used to pay the insurance premium. If group insurance is the only asset of the trust, there is no way to avoid this problem.

Care must also be taken if more than one beneficiary is given a *Crummey* power in a single trust. If there are multiple donees and insufficient trust property to make sure that each donee will be able to fully exercise his or her power of withdrawal, the full annual exclusion may not be available with respect to the gifts to any of the beneficiaries. It is also important that the trust instrument prohibit the trustee from exercising discretionary distribution rights in a way that would impair or negate a beneficiary's ability to exercise his or her *Crummey* power.

Ability of Minor to Exercise Withdrawal Rights. Local law usually forbids a minor to exercise a withdrawal right in a trust. The IRS has ruled that a minor will have a present interest in a trust only if there is no “impediment” under the trust or local law to the appointment of a guardian who could exercise the withdrawal right on the minor's behalf. Rev. Rul. 73-405, 1973-2 C.B. 321.

This does not require that a guardian actually be appointed. The trust instrument can identify a parent or other adult representative of the child who is empowered to exercise the withdrawal right on behalf of a minor (or incompetent) beneficiary. The trust also should direct that the parent or designated guardian be notified of the withdrawal right. The grantor of the trust, or a donor to the trust, probably should not act as guardian of a minor beneficiary for *Crummey* power purposes in order to avoid a claim that the grantor or donor has retained a power in the trust.

Naming the donor's spouse as the minor's representative should not cause the power to be illusory for these purposes since the spouse, as guardian, has fiduciary obligations to the minor beneficiary. See Letter Ruling 8712014. The spouse in this letter ruling had been appointed guardian of his minor child by the circuit court of the local county, which suggests that some caution should be exercised in relying on it. However, the IRS has not raised the identity of the representative for the minor as an issue in many years.

Beneficiaries Must Have Real Interests in the Trust. Some aggressive tax planners have attempted to multiply the number of annual exclusions available by granting *Crummey* powers to nominal beneficiaries who have no interests in a trust other than a *Crummey* power of withdrawal. This practice may result in the nonrecognition by the IRS of the annual exclusion for transfers to the trust.

For example, the IRS has ruled that, where each of three partners created a trust for his children and granted the other two partners *Crummey* powers, the powers were reciprocal and none of the partners was entitled to an annual exclusion for transfers subject to the *Crummey* powers granted to the other partners. Rev. Rul. 85-24, 1985-1 C.B. 329.

The IRS also has ruled privately that a trust may not grant withdrawal rights to nominal beneficiaries in order to expand the number of annual exclusions available to shelter property transferred to a trust. Technical Advice Memorandum 9141008, Technical Advice Memorandum 904500, Technical Advice Memorandum 8727003.

The IRS's interpretation of what constitutes a nominal beneficiary historically has been very broad. In some of its rulings, it has concluded that remainder beneficiaries of a trust had interests too remote to be treated as legitimate *Crummey* power holders. The Tax Court, however, has rejected the IRS's approach. In Estate of Cristofani v. Comm'r, 97 T.C. 74 (1991), the court held that the grantor's grandchildren, who had only contingent remainder interests in an irrevocable trust, were valid *Crummey* power holders. See also Estate of Kohlsaat v. Comm'r, T.C. Memo. 1997-212; Estate of Holland v. Comm'r, T.C. Memo. 1997-302.

D. Permanent Funding: Adding Business Interests to the Trust

A business owner may be able to make a significant contribution to his or her estate planning by giving or selling an interest in the business to the trustee of the

Insurance Trust. Generally, the business owner would recapitalize the business into voting and nonvoting units. The business owner would retain the voting units and control of the enterprise. The business owner would transfer some (or all) of the nonvoting units to the insurance trust. The transfer would have the effect not only of reducing the overall value of business owner's estate but also of providing an asset to the trust that would generate cash, in the form of distributions from the business, to help fund the insurance premiums.

Even if a business owner maximizes annual gifting to an insurance trust, and does so consistently, the gifts still may not be sufficient to cover the premium payments. The following diagram sets forth this long-term structure for a self-financed insurance trust:

Closely Held, Inc.
Permanent Funding

Business Owner creates Irrevocable Trust to own life insurance and purchases policy

Closely Held Business Owner

Business Owner recapitalizes Closely Held, Inc. into voting and nonvoting units and transfer nonvoting units (by gift or sale) to Insurance Trust

Closely Held, Inc.

Voting Units

Voting units and control of Closely Held, Inc. maintained by Business Owner

Nonvoting Units

STEP 4: Administration of Trust according to terms of documents

Insurance Trust held for Beneficiaries Selected by Business Owner

- Trust owns nonvoting units of Closely Held, Inc. and insurance on the life of Business Owner.
- Closely Held, Inc. distributes cash to trust in proportion to ownership of nonvoting units.
- Business Owner makes additional gifts as needed.
- Trustee maintains insurance on life of Business Owner.
- At Business Owner's death, trustee purchases voting units and any remaining nonvoting units from Business Owner's estate.
- Estate pays taxes.
- Trust runs Closely Held, Inc. for the benefit of the beneficiaries.

E. Planning for the Generation-Skipping Transfer Tax

There are advantages to using life insurance in multiple-generation trusts that have been exempted from the generation-skipping transfer (GST) tax. An insurance policy can be transferred and maintained at a relatively low cost, thus using a minimal amount of the insured's GST exemption. IRC § 2631. If the transfers are fully exempt from GST tax, the proceeds will be fully exempt when received.

The GST tax provisions diminish the benefits of using gift tax annual exclusion gifts. A transfer that qualifies for the annual exclusion for gift tax purposes will not necessarily qualify as a nontaxable gift for GST purposes. IRC § 2642(c)(3). An annual exclusion gift to a *Crummey* trust will be exempt from GST tax only if (i) the transfer is considered a direct skip (IRC § 2612(c)), and (ii) the trust is for a single beneficiary and the trust property will be included in that beneficiary's gross estate for federal estate tax purposes if the trust is still in existence at the beneficiary's death. IRC § 2642(c).

Thus, a gift to an irrevocable insurance trust for the sole benefit of a grandchild, and that is vested in the grandchild's estate, can qualify for both the gift tax annual exclusion and the annual exclusion exception to the GST tax by giving the grandchild a *Crummey* power with respect to contributions to the trust.

On the other hand, a gift to a single irrevocable insurance trust for a child and his or her descendants, or for a grandchild and his or her descendants (often referred to as a "one-pot" trust), may qualify for the gift tax annual exclusion, but it will not be exempt from GST tax. The trust can be exempt from GST tax, or a direct skip avoided if the trust is a skip person, only through the allocation of the GST exemption to the trust.

One way to address the GST tax issues arising with the use of irrevocable insurance trusts is to avoid multiple beneficiary trusts altogether and create a separate vested trust for each beneficiary.

In this context, "vested" means taxable in the beneficiary's estate. Frequently, each beneficiary is given a power to appoint trust property to creditors in order to ensure that the trust property is included in the beneficiary's gross estate.

Crummey powers can be used to qualify transfers to the trust for the gift tax annual exclusion, and, in the case of a trust for a grandchild, to avoid the GST tax. Because each trust will be taxable at the beneficiary's death, concerns regarding the lapse of *Crummey* powers do not arise and the full $12,000 in annual exclusion gifts (or $24,000 if gift-splitting is elected) can be made to the trust each year. With this approach, the client will forego the opportunity to protect the trust property from transfer tax at multiple-generation levels. Although the property in each beneficiary's trust will be included in the beneficiary's gross estate at his or her death, it will avoid the often more burdensome GST tax.

It is not necessary to fund each single-beneficiary trust of the type just described with a separate insurance policy. It is possible to draft a single master trust instrument that creates separate trusts, each of which has an undivided interest in a single life insurance policy held by the trustee. This approach is most relevant when the client intends for his or her children (and/or grandchildren) to receive the proceeds of the policy during their lives. The separate trust format ensures that there will not be an unintended transfer subject to GST tax if a child or grandchild dies before the proceeds are distributed. If a beneficiary dies before the policy matures, the estate tax consequences are usually minimal because only the beneficiary's interest in the cash value of the policy will be included in the beneficiary's estate. The client can, therefore, use his or her GST exemption elsewhere.

The principal problem in GST tax planning with *Crummey* powers is that a lapse of a *Crummey* power may result in a taxable transfer by the power holder if the amount subject to lapse exceeds the 5-and-5 limitation. This also can result in a shift in the identity of the transferor for generation-skipping transfer (GST) tax purposes from the person who made the contribution to the trust to the beneficiary who held the lapsed *Crummey* power. This shift can complicate the allocation of the GST exemption.

The rules governing the identity of the transferor for GST purposes are set forth in Treas. Reg. § 26.2652-1. In particular, Treas. Reg. § 26.2652-1(a)(1) states that "the individual with respect to whom property was most recently subject to Federal estate or gift tax is the transferor of that property for purposes of Chapter 13 [of the Internal Revenue Code]."

Under this regulation, to the extent that a transfer to a trust is subject to a nontaxable lapse of a *Crummey* power (ordinarily, a transfer within the 5-and-5 limitation, but also any transfer to a trust with a sole beneficiary or with respect to which the beneficiaries possess a testamentary power of appointment, the original donor is treated as the transferor.

On the other hand, to the extent that the lapse is taxable, the *Crummey* beneficiary is treated as the transferor. See Treas. Reg. § 26.2652-1(a)(5), Example 5. This rule can result in the existence of multiple transferors with respect to the property held by an irrevocable insurance trust.

For these reasons, it is critical that taxable lapses of *Crummey* powers be avoided in an irrevocable trust that is intended to be GST exempt. If the use of separate vested trusts is not practical, then *Crummey* powers should be limited to the 5-and-5 amount or hanging powers used. The safest approach is to fund the trust with sufficient assets, so that a full annual exclusion gift falls within the 5% lapse amount.

This means the trust should have at least $240,000 if gifts are from a single donor, or $480,000 if gifts are from a married couple who are gift-splitting.

Third. **<u>Charitable Planning for the Closely Held Business Owner</u>**

I. Charitable Giving - Overview

A. 2008 Survey from Giving USA

2008 saw the largest drop in annual giving in more than 50 years at 5.7%, yet charitable giving remained relatively high. Donors gave $307.65 billion to charity (vs. $314.07 billion in the prior year). Giving to private foundations decreased 22.2% in 2008.

IRS Statistics on Noncash Contributions for 2005 show that 25.4 million individuals made noncash contributions totaling $48.1 billion in deductions. 6.6 million of these individuals reported gifts totaling $41.1 billion on Form 8283 (greater than $500). The following is a list of assets that made up the $41.1 billion in noncash contributions:

- Stock gifts $16.3 billion
- Clothing $ 7.0 billion
- Household goods $ 3.9 billion
- Land $ 2.9 billion
- Conservation easements $ 1.8 billion
- Other investments $ 1.6 billion
- Art and collectibles $ 1.2 billion

B. Closely Held Business Interests as Charitable Gifts

Closely held business interests are not assets that make convenient or desired contributions to charitable organizations. Not only do the charitable regulations with respect to unrelated business income create a tax liability that will not be discussed in this paper, charities are generally not interested in the liability and complication of owning or liquidating such an interest.

If a business has reliable and steady cash flow, however, certain techniques can provide significant charitable deductions to the estate of a deceased business owner.

C. Current Environment for Giving

Endowments have suffered from significant investment losses since 2008. The same losses in donor's investment portfolios, real estate values, and retirement accounts have led to decreased gifts from individuals, foundations, and businesses.

The Obama administration's 2010 budget proposals include a plan to limit the tax rate at which taxpayers with income above $250,000 can take itemized deductions, including the charitable deduction to 28%. Several amendments to the Senate Finance Committee's markup of the America's Healthy Future Act of 2009 would cap the value of the itemized deductions for charitable donations to 33% or 35% for those taxpayers earning more than $200,000 per year, rather than allowing the deduction at a rate equal to the marginal tax bracket (brackets that will rise to 36% and 39.6%, respectively, in 2011). These changes, if enacted:

- Will make the IRA rollover more attractive if extended as a way to avoid income and the charitable deduction limitations.
- Will create an incentive for the establishment of private foundations.
- Will make grantor charitable lead annuity trusts more attractive in 2010.
- Will make prepayment of planned future contributions in 2010 more attractive.

D. Favorable Gift Techniques in a Down Economy

- *Bequests*
- *Charitable Gift Annuities*
- *Gifts of Real Estate*

    - Outright transfers
    - Gifts of an undivided interest
    - Bargain sales
    - Gift of remainder interest in personal residence or farm
- *Charitable Lead Trusts*
    - Zeroed out charitable lead annuity trusts
    - Grantor charitable lead trusts
    - Varying payout charitable lead annuity trusts
        - Increasing percentage payout
        - Shark-fin payout
- *Charitable Remainder Trusts*
    - Charitable remainder annuity trusts
    - Flip charitable remainder unitrusts
    - Termination of charitable remainder trust

II. Charitable Lead Trusts

A. Executive Summary

Many of the techniques listed above are employed by business owners, during their lifetimes, to accomplish their charitable objectives and to generate income tax deductions. However, a business owner can fund a zeroed out charitable lead trust at their death to generate a significant charitable deduction for estate tax purposes.

The charitable deduction will serve to reduce the overall federal estate tax burden on the estate. Not only will this relieve the estate of the pressure of liquidating the business interest, the technique may serve to leave the business interest in tact for future generations.

The following is a basic summary of the technique:

- During the term of the trust, income is paid to charity for the specified term and upon expiration of the term, assets pass to noncharitable beneficiaries outright or in further trust.

- The income payments to charity may be a fixed dollar amount or a fixed percentage of trust assets revalued each year.

- The trust may be established during donor's lifetime or at donor's death.

- Such a trust established during the donor's lifetime has the following advantages: reduces cost of transferring assets to noncharitable beneficiaries while offering opportunity to transfer growth tax free; removes appreciating asset and income from donor's taxable estate; avoids percentage limitations on charitable deductions.

- Such a trust established at the donor's death has the following advantages: estate receives deduction for value of income payable to charity; trust assets pass to descendants or other noncharitable beneficiaries with a stepped-up basis.

- The nontax advantages of this technique includes: accomplishing the donor's charitable objectives while keeping capital in the family without the need for "wealth replacement" techniques; charity receives income currently.

- The disadvantages of this technique include: a portion of donor's income and wealth shifted to charity rather than family members; donor foregoes current income from trust assets; gift of remainder interest to noncharitable beneficiaries does not qualify for annual gift tax exclusion and generally requires donor to use portion of unified credit or pay gift tax; noncharitable beneficiaries must wait until expiration of trust term to receive assets.

- The best candidates to establish charitable lead trust include: donors with genuine charitable interests, sufficient other assets to provide for personal cash needs, and ability to defer receipt of assets by noncharitable beneficiaries.

- The best assets with which to fund charitable lead trust include: common stocks and other assets likely to appreciate over the trust term, assets producing sufficient income to satisfy annual charitable payments, or mixture of cash and high yielding securities with nonincome producing property.

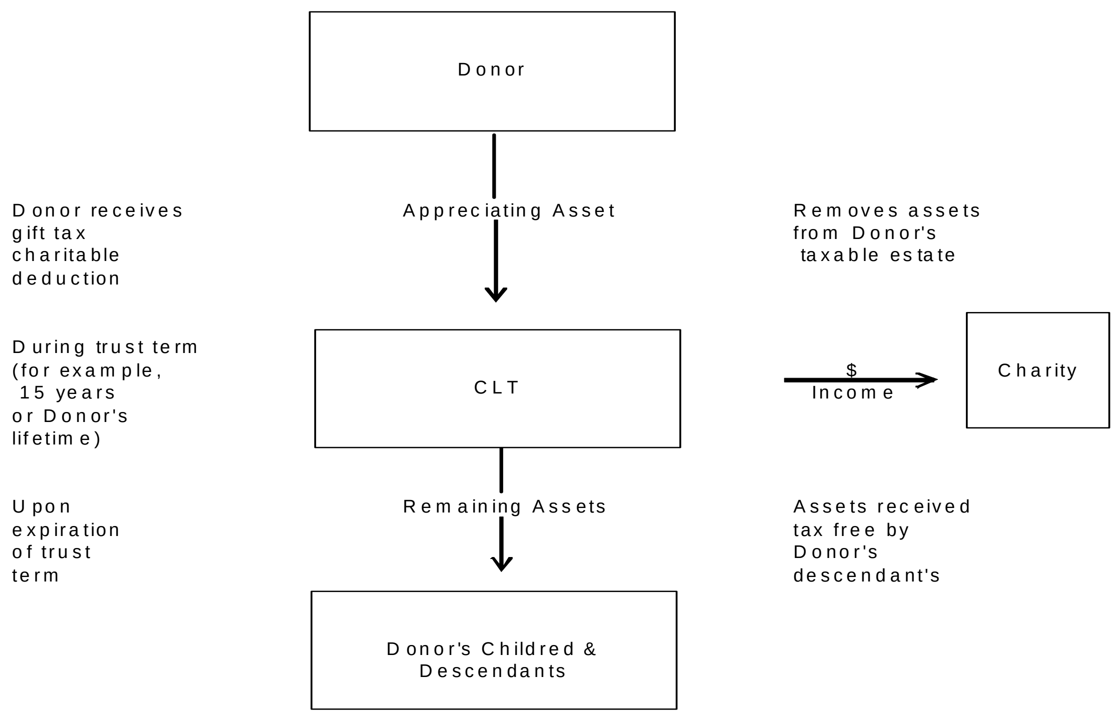
Interests in a closely held business are particularly attractive for establishing a charitable lead trust at the death of the business owner if the business has reliable cash flow. The value of the business can be discounted for valuing the interest at the time of the gift, thereby creating a lower required pay out to charity. The cash flow from the business can be used to meet the charitable payment while keeping the principal of the trust – the business interest – in tact through the term.

At the expiration of the trust term, the business interest can pass to the noncharitable beneficiaries selected by the business owner at his or her death.

B. General Overview

A charitable lead trust ("CLT") is a split-interest trust under which the income (or "lead" interest) is payable to one or more charitable beneficiaries for the term of the trust, and upon expiration of that term, the trust corpus (the "remainder" interest) is payable to one or more noncharitable beneficiaries or reverts to the creator of the trust (the "donor").

The following diagram shows the basic structure and operation of a CLT created during a donor's lifetime.



The Internal Revenue Service issued Revenue Procedures 2007-45 and 2007-46, which set forth sample forms for inter vivos and testamentary charitable lead annuity trusts, and Revenue Procedures 2008-45 and 2008-46, which set forth sample forms for charitable lead unitrusts.

The following tables show the percentage of the initial funding of a CLT (annuity or unitrust) that would be treated as a deductible gift to charity and the percentage that would be treated as a taxable gift based on different payout rates and trust terms. (All calculations assume section 7520 rate of 2.0% and quarterly payments.)

CHARITABLE LEAD TRUSTS FOR TERM OF YEARS

		Unitrust		**Annuity Trust**	
Term of Years	**Payout Rate**	**Charitable Lead**	**Taxable Remainder**	**Charitable Lead**	**Taxable Remainder**
5	3%	13.96%	86.04%	14.25%	85.75%
	5%	22.37%	77.63%	23.74%	76.26%
	7%	30.11%	69.89%	33.24%	66.76%
10	3%	25.97%	74.03%	27.15%	72.85%
	5%	39.74%	60.26%	45.25%	54.75%
	7%	51.15%	48.85%	63.35%	36.65%
15	3%	36.31%	63.69%	38.84%	61.16%
	5%	53.22%	46.78%	64.73%	35.27%
	7%	65.86%	34.14%	90.62%	9.38%

CHARITABLE LEAD TRUSTS FOR LIFE OF INDIVIDUAL

		Unitrust		Annuity Trust	
Term for Ages	**Payout Rate**	**Charitable Lead**	**Taxable Remainder**	**Charitable Lead**	**Taxable Remainder**
55	3%	51.15%	48.85%	57.98%	42.02%
	5%	68.15%	31.85%	84.81%	15.19%
	7%	78.31%	21.69%	91.80%	8.20%
65	3%	39.31%	60.69%	43.21%	56.79%
	5%	55.14%	44.86%	69.49%	30.51%
	7%	66.00%	34.00%	82.20%	17.80%
75	3%	27.02%	72.98%	28.83%	71.17%
	5%	39.89%	60.11%	47.93%	52.07%
	7%	49.87%	50.13%	63.36%	36.64%

CHARITABLE LEAD TRUSTS FOR TERM OF JOINT LIVES OF INDIVIDUALS

		Unitrust		Annuity Trust	
Term for Ages	**Payout Rate**	**Charitable Lead**	**Taxable Remainder**	**Charitable Lead**	**Taxable Remainder**
55/55	3%	60.20%	39.80%	69.33%	30.67%
	5%	78.00%	22.00%	96.05%	3.95%
	7%	87.58%	12.42%	98.95%	1.05%
65/65	3%	48.42%	51.58%	53.92%	46.08%
	5%	66.28%	33.72%	85.15%	14.85%
	7%	77.62%	22.38%	95.14%	4.86%
75/75	3%	35.09%	64.91%	37.83%	62.17%
	5%	50.83%	49.17%	62.81%	37.19%
	7%	62.42%	37.58%	80.94%	19.06%

For a charitable lead annuity trust, the lower the section 7520 rate at the time the trust is created, the greater the charitable deduction.

Changes in the section 7520 rate have little impact upon the valuation of charitable unitrust interests, although if the unitrust payout rate is lower than the section 7520 rate, the unitrust will produce a larger charitable deduction than the annuity trust because the excess of the assumed return over the payout rate is deemed to cause an increase in the trust assets from which the unitrust payout will be calculated.

C. Transfer Tax Savings

A qualified CLT enables a donor to achieve meaningful tax savings. First, because the present value of the remainder interest factors in the delay in the noncharitable beneficiaries' receipt of and control over the trust assets, these assets are valued at a discount, resulting in lower gift or estate tax liability for the donor. Although the value of the charitable interest is limited to the value of the property transferred to the trust, it is possible for the donor to create a CLT with a charitable interest equal (or nearly equal) to the value of the property transferred to the trust. In such a case, the remainder interest passing to the noncharitable beneficiaries would be equal to zero or of nominal value, and the donor would incur no (or nominal) gift or estate tax.

The following table shows payout rates and trust terms that "zero out" the remainder value for transfer tax purposes. (Assumes section 7520 rate of 2.0% and quarterly payments).

CHARITABLE LEAD ANNUITY TRUST FOR TERM OF YEARS

Payout Rates to Zero Out or Produce Nominal (Unitrust) Remainder Value

Term of Years	Annuity Payout Rate
10	11.050%
15	7.725%
20	6.071%
25	5.084%
30	4.432%

D. CLAT with Increasing Payout

The IRS Forms for charitable lead annuity trusts provide that the "governing instrument of a CLAT may provide for an annuity amount that is initially stated as a fixed dollar or fixed percentage amount but increases during the annuity period, provided that the value of the annuity amount is ascertainable at the time the trust is funded." Rev. Proc. 2007-45, 2007-9 I.R.B. 89, Sec. 5.02(2).

One alternative is to vary the payout rate by steadily increasing it over the term. This method of payment still qualifies as a guaranteed annuity, since the amount received by the charity may be calculated as of the date of the initial transfer. This method allows the trust's growth to be sheltered from depletion during the early years of the trust. For example, assume $50 million is contributed to a CLAT with a term of 20 years, the section 7520 rate is 2.0%, and the payout rate starts at $360,000 and increases by 20% each year. With a 4% growth rate, the charity receives a total of $67,207,680 (compared to $60,710,000 with a straight percentage payout of 6.071% to zero out the remainder), while the remainder interest is $27,006,641 (compared to $17,808,929 with a straight percentage payout).

Another alternative is to provide a low, steady payout rate until the last year of the term when the charity receives a balloon payment (referred to as a shark-fin CLAT). For example, assume $50 million is contributed to a CLAT with a term of 20 years, the section 7520 rate is 2.0%, and the payout rate is 0.01% or $5,000 each year until the final year. In order for the present value of the remainder to be zero, the final payment to the charity must be $74,180,885. With a 4% growth rate, the remainder interest is $34,479,223. Longer terms, such as 25 years or 30 years, will produce greater payments to the charity, as well as greater remainder interests.

III. CHARITABLE REMAINDER TRUSTS

A. Overview of Charitable Remainder Trusts

The charitable remainder trust is used primarily to provide income security to the noncharitable beneficiary or beneficiaries, while at the same time obtaining a current income tax charitable deduction. It is often used to avoid capital gains tax on appreciated assets that will be sold.

Example. Jack transfers $2 million worth of appreciated marketable securities paying little or no dividends to a charitable remainder trust that will pay him a 6% annuity interest for life. The trust can sell the marketable securities without paying capital gains tax and invest the proceeds in income producing property. Jack has used the trust to convert the marketable securities to an income stream of $120,000 per year. If he had sold the marketable securities directly and paid federal and state capital gains tax of $300,000, he would have had only $1,700,000 remaining, and, taking 6% would have given him only $102,000 per year.

Under Internal Revenue Code section 664, a charitable remainder trust is a trust that provides for the distribution of a specified payment at least annually to one or more persons, at least one of which must be a noncharitable beneficiary. The payment period must be for the life or lives of the individual beneficiaries (all of whom must be living at the time the trust is created) or for a term of years, not in excess of 20 years. Upon the termination of the noncharitable interest or interests, the remainder must either be held in a continuing trust for charitable purposes or paid to or for the use of one or more charitable organizations described in Internal Revenue Code section 170(c).

For a trust to be a qualified charitable remainder trust, the value of the remainder interest that passes to charity at the end of the term (i.e., the amount of the donor's charitable deduction) must be no less than 10 percent of the initial value of the assets contributed to the trust. With a 2.0 percent AFR, a unitrust cannot be established for the life of an individual under age 40. Also, in the case of the two-life unitrust, if both individual beneficiaries are the same age, a unitrust cannot be established unless the beneficiaries are at least 52 years old with a 2.0 percent AFR.

A qualified charitable remainder trust is generally exempt from federal income tax. The grantor is entitled to an income tax charitable deduction and a gift or estate tax charitable deduction based on the present value of the remainder interest ultimately passing to charity. If the noncharitable beneficiary is an individual other than the grantor, the creation of a charitable remainder trust may have gift tax consequences.

There are two basic types of charitable remainder trusts under Internal Revenue Code section 664, a charitable remainder annuity trust and a charitable remainder unitrust.

- A charitable remainder annuity trust is required to pay a sum certain annually to one or more beneficiaries, at least one of which is not a charity. The annuity amount must be equal to at least five percent (but not more than 50 percent) of the fair market value of the trust assets valued as of the date the assets are transferred to the trust.

- A charitable remainder unitrust is required to pay a fixed percentage of the net fair market value of the trust assets as revalued annually to one or more beneficiaries, at least one of which is not a charity. The unitrust amount must be equal to at least five percent (but not more than 50 percent) of the net fair market value of the trust assets valued annually.

- The amount paid by a unitrust fluctuates with the fair market value of the trust assets, whereas the annual payment from an annuity trust remains constant.

A unitrust may provide for the payment of the lesser of the fixed percentage or the net income of the trust. This type of unitrust is referred to as a "net income" unitrust. A net income unitrust may have what is called a "makeup" provision. A makeup provision provides that any amount by which the trust income falls short of the fixed percentage is to be paid out in a subsequent year to the extent the trust's income exceeds the fixed percentage in that subsequent year. A unitrust may also provide for the trust to be a net income trust initially and later convert to a straight unitrust. These types of trusts are often referred to as "flip" unitrusts.

B. "Flip" Charitable Remainder Unitrusts

The final regulations issued in 1998 allow the creation of a net income charitable remainder unitrust (whether with or without a makeup provision) that converts to a straight percentage charitable remainder unitrust upon the occurrence of a specified event. Under these rules, a net income charitable remainder unitrust may convert to a straight percentage unitrust (using the same percentage) if the governing instrument of the charitable remainder unitrust meets the following requirements:

- The change from a net income unitrust to a straight unitrust must be triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustee or any other person (referred to as the "triggering event").

- The change from a net income unitrust to a straight unitrust must occur at the beginning of the taxable year of the unitrust that immediately follows the taxable year during which the triggering event occurs. Under this rule, if the triggering event occurs on July 1, 2009, the conversion of the unitrust to a straight unitrust must occur on January 1, 2010.

- Following the conversion in the case of a net income unitrust with a makeup provision, the unitrust's governing instrument must provide that any makeup amount not paid as of the conversion date is forfeited.

These new flip unitrust rules are extremely broad and significantly enhance the planning opportunities available when establishing a charitable remainder unitrust for a donor. These rules generally apply to charitable remainder unitrusts established on or after December 10, 1998.

C. Planning with "Flip" Charitable Remainder Unitrusts

In the past, the use of a charitable remainder trust as a charitable gift technique had become fairly routine without much consideration given to planning opportunities presented beyond the immediate income tax benefits. Typically, the only decisions required were whether to use a charitable remainder annuity trust or a charitable remainder unitrust, the amount of the payout to the noncharitable beneficiary, and the timing of the payments to the noncharitable beneficiary. If a charitable remainder unitrust was selected, it was necessary to decide whether the unitrust should provide for payment of a straight percentage or the lesser of the net income or the set percentage. If a net income charitable remainder unitrust was selected, it was also necessary to decide whether to include a makeup provision. Because the options were somewhat limited, establishment of the charitable remainder trust and preparation of the trust agreement were fairly straightforward, and reliance on forms was the norm.

With the advent of the flip unitrust, traditional approaches to the establishment of a charitable remainder trust no longer work. Planned giving officers, lawyers, and other advisors to individuals desiring to establish charitable remainder trusts must now explore more fully the estate planning objectives and goals of the donor. Depending upon these objectives and goals, more attention must also be given to the drafting of the actual terms of the charitable remainder trust agreement. But, the charitable remainder unitrust is now a much more flexible estate planning tool. While there are certain obvious uses for a flip unitrust, there are also a myriad of circumstances for using flip unitrusts to accomplish the unique objectives and goals of the donor that are not so obvious.

The wide range of planning opportunities associated with a flip unitrust arises from the broad definition of a "triggering event" under the final regulations. It is the triggering event that causes the flip unitrust to convert from a net income charitable remainder unitrust (whether with or without a makeup provision) to a straight charitable remainder unitrust. The actual conversion to a straight charitable remainder unitrust will occur on January 1 of the first taxable year after the year in which the triggering event occurs.

- The final regulations offer a number of examples of permissible triggering events. A specific date is a permissible triggering event.

- A single event whose occurrence is not discretionary with, or within the control of, the trustee or any other person is a permissible triggering event.

- The sale of an unmarketable asset or the marriage, divorce, death, or birth of a child with respect to any individual are permissible triggering events. Unmarketable assets include real estate, closely held stock, or unregistered securities for which there is no available exemption permitting public sale under the rules of the Securities and Exchange Commission.

- The regulations also set forth a number of examples that illustrate the breadth of the definition of a permissible triggering event. Permissible triggering events under these examples include the sale of a personal residence, the attainment of a certain age by the noncharitable beneficiary of the flip unitrust, the marriage or divorce of the noncharitable beneficiary, the birth of the first child of the noncharitable beneficiary, and the death of the noncharitable beneficiary's father.

D. Use of Flip Unitrust for Unmarketable Assets

The most obvious use of a flip unitrust is in connection with a gift of an illiquid or unmarketable asset, such as real estate or closely held stock. In the past, charitable remainder trusts funded with these types of assets were typically structured as net income (either with or without a makeup provision) charitable remainder unitrusts. This approach was necessary to enable the charitable remainder unitrust to satisfy the payout requirements to the noncharitable beneficiary during the time before the unmarketable asset was sold. Under recent market conditions, however, the sale of the unmarketable asset did not usually result in payment of the full straight percentage to the noncharitable beneficiary following the sale without an investment approach that favored the generation of income. This type of investment approach often conflicted with the long-term objective of growth, which would have resulted not only in benefits to the charitable remainderman, but also to the noncharitable beneficiary in the form of higher payouts over time.

Use of a flip unitrust when dealing with an unmarketable asset, with the triggering event defined as the sale of the unmarketable asset, will avoid problems associated with a net income unitrust and allow the assets of the unitrust to be invested for total return following the sale of the unmarketable asset. The flip unitrust enables the initial problems associated with funding a charitable remainder trust with unmarketable assets to be handled during the period before the unmarketable asset is sold, but has solved the long-term problem associated in the past with net income charitable remainder unitrusts and an investment strategy designed to produce income. Now, if a flip unitrust is used, the trust assets can be invested for growth or total return following the sale of the unmarketable asset to the ultimate benefit of not only the charitable remainderman, but also the noncharitable beneficiary of the charitable remainder unitrust.

If the flip unitrust is structured initially as a net income with a makeup provision and post-contribution appreciation is allocated to income under the terms of the trust agreement, it may also be possible to ensure that the noncharitable beneficiary receives some of the unitrust amount accrued while the unitrust owned the unmarketable asset before this amount is forfeited following the conversion to a straight unitrust on January 1 of the year following the year in which the triggering event occurs.

Example. Donor establishes a flip unitrust and funds the unitrust with unimproved real estate on January 1, 2008. The flip unitrust provides that the Donor is to receive the lesser of the net income of the unitrust or six percent of the value of the trust's assets as valued each year until the year following the year in which the real estate contributed to the unitrust is sold. The flip unitrust also provides that post-contribution appreciation is to be included in income or purposes of determining the payments to the Donor before the conversion of the unitrust to a straight unitrust. At the time the flip unitrust is funded the real estate is valued at $100,000. The real estate is sold on December 30, 2010 for $150,000. The accrued unitrust amount through 2010 is $18,000. Because post-contribution appreciation is allocated to income, the trustee has $50,000 of income in 2010, which amount can be used to pay the Donor the accrued unitrust amount of $18,000. Beginning on January 1, 2011, the unitrust will pay the Donor six percent of the fair market value of the trust assets as revalued each year.

Because of the unique benefits of the flip unitrust when dealing with unmarketable assets, it is likely that the flip unitrust will supplant the net income charitable remainder unitrust and become more widely used. Of course, there may still be situations where the donor may prefer a net income charitable remainder unitrust instead of a flip unitrust, particularly if income is defined to include post-contribution appreciation as now permitted under the final regulations. For these reasons, it will be necessary for the donor's advisors to review the possible choices with the donor in greater detail to insure that the form of charitable remainder unitrust chosen meets the donor's objectives and goals.

E. Use of Flip Unitrusts for Retirement Planning

Another significant planning opportunity associated with the flip unitrust is in connection with planning for the donor's retirement. In the past, net income charitable remainder unitrusts have been promoted as an effective technique for retirement planning in conjunction with a charitable gift. Under this technique, the donor would contribute assets to a net income charitable remainder unitrust during a year when the donor's income was high, thereby obtaining an immediate income tax charitable deduction to reduce the donor's income taxes. Then, through a choice of an investment strategy designed to minimize income and maximize growth while the donor was still earning significant income, the income received from the net income charitable remainder unitrust during the employment years was limited. Upon the donor's retirement, the investment strategy of the charitable remainder unitrust would be changed so as to favor income in the years following retirement. While this technique could work in certain circumstances, its success depended in part upon market conditions, which are not always predictable. There have also been concerns in the past that the manipulation of the investments to favor the donor's income needs could be considered self-dealing under Internal Revenue Code section 4941.

The flip unitrust is an excellent alternative to the net income unitrust in connection with retirement planning for the donor. The triggering event in the flip unitrust would be either a set date or the date upon which the donor attains a certain age, such as age 65. Before that time, the unitrust would be invested for growth or total return and the donor would receive the actual income earned by the charitable remainder unitrust under the net income limitation. Upon the conversion of the flip unitrust to a straight charitable remainder unitrust, the donor will begin receiving a straight percentage of the value of the trust assets as revalued each year. Thus, the donor's retirement objectives have been met without having to alter the unitrust's investment strategy to achieve these goals. The investment of the trust assets for total return throughout the donor's lifetime should also have the added advantage of generating a higher unitrust amount in later years assuming the assets increase in value during the term of the unitrust.

The use of a flip unitrust for retirement planning again illustrates the need for the donor's advisors to explore the donor's objectives when establishing the unitrust. In the case of a donor who is still working, the advisors should point out the potential benefits associated with the use of a flip unitrust tied to the donor's anticipated retirement date. (Note that the triggering event should not be defined as the donor's retirement as this could be deemed to be an event that is discretionary with the donor. Instead, the triggering event should be defined as a specific date or the date upon which the donor attains a certain age.)

F. Use of Flip Unitrust to Meet Estate Planning and Income Objectives

Because of the broad range of possible triggering events, there is a greater need to explore the donor's particular objectives when establishing a charitable remainder unitrust, even if the trust is funded with marketable assets or the donor is not concerned about retirement. There are any number of circumstances where the flip unitrust may be advisable or prudent for the donor. Planning with the flip unitrust will require a great deal of attention to the specific circumstances of the donor and greater creativity when structuring a charitable remainder unitrust to meet the objectives and goals dictated by the donor's unique circumstances. Examples of the types of situations where a flip unitrust may be useful or advisable include:

Planning for Surviving Spouse. Many donors are not concerned about their income needs while they are living, but instead worry that their spouses may need greater income following their deaths. In these circumstances, the donor should consider a flip unitrust, with the surviving spouse as a noncharitable beneficiary and the triggering event defined as the donor's death.

Planning for a Child. Many donors worry that their children may not have the necessary financial resources in the event of certain occurrences during their children's lives, such as divorce or birth of a child. In these circumstances, the donor may consider a flip unitrust, with the child as a noncharitable beneficiary and the triggering event defined as the child's divorce or the birth of the child's first child. Other possibilities would include defining the triggering event as the death of the donor or the death of the child's spouse to ensure that the child is adequately provided for following the donor's death or the death of the child's spouse.

Planning for Education. Many donors have provided funds for grandchildren's education under favorable gift tax provisions. Often, there are younger grandchildren who are not yet of school age. If the donor is concerned that he may not be living when the grandchild reaches school age, the donor may consider a flip unitrust for a term of years with the triggering event defined as the date the grandchild reaches a certain age. Particular care should be taken to examine the transfer tax ramifications upon the creation of the trust.

Planning for Uncertainty. Many donors do not have a current need for income but worry about a possible need for income in the future. In these circumstances, a flip unitrust may be advisable with a triggering event tied to an event such as involuntary termination of employment or total disability. The examples under the final regulations also make it clear that it is permissible to use a triggering event tied to the sale of an unmarketable asset even when other assets of the unitrust consist of marketable assets. Because it may not be possible to plan for an unknown event, some flexibility could be created by funding a flip unitrust with marketable assets and one unmarketable asset, such as real estate or a share of closely held stock and defining the triggering event as the sale of the unmarketable asset. If the donor had a need for greater income in the future, the trustee could then sell the unmarketable asset to trigger a conversion of the unitrust from a net income charitable remainder unitrust to a straight charitable remainder unitrust.

Fourth. **<u>Section 6166 and the Deferral of Estate Taxes Attributable to a Closely Held Business</u>**

I. Overview of Section 6166 – Deferral of Estate Taxes Attributable to a Closely Held Business

A. Section 6166

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 $1,330,000[13] for estates of individuals dying in 2009 of value of closely held business interests (or $598,500 of tax) and 45 percent of the interest rate applicable to underpayments of tax (2.3 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.

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

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.

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

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[13]Revenue Procedure 2008-66. The amount of tax that can be deferred under section 6166 is subject to a cost of living adjustment. Revenue Procedure 2009-50 states that "the dollar amount used to determine the "2-percent portion" (for purposes of calculating interest under § 6601(j)) of the estate tax extended as provided in § 6166 is $1,340,000." However, no tax should be due on the estate of a decedent dying in 2010.

estate.[14] In addition, the 1976 version of section 6166 provided for a bargain interest rate of four percent for a portion of the estate tax.

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. 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.

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. 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.

Although section 6166 can be an attractive alternative to a private business owners' estate, there are issues concerning its operation and interpretation. The most significant issues with section 6166 include the following.

- What is the level of activity required for a business to qualify as a closely held business under section 6166?

- How are a holding company and its subsidiaries treated under section 6166?

- How does an estate maximize the benefits of section 6166 and redemptions under section 303 so as to avoid the acceleration of unpaid tax?

- Whether it is more economical to borrow from another source and deduct the interest payments rather than elect the lower interest rates and the resulting non-deductibility of interest under section 6166.

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

C. Section 6166 Requirements

To be eligible for deferral under section 6166, the decedent, the decedent's interest in the closely held business, and the decedent's estate must meet certain requirements.

- The decedent must have been at death a citizen or resident of the United States.[15]

- More than 35 percent of the decedent's adjusted gross estate must consist of an interest in a closely held business.[16]

- The personal representative of the decedent's estate must make an election on a timely filed estate tax return.[17]

D. Percentage Test

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.[18] 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),[19] but not the deduction for state death taxes under section 2058 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.[20]

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 if owned with the decedent as joint tenants, tenants by the entirety, or tenants in common.[21] Certain gifts made within three years

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[15]IRC section 6166(a)(1).

[16]IRC section 6166(a)(1).

[17]IRC section 6166(d).

[18]IRC section 6166(a).

[19]IRC section 6166(b)(6).

[20]Technical Advice Memorandum 8203009.

[21]IRC section 6166(c).

of the decedent's death are included in determining whether the 35 percent test is met.[22] 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.

II. Section 6166 Definition of Closely Held Business

A. General Definition of Closely Held Business

An interest in a closely held business is defined[23] to be:

- An interest as a proprietor in a trade or business carried on as a proprietorship,
- An interest as a partner in a partnership carrying on a trade or business, if
- 20 percent or more of the *total capital interest* is included in the decedent's gross estate, or
    - the partnership has 45 or fewer partners,
    - stock in a corporation carrying on a trade or business, if
    - 20 percent or more of the *voting stock* of the corporation is included in the decedent's gross estate, or
    - the corporation has 45 or fewer shareholders.

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 regular basis by the owner, a lessee, or employees of the owner or lessee for the purposes of operating or maintaining the farm.[24] In meeting the above numerical requirements, there are attribution rules available, which are discussed below.

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[22] IRC section 2035(c)(2).

[23] IRC section 6166(b)(1).

[24] IRC section 6166(b)(3); and Private Letter Ruling 9410011.

B. Trade or Business Test

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 within the last thirty years.[25] 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.[26] As exemplified by 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.

C. Trade or Business Test – Rental Real Property Without Duties

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.[27] In Private Letter Ruling 8020101, the Internal Revenue Service ruled that real property leased by a 97-year old parent 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.

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 the individual 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 supporting Revenue Ruling 75-366.[28]

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.[29] A Federal District Court[30]

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[25]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.

[26]See Rev. Rul. 75-367, 1975-2 C.B. 472, decided under section 6166A, a predecessor to section 6166.

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

[28]Private Letter Rulings 8133015 and 8020142.

[29]Private Letter Rulings 8601005, 8332025, 8314003, 8240054, 8229133,

ruled that a decedent's interest in farm land farmed by a non-family member under a share-cropping arrangement 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.

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

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 entities (such as a 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.[31]

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 as a closely held business 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.

The Internal Revenue Service allowed an estate to receive the benefits of section 6166 where the decedent's estate owned real property in a separate entity that was leased to a corporation that conducted an automobile dealership business on the real property. In holding that the real estate entity qualified, the Internal Revenue Service held that the real property was an integral part of the operation of the automobile dealership. In Private Letter Ruling 200518947, the decedent owned several golf course properties that were leased to a corporation that operated and managed the golf courses. In finding that the golf course properties were a trade or business, the Internal Revenue Service stated that the decedent was personally involved in the operation of the business until health issues prevented personal daily involvement. It is not known whether the personal involvement of the decedent was essential to the ruling.

8226156, 8218072, 8205026, 8145008, 8136022, 8134019, 8133022, and 8130057.

[30]Ronald C. Schindler, 87-2 USTC ¶ 13,735.

[31]Private Letter Rulings 200518047, 200518011, 200339001, 200006034, 8451014, 8140020, and 7917006.

In Private Letter Ruling 200518011, the decedent owned 100 percent of the stock in two corporations that conducted retail automobile dealerships. The decedent also owned two parcels of real estate with improvements constructed specifically for use by the two corporations, such as showrooms with special doors, service areas with automobile exhaust systems, and car lifts. In holding that the real estate qualified as a trade or business for purposes of section 6166, the Internal Revenue Service found that the real estate was "specifically necessary and essential to carry out the day-to-day operations" of the corporations.

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.[32] 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.

In Private Letter Ruling 8140020, the decedent owned real property that was leased to a corporation of which the decedent 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, 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.

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

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

[32]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.

respect to the real property. As the following Private Letter Rulings 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 trade or business that qualifies for deferral under Section 6166. One commentator has stated that section 6166 "is not user friendly" regarding real estate assets.[33] It would be helpful if the Internal Revenue Service would provide a bright line test that could be used to determine what level of activities are necessary to qualify for estate tax deferral under section 6166.

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 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 and in Revenue Ruling 2006-34.

Revenue Ruling 2006-34 describes safe harbors and a non-exclusive list of factors used in determining if a decedent's real estate activities were sufficiently active to qualify the real property interest as a closely held business interest for purposes of section 6166. The Revenue Ruling updated the series of revenue rulings issued in 1975. Under section 6166, in order for an interest in real property to qualify as an interest in a closely held business, the decedent must conduct an active trade or business or must hold an interest in a partnership, limited liability company, or corporation that itself carries on an active trade or business. The activities of agents and employees of the decedent, the partnership, LLC, or corporation are also taken into consideration.

According to Revenue Ruling 2006-34, the Internal Revenue Service ruled that it will consider the following non-exclusive list of factors to determine whether a decedent's interest in real property is an interest in an asset used in an active trade or business:

- the amount of time the decedent devoted to the trade or business;

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[33]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.

- whether an office was maintained from which the activities of the decedent were conducted or coordinated, and whether the decedent maintained regular business hours for that purpose;

- the extent to which the decedent was actively involved in finding new tenants and negotiating and executing leases;

- the extent to which the decedent provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;

- the extent to which the decedent personally made, arranged for, performed, or supervised repairs and maintenance to the property; and

- the extent to which the decedent handled tenant repair requests.

Numerous private letter rulings have addressed whether rental property qualifies for the benefits of section 6166. In Private Letter Ruling 200842012, the Internal Revenue Service ruled that the corporation's activities with respect to rental real estate constituted an active business "not just an entity managing assets."

F. Trade or Business Test - Activities of Agent

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

There are several attribution rules available under 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.[34] 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

[34]IRC section 6166(b)(2)(C).

shareholder or one partner.[35] 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.[36] Certain non-readily tradable stock owned by related parties can be treated as includable in determining the value of the decedent's gross estate.[37]

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.[38] 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, all such stock and 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 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 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).

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.[39] Because of these restrictions, there may be limited benefit to this election.

H. Holding Company Rules

The Internal Revenue Service has consistently taken the position that a corporation with its sole asset stock of another corporation is not a closely held business under section 6166.[40] 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

[35]IRC section 6166(b)(2)(B).

[36]IRC section 6166(b)(2)(D).

[37]IRC section 6166(b)(7).

[38]IRC section 6166(b)(7)(B).

[39]IRC section 6166(b)(7)(A).

[40]Technical Advice Memoranda 8219007 and 8134012; Private Letter Rulings 8448006 and 8130175; and <u>R.E. Moore</u> (DC) 87-2 USTC ¶ 13,741.

personal holding company did not qualify as an interest in a closely held business under section 6166. Because of amendments to section 6166, there are two legislative exceptions to the prohibition of deferral for holding companies under section 6166, section 6166(b)(8) and section 6166(b)(9).

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 trade or 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).

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 payments under section 6166(a)(3) are not available. If this election in 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.[41]

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 –

- owns 20 percent or more in value of the voting stock of another corporation or the corporation has 45 or fewer shareholders, and

- eighty percent or more in value of the subsidiary corporation is attributable to assets used in carrying on a trade or business,

- 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).[42]

The 2001 Tax Act expanded the holding company rules to include holding companies where the stock of the operating subsidiary or subsidiaries is readily

[41]IRC section 6166(b)(9)(B)(ii).

[42]Id., page A-12.

tradable but the holding company stock is not readily tradable. In this situation, the estate tax must be paid over five years.[43]

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.[44])

I. Deferral Not Available for Passive Assets

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 eligible for deferral.[45] A passive asset is defined as "any asset other than an asset used in carrying on a trade or business."[46] The passive assets rules are unclear.[47]

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.[48] There can be problems in determining whether subsidiaries in a multiple tier organization qualify for section 6166 deferral.[49]

A corporation or other entity that owns both active and passive assets may be limited in the amount of deferral available. In Private Letter Ruling 200845023, the

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[43]IRC section 6166(b)(8)(ii).

[44]Gopman and McCawley, 832 T.M., Estate Tax Payments and Liabilities, page A-11.

[45]IRC section 6166(b)(9).

[46]IRC section 6166(b)(9)(B)(i).

[47]Practical Drafting 1758 (R. Covey ed. 1989).

[48]Practical Drafting 1760-1761 (R. Covey ed. 1989).

[49]IRC section 6166(b)(9)(B)(ii).

Internal Revenue Service ruled that a only a portion of a decedent's interest in a limited liability company qualified as an active business. The limited liability company owned an interest in three pieces of commercial property. The company performed rental management services for only two of the three properties. As a result, the value of the decedent's interest in the entity attributable to properties that were actively managed qualified as an interest in a closely held business for purposes of section 6166, and the estate tax attributable to the third property, the property that was not managed by the company, could not be paid in installments because it was a passive asset.

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 for business loans.[50]

The 2001 Tax Act amended the passive asset rules by providing that an interest in a qualifying lending and financing business is treated as stock in an active trade or business and qualifies for deferral. In this situation, the estate tax must be paid over five years.[51]

III. The Mechanics of a Section 6166 Election

A. Section 6166 Election

The election under section 6166 is made by attaching to a timely filed estate tax return a notice of election.[52] 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 nor is 9100 relief available.[53] Even where a tax return preparer timely filed an extension of time to file the federal estate tax return containing a prospective statement about an estate's eligibility for deferral, the ultimate deferral was denied. Chief Counsel Advice Memoranda 200848004 described such a case. The tax return preparer timely filed an extension request with the following statement: "It is anticipated that the Estate will be eligible to elect to defer the payment of the federal estate tax pursuant to IRC Sec. 6166." The final estate tax return was filed 10 days late but contained the necessary notice of election. The estate's request for referral was denied because the notice of election was not attached to a *timely filed return* and the statement with the extension request merely anticipated the estate's eligibility and was not definitive on the matter. Return

[50]Technical Advice Memorandum 8848002.

[51]IRC section 6166(b)(10)(A)(ii).

[52]IRC section 6166(d).

[53]PLR 200721006.

preparers should not only be mindful of the strict requirements for filing a return on time but also consider preparing an entire notice of election under 6166 to accompany an extension request.

Under Regulation section 20.6166-1(b), the notice of election[54] should contain the following information:

- the decedent's name and taxpayer identification number;
- the amount of tax to be paid in installments;
- the date selected for the payment of the first installment;
- the number of annual installments in which the tax is to be paid;
- the properties shown on the estate tax return that constitutes a closely held business interest (identified by schedule and item number); and
- the facts that form the basis for the personal representative's conclusion that the estate qualifies for payment of the estate tax in installments.

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 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.[55]

It is preferable that the personal representative execute the notice of election. If the attorney for the estate in all matters executes the notice of election, it should be a valid election under section 6166 notwithstanding that the attorney had no power of attorney on file with the Internal Revenue Service.[56]

B. Judicial Review of Denial of Section 6166 Election

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

[54]An example of an election under section 6166 can be found in Gopman and McCawley, 832 T.M., Estate Tax Payments and Liabilities, Worksheet.

[55]Reg. Section 20.6166-1(b).

[56]Private Letter Ruling 8124050.

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.

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.

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

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

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

For a decedent who dies in 2009, the estate tax attributable to the first $1,330,000 value of closely held business interest (indexed for inflation) will bear interest at the rate of two percent.[57] The two percent interest rate will apply to $598,500 of such deferred tax. 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.[58] For 2009, the underpayment interest rate was four percent, and the rate applicable to the balance of the deferred estate tax was 1.8 percent.[59] This rate changes periodically as the underpayment interest rate

[57]IRC section 6601(j)(1)(A).

[58]IRC section 6601(j)(1)(B).

[59]The underpayment interest rate is determined quarterly by adding three percentage points to the section 1274(d) Federal short term rate for the first calendar month of the quarter. Where the interest rate applicable to the balance of the deferred estate tax falls below two percent, as it has in recent months because of the overall decline in interest rates, there is no clear guidance to suggest that estates can elect out of the two percent rate on the first $598,500 of deferred estate tax.

changes.[60] In both instances, the interest is compounded daily.[61] 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.[62]

If the closely held business amount is in excess of “2-percent portion,”[63] the Internal Revenue Service prorates the two percent interest rate and 45 percent of the general underpayment interest rate.[64] 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 “2-percent portion.” It is possible, however, to elect section 6166 treatment for only the “2-percent portion” 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.

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.

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[65] that interest accrues at the prevailing rate under

[60]Private Letter Ruling 200529006.

[61]IRC section 6622(a).

[62]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.

[63] See Footnote 10 for an explanation of the “2-percent portion.”

[64]IRC section 6601(j)(3).

[65]1989 C.B. 307.

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.[66]

D. Election in Case of Deficiency

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.[67] This election is available notwithstanding that the personal representative did not make an election when the return was filed. This election is not available if the deficiency is due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax.[68] The election must be made no later than 60 days after request for payment of the deficiency.[69] 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.[70] 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.

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.[71]

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[66] 1967-1 C.B. 342.

[67] IRC section 6166(h).

[68] IRC section 6166(h)(1).

[69] IRC section 6166(h)(2).

[70] IRC section 6166(h)(3).

[71] Technical Advice Memorandum 9828002.

IV. Acceleration of Deferred Tax

A. General Rules Applicable to Acceleration of Deferred Tax

A distribution, sale, exchange or other disposition of 50 percent or more of the value of the decedent's interest in the closely held business will accelerate all unpaid tax deferred under section 6166.[72] 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.[73] A mere change in form is not construed to be a disposition. Thus, a sole proprietorship may be incorporated without accelerating the unpaid tax.[74] But, the issuance of corporate debentures in the incorporation of a sole proprietorship is considered a disposition.[75] The exchange of estate assets for an interest as a limited partner in a limited partnership is not a disposition.[76]

A withdrawal of 50 percent or more of the value of the closely held business will also accelerate the unpaid tax.[77] 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.[78] This issue is discussed in more detail later in this paper.

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.[79] If the liquidation results in a distribution of assets to stockholders so that the stockholders

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[72]IRC section 6166(g).

[73]Private Letter Ruling 8113120.

[74]Rev. Rul. 66-62, 1966-1 C.B. 272; Private Letter Rulings 8108090, 8103066, 8105063, 7724045, 7721043, 7807104, 7825029, and 7929055.

[75]Private Letter Ruling 8220119.

[76]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.

[77]Reg. section 20.6166-3(d).

[78]Rev. Rul. 72-188, 1972-1 C.B. 383.

[79]Rev. Rul. 66-62, 1966-1, C.B. 272. Private Letter Rulings 8213075, 8108090 and 8103066.

will conduct separate businesses, there is a disposition under section 6166 and the unpaid tax may be accelerated.[80]

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.[81] As long as the closely held business is transferred to a family member (within the meaning of section 267(c)(4)), the death of a beneficiary during the deferral period no longer accelerates the unpaid tax.[82] 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.[83]

The Internal Revenue Service ruled in Revenue Ruling 89-4[84] 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). 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

Section 303 permits a redemption by a corporation of stock owned by a deceased stockholder to the extent of federal and state 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 the corporation will be the source of cash for the payment of estate taxes and costs of administration, and 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.

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[80] Private Letter Ruling 8131031.

[81] Reg. section 20.6l66-3(e)(l).

[82] IRC section 6166(g)(1)(D).

[83] IRC section 6166(g)(2).

[84] 1989 C.B. 298.

There is a time restriction on the availability of a redemption under section 303.[85] In general, a redemption must be made 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) 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 lessor 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.[86]

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. A redemption under section 303 should follow each installment paid under section 6166.[87]

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.[88]

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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[85]IRC section 303(b)(1)(A).

[86]IRC section 303(b)(4).

[87]Private Letter Ruling 8204129 involves a series of redemptions under section 303 and the effect on a section 6166 election.

[88]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

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.[89] In light of Delguzzi, the Internal Revenue Service issued Revenue Ruling 82-120.[90] 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.

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.[91] 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.

V. Miscellaneous Section 6166 Matters

A. TPT Credit and Section 6166

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.

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.[92] 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

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

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[89] 80-2 USTC ¶ 13,364 (W.D. Wash. 1980).

[90] l982-1 C.B. 203.

[91] IRC section 6166(g)(3).

[92] Technical Advice Memorandum 8301007.

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.[93]

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. 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.

VI. Lien to Secure the Section 6166 Deferred Estate Tax

A. Section 6166 Lien

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.[94] A personal representative has personal liability for unpaid estate tax to the extent the personal representative distributes assets to the beneficiaries.[95] Although the general estate tax lien extends for a period of ten years from the decedent's death, the section 6166 deferral period can last up to 14 years, which extends the liability period.

A personal representative who seeks to be discharged from personal liability from the unpaid estate tax may either post a bond under section 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

[93]Rev. Rul. 82-6, 1982-1 C.B. 137.

[94]Section 6166 lien property is defined in section 6324A(b) as property expected to survive the deferral period and designated in the section 6166 election agreement.

[95]IRC section 6324(a)(2).

pledged.[96] 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

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 Treasury 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, which did not have liens or bonds. 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.

The Treasury Inspector's concern was highlighted in a bankruptcy case[97]. 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 corporation's assets.

C. The Internal Revenue Manual Provisions Regarding Section 6166

Section 5.5.6.1 of the Internal Revenue Manual is 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:

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[96] Code of Federal Register 301.6324A-1.

[97] <u>IRS v. Skiba</u> (In re Roth), W.D. Pa., Adv. No. 03-1171

- require the estate to furnish a performance bond with a face value up to double the amount being deferred, or

- allow the estate to substitute the filing of a special lien (Form 668J) pledging the estate's right, title, and interest to specific property to the government.

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.[98] The Tax Court has ruled that the Internal Revenue Service has no authority to require a bond or lien in every case in which an estate files a Notice of Election under section 6166.[99] Judge Goeke said he was weary of the Internal Revenue Service's contention that the Service may adopt a bright line requirement requiring a bond or lien because the government has changed its stance on the issue several times in the past. While previously published guidance cannot be cited as precedent, Judge Goeke wrote that it could highlight the government's confusion about the proper interpretation of the bond requirement. The legislative history of section 6166 reveals that the bond requirement is discretionary and was not intended to be mandatory.

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.[100] 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.

In response to Roski, the Internal Revenue Service released Chief Counsel Advice 200803016. In that Advice, the Internal Revenue Service's Chief Counsel ruled that the Internal Revenue Service must accept as collateral the interest for which the election was made for the tax deferred under section 6166 if the following three requirements are met:

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[98] The Internal Revenue Service provides information to the personal representatives of estates making a section 6166 election. Copies of this material are in the Appendix.

[99] Roski v. Commissioner, T.C., No. 5639-05, 128 T.C. No. 10, 4/12/07.

[100] IRC section 6901.

- the collateral must be expected to survive the deferral period and retain value,

- the interest must be identified in the written agreement (specifically all of the persons having an interest in the collateral must agree to the creation of the lien, and

- the value of the collateral must be sufficient to pay the deferred taxes plus the required interest.

The Chief Counsel's Advice was followed by Notice 2007-90, and more recently, interim guidance issued to the Small Business/Self Employed division for handling estate tax cases involving deferred installment payments.[101] The majority of Memorandum SBSE-05-0609-010 confirms the procedures for processing estate tax cases with a 6166 election and reviewing changes within the Internal Revenue Service for handling those cases.

The guidance leaves no doubt: any estate tax return with an election for deferred installment payments will be selected for review and closer examination by the Internal Revenue Service.[102] Whether that review leads to field consideration (audit) or the return being accepted as file, a special lien package, including information relevant to the closely held business interests and the return, will be forwarded to the Estate Tax Lien Advisory Group within the Internal Revenue Service. This group (referred to within the Memorandum as "Advisory") will be responsible for determining, on a case-by-case basis, whether the deferred installment payments of estate tax under section 6166 pose a sufficient credit risk to justify the requirement of bond or special lien.[103]

Advisory is advised to request a voluntary bond or lien on the property to secure the deferred estate tax. If the executor does not agree to voluntarily encumber the property, Advisory will determine whether to require a bond or lien. The Memorandum lists the following (non-exclusive) factors to be considered by Advisory in this decision:

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[101] IRS SBSE Memorandum (SBSE-05-0609-010) Updating Procedures for Processing Certain Estate Tax Cases Involving Deferred Installment Payments, June 12, 2009.

[102] Id., at section 12(3).

[103] Id., at section 19.

- Duration and stability of the business, including examination of the assets of the business, the economic and market forces impacting the future of the business, recent financial history and experience of the business's management.

- Ability to pay the installments of tax and interest timely, including the assets and liabilities of the business, the existing debt and debt structure of the business and the cash flow – both past and expected – of the business.

- Compliance history, including the record of the estate and the executor, as well as the business and its management, in compliance with required federal tax payments and filings.[104]

VII. Planning for Section 6166

A. Lifetime Planning for Section 6166

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 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. 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 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.

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

[104] Id., at section 19(7).

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

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.

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

VIII. Obstacles to Section 6166

A. Obstacles Created by Statute

Some of the obstacles to obtaining the benefits of section 6166 are created by the statute itself. These obstacles include the following:

- Section 6166 has a "cliff" 35 percent qualification 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).

- Only active businesses qualify for section 6166 deferral.

- The rules regarding holding companies are not clear.

- The rules regarding multiple levels of tiered entities are not clear.

These obstacles create uncertainty that will not be resolved without Congressional action or published rulings.

B. Business Obstacles

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.

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 a commercial lender would make a fixed rate loan for a 14-year term.

C. Suggested Legislative Changes to Section 6166[105]

Although section 6166 provides benefits in many instances, section 6166 is outdated. Business owners now use business entities and business structures that were not contemplated when section 6166 was enacted. In April 2008, the Senate Finance Committee held a hearing on estate tax reform. The testimony of one witness addressed the issues associated with section 6166.[106] Among the areas that Congress needs to review and change are the following:

- Expand the definition of closely held business interest to accommodate new forms of doing business;

- Treat multiple entities in which an individual has an interest as a single business enterprise so as to avoid artificial disqualification under section 6166;

- Define what is an active trade or business;

- Allow late elections; and

- Address the issue of liens, bonds, and other security issues to minimize interference with the continuing business.

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[105] Many of the suggestions are based on the recommendations from members of the Business Planning Group of the Probate and Trust Division of the Real Property, Probate and Trust Law Section of the American Bar Association with Steven B. Gorin assuming principal responsibility submitted to the Senate Finance Committee in July 2005. The report can be obtained at the website of the American Bar Association's Section of Real Property, Probate and Trust Law.

[106] The testimony can be found at http://www.actec.org/public/Governmental_Relations/BelcherTestimony4_3_08.asp

Section 6166 was enacted more than 50 years ago and has not been updated to reflect the new business entities available and used by business owners. Notwithstanding that in many instances limited liability companies are the preferred form of business entity, section 6166 has no reference to limited liability companies. Congress should expand the definition of a business entity to include all forms of doing business including limited liability companies and Massachusetts business trusts. If Congress amends section 6166 to accommodate new business forms, Congress should not distinguish between the treatment of ownership interests in the different business entities as is the case under present law. For example, an individual must own 20 per cent of the total capital interest in a partnership,[107] but only 20 percent of the total voting stock of a corporation in order to qualify for section 6166 treatment.[108] There is no perceived reason for this distinction between corporations and partnerships and it should be eliminated.

Many business owners conduct business operations in multiple entities, some as brother-sister entities, and some as tiered parent-subsidiary entities. Because it is not clear under section 6166 whether these entities qualify for section 6166 treatment, the Internal Revenue Service has had to rule in many private letter rulings on a case by case basis which prevents relief in some instances and may result in inconsistent treatment of taxpayers.[109] A 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 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)[110] Congress should also amend section 6166 to provide that directly owned entities (brother-sister entities) and indirectly owned entities (parent-subsidiaries) be combined in determining whether the combined business entity meets the qualification tests under section 6166. This amendment would accommodate modern business practices.

Section 6166 requires that to qualify for estate tax deferral the closely held business must conduct a trade or business. In addition, section 6166 provides there is

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[107] IRC section 6166(b)(1)(B)(i).

[108] IRC section 6166(b)(1)(C)(i).

[109] See Technical Advice Memoranda 8219007 and 8134012 and Private Letter Rulings 8448006 and 8130175. R.E. Moore (DC) 87-2 USTC ¶ 13,741

[110]Gopman and McCawley, 832 T.M., Estate Tax Payments and Liabilities, page A-11.

no estate tax deferral for the estate tax attributable to passive assets.[111] Unfortunately, section 6166 does not contain a definition of either an active trade or business or a passive asset. When an individual conducts a business in multiple entities, it is not clear what assets are passive. This lack of clear definitions has resulted in numerous Internal Revenue Service rulings determining on a case to case basis what is an active trade or business resulting in inconsistent treatment from taxpayer to taxpayer. This is particularly troublesome for real estate entrepreneurs. In addition, the typical planning device used by many taxpayers 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.[112]

Section 6166 does not allow late elections.[113] Unfortunately it is not possible to make late elections on a late filed return. This prohibition can create hardships in certain instances. It is recommended that section 6166 be amended to permit late elections.

Section 6166[114] provides that the personal representative must post a bond with surety for the unpaid tax. If the personal representative does not post a bond, the personal representative alternatively may provide a lien on property acceptable to the Internal Revenue Service. Because of the underwriting requirements imposed by bonding companies, it may be impossible to obtain a bond to secure the payment of the deferred tax using estate assets. It is important to ensure that the deferred estate tax be paid, but this leaves the determination of adequate security to the discretion of the Internal Revenue Service auditing agent without guidance. Depending on the agent's decision on what is the appropriate amount of security, the business may have a problem in raising operating capital to continue the business. Congress should amend section 6166 to provide guidance as to the proper security for the unpaid deferred tax. One approach is to limit the security to the assets included in the gross estate and not the assets owned by business entity. This approach should allow the business to raise capital using assets owned by the business entity as collateral for loans. Without guidance, the successors to the business owner will not be able to plan on meeting the future capital needs of the business.

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[111] IRC section 6166(b)(9).

[112] Private Letter Rulings 200339001, 200006034, 8451014, 8140020, and 7917006.

[113] IRC section 6166(d).

[114] IRC section 6324A.

IX. Funding Section 6166 Payments With Corporate Distributions

A. Corporate Distributions

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.

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.

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. 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.[115] 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).[116] 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.

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

[115] IRC section 301(c)(2).

[116] IRC section 301(c)(3).

B. Redemptions of Stock under Section 302

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 redemption that is not essentially equivalent to a dividend under section 302(b)(1);

- a redemption that is substantially disproportionate under section 302(b)(2); and

- a redemption that completely terminates the shareholder's interest under section 302(b)(3).

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.[117]

C. Stock Attribution Rules under Section 318

In connection with any redemption transaction under section 302, the rules of constructive ownership of stock under section 318 must be considered. 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.

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.

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[117]IRC section 302(d).

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. 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

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.[118] In order to qualify for complete termination, the shareholder's proprietary interest in the corporation must be completely terminated by the redemption. 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.

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 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.

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:

- retain no interest in the corporation (including an interest as an officer, directly or employee), other than as a creditor;

[118]IRC section 302(b)(3).

- not acquire any interest in the corporation within 10 years from the date of the redemption (other than by inheritance); and

- notify the Internal Revenue Service of any interest in the corporation is acquired within the 10-year period.

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)

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). 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)

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.

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.[119]

G. Conclusion Regarding Corporate Distributions to Fund Section 6166 Payments

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.

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).[120] 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.

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.

X. Redemptions to Pay Death Taxes – Section 303

A. Section 303 Redemptions Are Exceptions to Dividend Treatment

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

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[119] 397 U.S. 301 (1970).

[120] These provisions are set to expire on December 31, 2010, returning the income tax rate on qualified dividends to pre-2001 rates. The lowest rate for qualified dividends will be 15%, and the highest rate for qualified dividends will be 39.6%. Congress is considering legislation to extend the 2010 rates, but the status of such legislation is uncertain.

treatment to the extent of the corporation's earnings and profits.[121] 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.

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. 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 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

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.[122] 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.

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).[123] Allowable deductions under sections 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.[124] No redemption is permitted for the amount of the decedent's debts, but only for death taxes (including

[121] IRC section 301.

[122] IRC section 303(c).

[123] IRC section 303(a)(2).

[124] Rev. Rul. 56-449, 1956-2 C.B. 180.

interest), funeral and administration expenses.[125] The family or widow's allowance is not considered an administration expense.[126]

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.

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.[127] 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

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.

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.

D. Timing of Redemptions under Section 303

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 Good's Transfer, Inc. and 50 percent of the stock of Brookdale Farms, Inc. (The other 50 percent of the stock of Brookdale Farms, Inc is owned by an unrelated third party.) Assume that Brookdale Farms, Inc redeems all of the decedent's stock. Later, Good's Transfer, Inc. redeems 25 percent of the decedent's stock, which is equal to

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[125] IRC section 303(a).

[126] Majerus v. Coyle, 254 F. Supp. 214 (N.D. Ill. 1966).

[127] Reg. section 1.303-2(f) and (g).

the amount allowable to be redeemed under section 303. Section 303 will be applied first to the redemption by Brookdale Farms, Inc. notwithstanding that the redemption would be tax free as a complete termination under section 302(b)(3). The redemption by Good's Transfer, Inc. will not be accorded section 303 treatment and the redemption proceeds may be taxable as a dividend. If the redemption by Good's Transfer, Inc. had been before the redemption by Brookdale Farms, Inc., both redemptions may have been tax-free.

A redemption under section 303 must be made within the following time limitations:

- 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);

- if there is a deferral of estate taxes under section 6166, the redemption must be within the time period for paying the unpaid tax;

- 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:

  - the section 303 amount that has not been paid; or

  - 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

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.[128]

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

[128]Reg. section 20.6166A-3(d)(2); and Rev. Rul. 72-188, 1972-1 C.B. 383.

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.

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.[129]

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.

F. Planning with Sections 6166 and 303

Through careful pre- and post-mortem 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. 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.

XI. The Economics of Estate Tax Deferral

A. Deductibility of Interest Incurred to Pay Estate Tax

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

[129] 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.

expense.[130] 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."

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 restriction agreement.[131] In Private Letter Ruling 200020011, the Internal Revenue Service ruled that interest attributable to a loan obtained from a commercial lender to pay federal estate taxes deferred under section 6166 is deductible as an administration expense under section 2053(a)(2).

In Revenue Ruling 84-75,[132] 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.

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.[133] 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

[130] In Rupert v. 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. In Estate of Gilman, T.C. Memo. 2004-286, the Tax Court allowed the interest deduction to the extent necessary to pay estate taxes and until the estate received sufficient cash to pay the loan.

[131] McKee, T.C., CCH p. 13,058.

[132] 1984-1 C.B. 193.

[133] Bailly Estate v. Com'r, 81 T.C. 246 (1983); Rev. Rul. 80-250, 1980-2 C.B. 278.

tax.[134] If interest is paid after the applicable statute of limitations, the estate cannot obtain a refund of estate tax unless the estate has filed a protective claim for refund. Private Letter Ruling 9449011 sets forth the procedure for filing a protective claim to keep alive a potential refund of estate tax for interest to be paid in the future.

B. Nondeductibility of Section 6166 Interest Payments

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 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.

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 2005 first quarter 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.

Commissioner v. Hubert[135] 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.[136]

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[134] IRC section 6511.

[135] 520 U.S. 93 (1997).

[136] T. D. 8846, 1999-52 I.R.B. 679.

XII. Alternative Strategy: Third Party Borrowing with Estate Tax Deduction for Interest Payments

A. General Description

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 or owned by the decedent's estate or beneficiaries.

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 and is explained in Eastland, Why My Algebra Teacher Rolls over in Her Grave: The Mathematics of Estate Planning. [137]

B. Estate of Graegin

Estate of Graegin v. Commissioner[138] 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

[137] 1990 Heckerling Institute on Estate Planning, Chapter 18.

[138] T. C. Memo. 1988-477.

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.

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

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 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.

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.

One item in the Joint Treasury Internal Revenue Service 2008-2009 Priority Guidance Plan is "Guidance under section 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of administration expenses and claims against the estate." It is believed that this is aimed at the deductibility of interest payable over a period of time for loans incurred to pay estate taxes.

D. Graegin Rulings by the Internal Revenue Service

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 made by a commercial bank and provided 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. Private Letter Rulings 200449031 and 199952039 reached a similar result.[139]

E. Technical Advice Memorandum 200513028

In the recent Technical Advice Memorandum 200513028, 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).

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

[139]Private Letter Ruling 200449031 illustrated an interesting planning technique of retaining the right to prepay the loan to an unrelated commercial lender but waiving the right if the ruling request was successful.

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.

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.

F. Klein v. Hughes – Graegin-Style Promissory Note Accepted by Internal Revenue Service

Conrad Lee Klein et al as Trustees vs. Alexander Reynolds Hughes[140] is an unpublished opinion issued by the California intermediate appellate court in 2004. In that case, the Trustees for a large estate petitioned the court for instructions concerning a loan transaction that the Trustees wished to enter into for the payment of estate taxes. The lower court granted the Trustees' petition over the objections of the guardian of the estate's principal beneficiary. The basis of the objection was that the guardian needed more time to analyze the proposed transaction and that the trial court granted the petition without an evidentiary hearing or trial. The California Court of Appeals affirmed the lower court's decision.

Mark Hughes, the founder of Herbalife Inc. died in May, 2000. Mr. Hughes' estate was valued at well over $300,000,000. The bulk of his estate was held in the Mark Hughes Family Trust for his son Alexander who was nine years old. The Trustees filed an estate tax return and determined that the Trust owed more than $200,000,000 in estate taxes. The Trustees undertook negotiations with the Internal Revenue Service and third-party lenders seeking ways to satisfy the tax liability. The Trustees sought instructions from the probate court regarding a proposed loan transaction to pay the estate taxes. In the petition, the Trustees stated that the Hughes

[140] 2004 Cal. App. unpublished Lexis 3788, filed April 20, 2004.

estate had substantial tax liability but due to the nature of the Trust investments, did not have sufficient liquid assets to pay the tax liability. Most of the Trust investments were in limited liability companies from which the Trust had no power to compel cash distributions, and the Trust interests were subject to stringent restrictions on transfer.

The Trustees had reached a settlement with the Internal Revenue Service regarding the estate tax liability. The terms of the settlement with the Internal Revenue Service were that the Trust agreed to borrow $49,000,000 from a third party using a zero coupon loan transaction to pay the Trust's federal and state estate tax liabilities. The loan would carry an interest rate of 8.75 per cent with all unpaid principal and interest due December 31, 2027. Aside from a $10,000,000 payment due September 9, 2005, no interim interest payment would be required for the loan. Prepayment of the loan was prohibited and it was therefore determined that the Trust would incur a total of approximately $309,000,000 in deductible interest expense by the due date of the loan. Because section 2053 would permit a current estate tax deduction for all interest payable through the term of the 25-year loan, with no present-value discount of the sum, the Trustees calculated that this financing arrangement would reduce the Trust's liability for estate tax by more than $166,500,000.[141]

The Trustees had negotiated with several financial institutions to obtain the necessary financing. Because the lending institutions proposed conditions that the Trustees believed the Trust may not be able to satisfy, the Trustees' tax counsel proposed an alternative transaction using an entity related to the lawyer's family. The lawyer and his family would create a family limited liability entity that would be owned primarily by the lawyer's family. Under the arrangement proposed by the lawyer, an investment partnership owned 99 percent by the Trust would make a zero coupon loan to the lawyer's limited liability entity for approximately $50,000,000 with all interest and principal due in 25 years. The lawyer's limited liability company would loan the entire $50,000,000 to the Trust at 8.75 percent interest on a zero coupon basis. The lawyer would receive a loan fee of approximately $125,000 and would obtain a profit based upon the spread between the interest rate charged on the loan from the Hughes Investment Partnership and the 8.75 percent interest rate the lawyer's limited liability company charged on its loan to the Trust. The lawyer initially proposed to borrow funds at 8.25 percent but the Trustees successfully negotiated the interest rate on the loan to 8.6 percent, a fifteen basis point interest rate spread. The investment partnership would have to pay income tax throughout the

[141]The savings to the Estate does not present the entire picture. Although the Estate will receive an up-front estate tax deduction for the interest payable over the term, the lender will have to recognize income over the term of the loan. Accordingly, the total savings to the family group will be the estate tax deduction less the present value of the income tax on the interest income.

term on the loan on the phantom income the investment partnership would appear to receive from the loan to the lawyer's limited liability company. The Trustees calculated the Trust would gain a net savings of approximately $115,000,000 by entering into this transaction. The net savings comes because section 2053 would allow the deduction of the full amount of interest paid on a $50,000,000 loan.

In its petition for instructions to the probate court, the Trustees attached a copy of the final agreement between the Hughes Estate and the Internal Revenue Service (a closing agreement). In the petition, the Trustees said that the Trustees had told the Internal Revenue Service of their desire to use an alternative financing arrangement and the Internal Revenue Service said it would be acceptable so long as the third party lender was not owned or controlled by the Trust or an entity owned by the Trust. Thus, it became necessary for the Trust and the investment partnership controlled by the Trust to have a middleman. The tax lawyer's limited liability company served as the middleman. [142]

The probate court approved the Trustees request to enter into the transaction and the California Court of Appeals affirmed the lower court's decision.

G. Keller v. United States – Federal District Court Upholds Interest Expense Deduction

In Keller v. United States[143] a United States Federal District Court upheld the right of an estate to take a deduct the interest on a loan from an investment partnership set up by the decedent's financial advisers to two trusts the decedent controlled. The court held that the estate was entitled to a $60.4 million deduction for interest, fees, and administrative expenses because the loan was found to be a necessary administrative expense, was entered into to preserve the liquidity of the estate, and satisfied the economic substance test.

The court cites the Graegin decision in finding that the interest expense is deductible. The court, however, does not address why it found that the loan was necessary. The estate paid approximately $148 million in estimated estate tax when the return was initially filed in 2001. This suit for refund has allowed the estate to deduct from the tax due the amount of interest paid on the Graegin-style note created by the trustees. The reason given for creating the note, and the reason held to be the court in allowing the deduction, was to preserve the liquidity of the estate.

[142] An irrevocable life insurance trust may be an alternative to using an unrelated third party as the middleman.

[143] No. V-02-62 (S.D. Tex 2010).

Since 2001, interest has be paid on the loan (at the applicable Federal rate, per the terms of the note), and that interest has been reported as income by the partnership that made the loan. In this case, unlike TAM 200513028 (discussed above), the District Court was sympathetic to the estate and allowed the deduction. In that TAM, the partners that made the loan were identical to the beneficiaries of the estate. Here, as in Graegin, the partners which made the loan were third parties. In Keller, repayment of the loan had economic impact on both parties, precisely because the parties were unrelated. The partnership that loaned the funds earned real interest, and as a result, the estate was entitled to a real interest deduction. Because this decision comes at or near the end of the term of the note, it is unclear if the deduction would have been available up-front, before all the interest had been paid. Presumably, because the Court relied on a Graegin-style theory, that would have been the case. As it is, because the term is nearly done, the estate has in fact paid the interest which it is claiming as a deduction.

H. Estate of Henry H. Stick, et al. v. Commissioner – Tax Court Denies Deduction for Interest Expense on Promissory Note

Estate of Henry H. Stick, et al. v. Commissioner[144] is a recent case from the Tax Court where the taxpayer's deduction for interest expense was denied. Henry H. Stick died in 2004, and his personal representative filed a tax return listing nearly $2,000,000 in liquid assets (consisting of mutual fund investments, cash, and marketable securities held in a family limited liability company). The estate reported approximately $820,000 of administration expenses; the largest single administration expense was $656,250 reported as interest on a loan to the estate from a related foundation to provide liquidity for paying the estate tax. The terms of the loan are not discussed in the case, but the facts suggest that the personal representative claimed the entire amount of interest that would be paid over the term of the loan as a current expense on the estate tax return. The estate reported a total estate tax liability of $1,046,000.

During the review of the return, the Internal Revenue Service denied the interest expense deduction and issued a notice of deficiency demanding additional tax from the estate totaling $371,728. The estate petitioned the Tax Court for reconsideration.

The Tax Court found that the federal and state estate tax liability and administration expenses, excluding the interest expense deduction, totaled $1,367,861. Because the estate had nearly $2,000,000 in liquid assets, there was no need to borrow the funds to meet the administration expenses of the estate. The Tax Court noted that the estate tax return provided no evidence showing that "it was actually necessary to borrow in order to meet [the estate] obligations." The deduction for the interest expense was denied.

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[144] TC Memo 2010-192 (2010).

In all circumstances, it is necessary to provide the Internal Revenue Service with evidence that the estate lacks sufficient liquid assets to meet its current obligations. Without such evidence, and where the estate has sufficient liquid assets available to the pay the tax, the large interest expense deductions will likely be disallowed.

XIII. Practical Considerations with Section 6166 Payments and Section 303 Redemptions

A. Have A Backup Plan

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 sections 6166 and 303 may prevent the client from undertaking other estate planning techniques that could reduce the overall estate tax burden. For these reasons, it is wise to have a backup plan in case the client's estate will not meet the requirements of sections 6166 and 303.

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

Eligibility for the benefits of section 6166 requires that the business be 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. 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

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.

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

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. 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-Style Promissory Note

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 style 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. 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.[145]

[145]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 Heckerling Institute on Estate Planning § 904.2.

Fifth. <u>Conclusion</u>

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.

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.

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.

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 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.

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.

APPENDIX A

Internal Revenue Service Information: Requirement of Estate to Secure Internal Revenue Code Section 6166 Election by Bond or Lien

Our records indicate that the Estate has elected to pay the estate tax by installment payments as allowed by Section 6l66 or 6166A of the Internal Revenue Code (IRC). Under the provisions of Section 6166(k)1 and (2), the Area Director now requires that an estate furnish a surety bond, as outlined in Section 6165, as a prerequisite for granting the installment election. As an alternative, the executor may elect the special lien under the provisions of Section 6324A.

The estate made the election under IRC Section 6166 at the time the 706 return was filed, and the Service Center has tentatively granted you the election, pending review by the Estate and Gift Tax Group. Be advised that while the bond or special lien did not need to be furnished at the time the Form 706 was filed, the final approval and granting of the installment election is dependent upon the estate providing the required bond or lien prior to the conclusion of the audit process.

The estate has been selected for review. If it is selected for audit, the Estate Tax attorney assigned to conduct the audit will negotiate the bond or lien agreement. If the estate is surveyed, meaning it will not be assigned to an attorney for a complete audit, the matter will be referred to a Technical Services Advisor who will secure the bond or lien agreement. In the sections below, you will find an explanation of the procedures for furnishing a surety bond, or, alternatively, electing the special lien provisions.

Collateral By Bond

The estate may elect to provide a bond under IRC Section 6165. The Code is specific as to a surety bond, and you may not substitute either a letter of credit or a trust deed for a bond. A listing of approved surety companies has been published in the Federal Register. In addition, there is a website, www.fms.treas.gov, which lists the companies already screened and determined as acceptable to the Service. It is the responsibility of the estate to secure the bonding company and then to present the proposal for the bond to the Service. We will, with the assistance of our legal Counsel, prepare a collateral agreement which sets forth the terms under which the bond will secure the installment agreement. It also provides for the surety company to satisfy the bond should the installment agreement default.

Collateral By Lien

If the estate elects the lien provisions, Section 6324A requires that the lien be placed on property having a maximum value equal to the sum of the total deferred tax plus four years of interest. To determine the maximum value we need to determine the equity to which the lien interest would attach. For example, if the tax liability is $100,000.00 and the interest rate is 4%, then the maximum value to be collateralized would be about $116,000.00. If the fair market value (FMV) of the property is $200,000.00 and the encumbrances are $50,000.00, the equity would be $150,000.00, and there would be sufficient equity to cover the lien interest. Generally the appraisal of property provided with the 706 return may be used to establish FMV. A copy of the appraisal should be provided to IRS as part of the lien process. The property must also be expected to survive the deferral period, which would be defined at the 15 year term of the 6166 election.

The estate will be required to provide a title report on the property(s) pledged. The title report must provide a complete legal description of the property being pledged, which will serve as an exhibit attached to the recorded lien. A Lot Book Guarantee issued by a title company is acceptable as a substitute for a complete title report. All parties listed as title holders on the subject property, whether or not they are heirs, are required under section 6324A (c) to consent to the creation and filing of the lien. This consent will be granted by signing a formal "Agreement and Consent" to the creation and recordation of the lien. If any interest in the property is held by a corporation or partnership, provide the IRS a copy of the Articles of Incorporation, or statement of partnership. The designated officer, or general partner, will be expected to sign the Agreement. In the case of a trust, the trustee(s) would sign. The "Agreement" will also designate an "agent," generally either the executor, or the representative of the estate, who will serve as the contact person for dealings with the IRS on lien issues.

In addition to vesting, the title report will reflect any encumbrances on the property, which may or may not have priority over the estate tax lien under IRC Section 6324. Provide the Service with current balances due on all outstanding encumbrances. This will assist us in determining whether there is sufficient equity in the property to meet the Code requirements.

Once all of the required information has been provided to the Service, it will be reviewed for completeness, and the lien will be filed by the Advisor in Technical Services. Upon payment in full of the liability, the lien will be released from the property. Contact the local Technical Services office immediately should the estate wish to sell the liened property, so that an escrow demand may be prepared. If the estate wishes to re-finance the property, a request to subordinate the tax lien to the new trust deed/mortgage would be submitted to Technical Services.

Questions regarding the bond or lien process should be directed to the Estate and Gift attorney assigned to the audit, or to the Advisor in Technical Services. Should the estate fail to comply with the requirement to provide the bond or lien, the election will be rejected and the estate will be granted appeal rights.

APPENDIX B

Internal Revenue Service Audit
List of Questions Regarding Real Estate Activities of Real Estate Partnership[146]

- Schedule of rental payments

- Space leased to operating company

- Support the active management of the property by the decedent

- Indicate the activities that were performed or supervised by the decedent with respect to the property owned by the Partnership, including, but not limited to

    - Interviewing and screening prospective tenants
    - Negotiating leases
    - Collecting rents
    - Preparing premises for new tenants
    - Maintenance of premises - water, heating, lighting, garbage disposal, plumbing, roof repairs, painting, gardening, etc.
    - Installation of fixtures, improvements
    - Maintaining financial records, paying bills
    - Obtaining and reviewing insurance coverage
    - Making bank deposits
    - Inspecting building
    - Consulting with legal counsel and accountants

[146] This material was derived from an estate tax proceeding handled by Marc S. Bekerman and the law firm Meltzer, Lippe, Goldstein & Breitstone, LLP, Mineola, New York. Marc is now with Fleischman & Bekerman, LLP in New York City.

APPENDIX C

CLOSELY HELD BUSINESS CASE STUDY

In 1967, George Wythe founded Closely Held, Inc. Closely Held, Inc. operates an extremely successful chain of dry cleaners and self-service laundry facilities throughout the southeast called "Founder's Cleaners." George has always thought it was important to own the real estate with every store. Some are free-standing stores; others are part of shopping centers. He owns the real estate, whether it is the free-standing store or the entire shopping center, in a separate corporation, Closely Held Real Estate, Inc., and the dry cleaning or self-service laundry facilities are leased to Closely Held, Inc. Where George owns the shopping center, the remaining facilities are managed by a property management company, and George collects the rents.

Closely Held, Inc. has been under George's sole control since he opened his first coin-operated store. He works every day in the business, and he is involved in selecting new locations, hiring and firing management, and ensuring the profitable day-to-day operations of the stores. Over the years, George has built a management team that he trusts. Cash flow has reliably been steady and strong. Even with the current difficult economic times, George predicts that the cash flow will remain steady and strong.

George and his wife Mary have two children. Neither of the children works in the business, but they both serve on the Board of Directors for Closely Held, Inc. George wants his dry cleaning and laundry empire to remain intact following his death, and he wants the business to support his wife, his children, and the Wythe Family Foundation (a family charitable foundation).

The estimated fair market value Closely Held, Inc. is $75,000,000. The real estate owned by Closely Held Real Estate, Inc. has an estimated value of $125,000,000. In addition, George owns real estate, marketable securities, and other assets with an estimated value of $45,000,000.

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1. How much life insurance should George consider purchasing?

2. How should George structure the ownership of Closely Held, Inc.?

3. Will George's ownership of Closely Held, Inc. qualify as ownership of closely held business under Internal Revenue Code section 6166(b)(1)? What about George's ownership of Closely Held Real Estate, Inc.?

4. What charitable techniques would be appropriate for George to consider?