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Planning to Pay Estate Taxes

Louis A. Mezzullo
PLANNING TO PAY ESTATE TAXES

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PLANNING TO PAY ESTATE TAXES

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I. INTRODUCTION

A. Is There a Liquidity Problem?

1. Nature of the client’s assets.
   a. Marketable securities and other liquid investments.
   b. Life insurance.
   c. Retirement plans.
   d. Commercial real estate.
   e. Residential real estate.
   f. Closely held business interests.
   g. Farms and Ranches.

2. Estimated size of the client’s estate and estate tax liability.
   a. Determine value of non-marketable assets, including closely held business interests and real property.
      (1) This will usually involve engaging one or more appraisers.
   b. Size of the estate tax applicable exclusion amount, currently $1,500,000, but scheduled to go to $2,000,000 in 2006 and $3,500,000 in 2009.
   c. Effective estate tax rate.
      (1) Currently the maximum rate is 47%, scheduled to go down to 45% in 2007.

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1 Portions of the outline were taken from an outline prepared by Dennis I. Belcher, a partner with McGuireWoods LLP, for the 39th Annual Heckerling Institute on Estate Planning.
(2) After 2005, the maximum rate will also be the effective rate.

(3) A current proposal is to reduce the rate to 15% if permanent repeal does not occur.

d. Client's current estate plan.

(1) Is the client married?

(2) If so, is the client using the maximum marital deduction to reduce the estate tax to zero if the client dies before the spouse?

(3) What are the client's intentions with regard to the disposition of interests in closely held businesses and farms?

(4) Does the client have a business succession plan?

(5) Has the client made plans to pay estate taxes?

e. Uncertainty about the existence of a federal or state estate tax or generation-skipping transfer tax will complicate planning.

(1) The best strategy may be to assume the present regime and provide for maximum flexibility through the use of powers of appointment and trust protectors with the power to amend and revoke trusts.

B. Premortem Planning to Reduce Transfer Taxes.

1. Use the gift tax applicable exclusion amounts ($1,000,000) of both spouses for transfers during lifetime.

2. Defer the payment of estate tax until death of the surviving spouse through the use of the marital deduction.

3. Plan to use the remaining estate tax applicable exclusions of both spouses at death through the use of by-pass trusts.

4. Make annual exclusion gifts ($12,000 in 2006).

5. Taking advantage of lack of control and lack of marketability discounts.
a. This will entail making transfers of closely held business interests during lifetime, which may prevent the client’s estate from qualifying for favorable treatment under §§ 303 (sale or exchange treatment), 2032A (special use valuation for real property), and 6166 (installment payment of estate tax).

b. Another disadvantage is the donee receives the donor’s basis in the gifted asset.

c. Should the donor give up control?

   (1) Beneficial for discounts, but probably not what donor wants.

d. What if the business or farm is sold during the donor’s lifetime? The proceeds would be distributed to the owners according to their percentage of ownership.

6. Use techniques that do not involve taxable gifts or that minimize the value of the gift.

a. **GRATs**, grantor retained annuity trusts designed to qualify the grantor’s retained right to receive a fixed dollar amount each year (usually based on a percentage of the fair market value of the asset transferred to the trust, and that can increase each year by 20% of the amount payable in the previous year) as a qualified interest under I.R.C. § 2702 so that the value of the gift to the remainder beneficiaries is reduced by the value of the grantor’s retained annuity interest.

b. **CLATs**, charitable lead annuity trusts designed to qualify the right of a charitable organization to receive a fixed dollar amount each year (usually based on a percentage of the fair market value of the transferred assets) for the gift tax charitable deduction so that the value of the charitable organization’s right to receive the annuity reduces the value of the gift to the remainder beneficiaries.

   (1) Charitable lead unitrusts (CLUTs), because the GST exemption can be allocated at the creation of the trust without further adjustments and because the charitable organization shares in increases in the value of the gifted assets, may be more appealing to some wealthy individuals, although for the very wealthy, the CLAT can provide more benefit to the
family if substantial gifts in excess of the GST exemption are intended.

(2) Because the charity does not share in the future growth in value of the trust assets, the remainder beneficiaries may end up with more in a CLAT than in a CLUT.

c. **Installment sales to grantor trusts**, designed to avoid recognition of income as a result of the sale and to shift future growth of the transferred asset to the beneficiaries of the trust without any transfer tax.

d. **Preferred equity interests** (also called frozen equity interests), designed to qualify the right to receive a preferred payment from an entity, usually a limited partnership or limited liability company (LLC), as a qualified payment right under I.R.C. §2701, thereby reducing the value of the transferred residual interests and shifting future growth to the holders of the residual interests.

e. **SCINs**, self-canceling installment notes under which payments cease at the death of the seller if he or she dies before the note is paid off, thus eliminating the balance of the note in the seller’s estate.

f. **Private annuities**, annuities that are issued by a person not in the business of selling commercial annuities in exchange for cash or an asset, that are unsecured to avoid current recognition of gain by the annuitant, and that terminate at the annuitant’s death thereby excluding the value of the asset exchanged for the annuity from the annuitant’s transfer tax base to the extent such value exceeds the value of the annuity payments actually made to the annuitant during his or her life.

g. **A combination of techniques**, such as the purchase of assets from a GRAT by a grantor trust for a SCIN.

C. **Planning to Pay the Estate Tax.**

1. Liquid assets.

2. Life insurance.

3. Installment payments under §6166.
4. Third party loans.

5. Related party loans (Graegin loans).

II. DEFERRAL OF THE PAYMENT OF ESTATE TAX

A. In General.

1. The federal estate tax is due nine months after the decedent’s death.

2. There are three provisions permitting a taxpayer to defer the payment of estate tax.
   
a. Under § 6161(a)(1), the IRS may extend the time for payment of the estate tax, or any installment of the estate tax, for a reasonable period not to exceed 12 months from the due date.
      
      (1) In addition, under § 6161(a)(2), an extension may be granted for reasonable cause with respect to any part of the estate tax or any part of any installment under § 6166, for up to ten years from the due date of the return or 12 months after the due date of the last installment.

b. Under § 6163, the payment of estate tax attributable to a reversionary or remainder interest included in a decedent’s gross estate may, at the election of the executor, be postponed until six months after the termination of the precedent interest or interests in the property.
      
      (1) An additional postponement for up to three years may be granted for reasonable cause.

   
c. Under § 6166, the federal estate tax attributable to closely held businesses may be paid in over two to ten equal installments.
      
      (1) In most cases, the installment payments of the estate tax must begin on or before the fifth anniversary of the due date of the estate tax return. § 6166(a)(3).

      (2) Interest is paid on the unpaid estate tax in annual installments beginning one year after the estate tax return was due.
(a) The interest rate on the estate tax on the first $1,170,000 in 2005 (as adjusted for inflation) of closely held business interests (after taking into account the applicable exclusion amount, $1,500,000 in 2005) is 2%. § 6601(j); Rev. Proc. 2004-71, Sec. 3.34.


§ 6601(j).

(3) The amount of the federal estate tax that can be paid in installments is an amount that bears the same ratio to the estate tax, reduced by the credits against such tax, as the closely held business amount bears to the amount of the adjusted gross estate. § 6166(a)(2).

(a) The closely held business amount is the value of the interests in closely held businesses that qualify under § 6166(a)(1). § 6166(b)(5).

B. Qualifying for Installment Payment of the Estate Tax.

1. In order to elect to pay the estate tax attributable to closely held business interests included in the estate in installments, the closely held business interests must exceed 35% of the decedent’s adjusted gross estate. § 6166(a)(1).

   a. The adjusted gross estate is the value of the gross estate reduced by the sum of the amounts allowable as a deduction under §§ 2053 and 2054, based on the facts and circumstances existing on the due date, including extensions, for filing the estate tax return, or, if earlier, on the date the return is filed. § 6166(b)(6).

   b. Because the statute refers to “allowable” deductions, such amounts reduce the gross estate for purposes of the 35% requirement regardless of whether they are actually claimed as a deduction on the estate tax return (in other words, they are claimed as deductions on the estate’s income tax return instead).
c. The decedent must be a citizen or a resident of the United States at the time of death.

d. The executor must make an election on a timely filed estate tax return.

2. An interest in a closely held business is:

a. An interest as a proprietor in a trade or business carried on as a proprietorship;

b. An interest as a partner in a partnership carrying on a trade or business if 20% or more of the total capital interest is included in determining the decedent’s gross estate or the partnership has 45 or fewer partners; or

c. Stock in a corporation carrying on a trade or business if 20% or more of the value of the voting stock of the corporation is included in determining the decedent’s gross estate or the corporation has 45 or fewer shareholders.

§ 6166(b)(1).

3. In determining whether the 35% requirement has been satisfied and the amount of the estate tax attributable to closely held businesses that may be deferred, the value of an interest in a closely held business does not include the portion of the interest attributable to passive assets held by the business.

a. A passive asset is an asset other than an asset used in carrying on a trade or business. See Section II.C below for a discussion of the IRS’s position on what constitutes a trade or business.

b. A passive asset includes stock in another corporation unless the stock is treated as owned by the decedent because the executor has made an election to treat the stock held by a holding company as business company stock under § 6166(b)(8). § 6166(b)(9)(B)(ii).

(1) However, if a corporation owns 20% or more of the value of the voting stock of another corporation or the other corporation has 45 or fewer shareholders and 80% or more of the value of the assets of each corporation (not taking into account the stock held in the other corporation by the first corporation) is attributable to assets used in a trade or business,
both corporations will be treated as one corporation for this purpose. § 6166(b)(9)(B)(iii).

(a) While not entirely clear, this treatment should apply to more than one subsidiary as long as the requirements are satisfied.

c. It is not clear whether inter-company loans will be treated as passive assets, although they should not be treated as passive if they are used for conducting the trade or business of the subsidiary.

d. The holding company rules should apply to partnerships and LLCs treated as partnerships.

e. In TAM 8848002 life insurance proceeds received by the company's creditor were excluded from the amount qualifying for installment payment.

4. Section 572 of the Economic Growth and Tax Relief Reconciliation Act of 2001 added § 6166(b)(10), which treats stock in a qualifying lending and finance business as stock in an active trade or business and any asset used in such business as an asset used in carrying on a trade or business.

a. The five-year deferral is not available in this case, and the tax must be paid in five (and not ten) installments. § 6166(b)(10)(A)(ii) and (iii).

5. The determination of whether the 35% requirement is met is made immediately before the decedent's death, although the value may be determined at either the date of death or the alternate valuation date, and real property held as an asset in a closely held business will be valued under § 2032A if the estate satisfies that section's requirements. § 6166(b)(2)(A) and (4).

6. For purposes of determining whether an interest is an interest in a closely held business, special rules apply for determining the number of owners.

a. Interests held by a husband and wife as community property, joint tenants, tenants by the entirety, or tenants in common are treated as owned by one of them. § 6166(b)(2)(B).

b. The property owned directly or indirectly by or for a corporation, partnership, estate, or trust is considered as
being owned proportionately by or for its shareholders, partners, or beneficiaries. § 6166(b)(2)(C).

(1) A person is treated as a beneficiary of a trust only if the person has a present interest in the trust.

c. Any stock or partnership interests held by the decedent’s family are treated as owned by the decedent. § 6166(b)(2)(D).

(1) Members of the family include the decedent’s spouse, brothers and sisters, ancestors, and descendants. § 267(e)(4).

7. For purposes of the 35% requirement, a farming business includes the value of residential buildings and related improvements on the farm that are occupied on a regular basis by the owner or lessee of the farm or by persons employed by such owner or lessee for purposes of operating or maintaining the farm. § 6166(b)(3).

8. For purposes of the 20% tests for determining whether an interest qualifies as a closely held business interest and whether two or more closely held businesses are treated as a single entity, an executor may elect to treat a capital interest in a partnership and any non-readily-tradable stock treated as owned by the decedent under the constructive ownership rules discussed in 6.a. through 6.c. above as owned by the decedent.

a. If this election is made, the special 2% interest rate and the five-year deferral are not available. § 6166(b)(7).

9. If an executor elects, holding company stock will be treated as business company stock to the extent it represents direct or indirect ownership through one or more other holding companies by the holding company in a business company.

a. A holding company is any corporation holding stock in another corporation.

b. A business company is any corporation carrying on a trade or business.

c. If the election is made, the special 2% interest rate and the five-year deferral are not available.
d. The stock of the holding company must be non-readily-tradable.

e. If the stock of the business company is readily-tradable, the installments must be paid over five years.

f. For purposes of the 20% voting stock requirement, holding company stock deemed to be business company stock is treated as voting stock to the extent that voting stock in the holding company owns directly or through one or more other holding companies voting stock in the business company.

g. Note that the election under § 6166(b)(8) is not needed if a corporation owns 20% or more of the value of the voting stock of another corporation, or such other corporation has 45 or fewer shareholders, and 80% of more of the assets of each corporation is attributable to assets used in carrying on a trade or business, excluding for this purpose the stock owned in the other corporation. § 6166(b)(9)(B)(iii). In such a case, the two corporations are treated as one.

h. Under a transition rule, if a corporation was in existence on June 22, 1984, and had five or fewer shareholders on that date and at all times until the decedent died, the executor may elect to treat the stock of all wholly-owned subsidiaries of the corporation as one corporation, provided that at least some of the subsidiaries are carrying on a trade or business. P.L. 98-369, § 1021(e)(2).

§ 6166(b)(8).

10. Interests in two or more businesses will be treated as one business if 20% or more of the value of each business is included in the value of the decedent’s gross estate.

a. Interests held by a surviving spouse in property held by the decedent and surviving spouse as community property, or as joint tenants, tenants by the entirety, or tenants in common are treated as having been included in the decedent’s gross estate for this purpose.

b. As noted above, an executor may elect to have other attribution rules apply, but the special 2% interest rate will not apply and the five-year deferral is not available.

§ 6166(c).
C. Trade or Business Test.

1. In General.

   a. In order for the federal estate taxes attributable to a decedent’s interest in a closely held business to qualify for deferral under § 6166, the IRS takes the position that the closely held business must be engaged in an active trade or business as of the decedent’s death.

      (1) There have been several published rulings in this area, but none recently.\(^2\)

   b. The IRS 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 § 6166.\(^3\)

      (1) From the private letter rulings discussed below, the IRS has taken inconsistent positions where the individual rents land to a corporation or other entity in which the individual is an owner.

   c. In dealing with farmers and ranchers, generally, the trade or business test is an issue in the following circumstances:

      (1) The net cash rental of farm real property;

      (2) A crop-sharing arrangement;

      (3) A family member managing the farm when the owner retires or becomes incompetent; and

      (4) Holding companies.

2. Trade or Business Test - Rental Real Property Without Duties.

   a. 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 § 6166.\(^4\)

      (1) In PLR 8020101, the IRS ruled that real property leased by a 97-year old to children with the children paying real property taxes and maintenance

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\(^3\) See Rev. Rul. 75-367, 1975-2 C.B. 472, decided under § 6166A, a predecessor to § 6166.

\(^4\) Smith v. Booth, 87-2 USTC ¶ 13,731 (5th Cir. 1987), rev’d: 86-2 USTC ¶ 13,748.
expenses did not qualify as a trade or business under § 6166.

(2) In PLR 8144012, the IRS 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.

b. Real property that is subject to a crop-sharing arrangement should be a trade or business under § 6166.

(1) Rev. Rul. 75-366 provided that an individual is in the business of farming if he receives a rental based upon farm production rather than a fixed rental.

(a) If this is the case, the benefits of § 6166 should be available.

(b) There are several PLRs that support Rev. Rul. 75-366.5

c. If the lease arrangement calls for activity on the part of the decedent, the real property may be a trade or business under § 6166.6

(1) A Federal District Court7 ruled that a decedent’s interest in farm land farmed under a sharecropping arrangement by a non-family member did not qualify as an interest in the closely held business.

(a) The Court’s ruling was based on the finding that the decedent was not actively engaged in the operation of the farm business.

(b) The Court made this finding notwithstanding that the decedent was consulted on management matters and contributed a portion of the expenses.

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

a. The typical planning device of separating the ownership of real property used in connection with an operating business

5 See PLRs 8133015 and 8020142.
6 See PLRs 8601005, 8332025, 8314003, 8240054, 8229133, 8226156, 8218072, 8205026, 8145008, 8136022, 8134019, 8133022, and 8130057.
7 Ronald C. Schindler, 87-2 USTC ¶ 13,735.
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 § 6166.

(1) The IRS has ruled for and against taxpayers in these circumstances and it is difficult to predict the IRS’s position.\(^8\)

b. Rev. Rul. 75-367 is the only published ruling dealing with the issue of whether real property owned by a decedent and used by the decedent’s corporation qualified under § 6166.

(1) In that ruling, the decedent owned a corporation that built homes on land owned by both the corporation and the decedent.

(2) In addition, the decedent owned personally several buildings used by the corporation.

(3) The IRS ruled that the real property owned by the decedent but used by the decedent’s corporation qualified for § 6166 deferral.

c. In PLR 200339001, the decedent owned three corporations.

(1) One corporation leased real property to the other two corporations.

(a) The leases did not require any services by the landlord corporation.

(2) The IRS ruled that the decedent’s ownership of stock in the landlord corporation was a passive asset.\(^9\)

d. In PLR 200006034, the IRS 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 § 6166.

(1) The IRS concluded that the land and building were held for the overall operation and management of the corporation.

\(^8\) PLRs 200339001, 200006034, 8451014, 8140020, and 7917006.

\(^9\) Chief Counsel Advice Memoranda 2003 39047 outlined the reasons the IRS had tentatively reached an adverse conclusion in a withdrawn PLR that appears to be the basis for this TAM.
e. In PLR 8140020, the decedent owned real property that was leased to a corporation of which he was a substantial shareholder.

   (1) The real property was the principal place of business of the corporation.

   (2) Under the lease agreement, the corporation was responsible for all expenses, maintenance, repairs, taxes and insurance.

   (3) The IRS ruled that the real property was not a closely held business under § 6166 and, thus, the federal estate taxes attributable to the property could not be deferred.

f. In PLR 7917006, the IRS held that real property leased to the decedent’s corporation was not considered eligible for § 6166 deferral.

   (1) PLR 81400020 reached a similar result.

   (2) In PLR 200339001, the IRS ruled that a corporation that rented property to corporations owned by the decedent did not qualify for § 6166 deferral.

4. Trade or Business Test - Rental Real Property Business.

a. Frequently, the personal representative of an estate of the owner of rental real property will be interested in the benefits of § 6166.

   (1) Whether the estate of the owner will qualify for § 6166 will depend upon the decedent’s activities with respect to the real property.

   (2) As the following PLRs will illustrate, the IRS has not drawn a bright line between what it defines as an active trade or business versus a passive asset.

      (a) It is clear that passively owning real estate and collecting rents is a passive activity.

      (b) 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 § 6166.
(c) One commentator has stated that § 6166 “is not user friendly” with regards to real estate assets.  

(d) It would be helpful if the IRS 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 § 6166.

b. Rev. Rul. 75-365 involved the issue of whether a real estate management office qualified as an interest in a closely held business for purposes of § 6166.

(1) In the facts in the ruling, the decedent maintained a fully equipped office, collected rental payments on the properties, received payments on notes receivable, negotiated leases, made occasional loans, and contracted and directed the maintenance of the properties using outside vendors.

(a) Notwithstanding this level of activity, the IRS ruled that the decedent’s business was not considered an active trade or business.

(b) Fortunately, the IRS has backed off this position in later private letter rulings, but, unfortunately, the IRS has not issued any published rulings contrary to Rev. Rul. 75-365.

c. PLR 200340012 involved the issue of whether the decedent’s interest in certain real estate qualified as an interest in a closely held business for purposes of § 6166.

(1) The decedent owned and operated as a sole proprietor 109 rental units on six parcels of real property.

(2) In addition, the decedent owned a 50% interest in 36 rental units and the decedent owned a membership interest in a limited liability company that held rental property.

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(3) The decedent and his son, assisted by five part-time employees, performed all services in the management and maintenance of the rental properties.

(4) The activities included advertising vacant apartments, interviewing, screening and selecting prospective tenants, negotiating and executing leases, collecting rents, maintaining common areas, making ordinary plumbing and electrical repairs, purchasing appliances, supplies and equipment, and inspecting rental units.

(5) The decedent and his son routinely devoted up to 14 hours a day on weekdays and several hours on weekends for maintenance and management of the property.

(6) The IRS ruled that the decedent's interest in the properties and the limited liability company qualified as an interest in a closely held business under § 6166.

d. In PLR 200114005, the IRS ruled that a sole proprietorship consisting of 82 rental units on 20 parcels of land qualified as an interest in a closely held business for purposes of § 6166.

(1) Under the facts of that ruling, the decedent found tenants, negotiated leases, collected rents, and paid the expenses for the operation of the rental units.

(2) The decedent performed most of the repairs and employed others to perform those repairs that were beyond the decedent's capabilities.

e. In TAM 9801009, the IRS ruled that a decedent's interest in a corporation involved in the rental real estate business was an interest in a closely held business for purposes of § 6166. For the 29-year period before his death, the decedent was engaged in the real estate leasing and management business, and at some point, he formed a corporation to manage his rental properties.

(1) The decedent and his wife wholly owned the corporation, and the decedent continued to personally operate, manage, and maintain the properties on a full-time basis.
Two months before the decedent’s death, the decedent hired a company to help manage the properties due to his inability to do so.

The IRS held that § 6166 was not intended to apply to activities involving the management of investment assets and indicated that the level of activity is the factor that distinguishes an active business from mere passive ownership of income producing assets.

The IRS determined that the decedent’s activities were more than an owner merely managing investments to obtain rents, and was instead similar to the level of activity in Rev. Rul. 75-366 and distinguishable from that of Rev. Rul. 75-365 and Rev. Rul. 75-367.

As to the decedent’s hiring of a management company, the IRS said that it would be unreasonable to deny relief on that basis, because death is frequently preceded by a period of incapacity.

In TAM 9832009, the IRS ruled that the decedent’s interest in several commercial real estate properties constituted an interest in a closely held business and in other properties the decedent’s interest did not qualify.

The IRS based its rulings on the activities of the decedent and the services provided to the tenants.

In PLR 9621007, the IRS ruled that an estate may not elect to pay estate tax in installments under § 6166, because the decedent’s real estate interests were not a trade or business.

The decedent held the real estate interests as a tenant in common and through partnerships.

The interests exceeded 35% of the adjusted gross estate.

The decedent was an active participant in managing the business until ill health forced the decedent’s daughter to replace him.

Business activities included obtaining tenants, enforcing lease terms, resolving tenant complaints,
collecting rent, paying bills, and overseeing repairs and improvements.

(5) In some cases many of those activities were assumed by the tenants.

(6) The IRS concluded that the decedent’s real estate interests were not interests in a closely held business under § 6166, even though the decedent might be considered to be operating a trade or business for purposes of other code sections.

(7) According to the IRS, the decedent’s activities fit squarely within the activities described in Rev. Rul. 75-365.

(8) The activities performed by the decedent and his daughter were merely those of an owner managing investment assets to obtain rents.

(9) Further, the services provided for the tenants were limited and a relatively small number of tenants occupy the assets.

h. In TAM 9635004, the IRS ruled that an estate may elect to pay in installments the estate taxes due on land owned by a decedent that was used by a partnership in the cattle ranching business.

(1) Most of the decedent’s cattle ranching business was conducted by a partnership that was owned two-thirds by the decedent and one-third by his son.

(2) The decedent actively participated in all operations of the partnership.

(3) Two-thirds of land used in the cattle ranching business was owned outright by the decedent.

(4) Although the land was essential to the operation of the partnership, it was never transferred to the partnership.

(5) Land owned outright by the son, also essential to the operation of the partnership, was never transferred to the partnership.
(6) Nevertheless, the partnership paid to maintain fences on the land, paid the real estate taxes, and paid for casualty and liability insurance.

(7) The IRS concluded that the decedent’s land qualified for the benefits of § 6166, reasoning that the decedent was carrying on the cattle ranching business both as a partner and as proprietor of a sole proprietorship.

(8) The land was essential to the overall operation of the decedent’s cattle ranching business even though it was not owned by the partnership.

(9) According to the IRS, the situation was distinguishable from the facts in Rev. Rul. 75-365 because the asset was used in the active business enterprise and produced income.

(10) The IRS noted that income from the land depended on and arose out of the profitability of the cattle ranching enterprise, rather than a fixed rental fee.

i. In TAM 9634006, the IRS ruled that two corporations that developed and managed rental real property were engaged in carrying on a trade or business for the installment payment of estate taxes.

(1) The decedent owned 17.65% of the voting stock of one of the corporations and 38.7% of the other.

(2) One corporation developed and constructed rental real estate and the other managed rental properties.

(3) The IRS ruled that both corporations were engaged in a trade or business under § 6166.

(4) The IRS noted that one of the corporations provided substantial services to tenants, such as maintaining common areas, providing water, heating, and sewer service, and disposing of garbage.

j. In PLR 8136022, the IRS ruled that the decedent’s ownership in a corporation that managed rental real estate was an interest in a closely held business because the corporation was engaged in an active trade or business rather than in mere leasing of property.
(1) Under the facts of that ruling, the corporation provided extensive maintenance, operation, and repair services to tenants of the properties and, thus, was conducting an active service enterprise.\(^{11}\)

k. In TAM 9403004, the IRS ruled that the decedent’s interest in ranch land did not qualify as an interest in a closely held business under § 6166(b).

(1) Accordingly, the estate may not elect to pay estate tax in installments.

(2) Citing Rev. Rul. 75-365, Rev. Rul. 75-366, and Rev. Rul. 75-367, the IRS stated that whether an estate should be permitted to elect under § 6166 should turn not on whether payment of the estate tax might require the estate to sell some income-producing assets, but on whether the estate’s properties form a genuine, active business.

(3) The IRS pointed out that ranch land, which was rented to ranch corporation B, was held as a passive income-producing investment.

(4) Accordingly, the decedent’s interest in the ranch land did not qualify as an interest in a closely held business under § 6166(b).

l. Residential real property actively managed by a decedent and two employees qualified as an interest in a closely held business in PLR 8524037.

(1) Under the facts of that ruling, the decedent and two employees operate, maintain and repair the buildings and surrounding grounds.

m. In TAM 8601005, the IRS ruled that a decedent’s interest in real property held in a partnership qualified as an interest in a closely held business notwithstanding that the partnership leased certain real property to a limited partnership in which the decedent also had an interest.

n. In PLR 9602017, the IRS allowed a § 6166 election for estate taxes attributable to real property owned by a partnership and several corporations that owned commercial and residential rental real property.

\(^{11}\) The IRS ruled similarly in PLR 8145008 and 8240055.
(1) The basis of the ruling was that the companies were going business concerns with active agents and not merely holders of passive assets.

o. In *Gettysburg National Bank*\(^{12}\) the District Court held that a decedent’s estate was entitled to the benefits of § 6166 because the decedent was closely involved in both the management of the corporation and the leasing of farm real property to the corporation.

5. Trade or Business Test - Activities of Agent.

a. As owners of farm real property become elderly, frequently management of the farm is given to family members or third parties.

(1) The question becomes whether this is detrimental to § 6166.

b. PLR 8144012 addressed this issue.

(1) In that ruling, the decedent was in failing health for some time before her death.

(2) The decedent’s son took over the operation of her farm and received all proceeds and made all farm payments.

(3) The IRS ruled that the farm was actively managed by the decedent’s son acting on behalf of the decedent.

(4) Therefore, the decedent was a proprietor in an active trade or business and the benefits of § 6166 were available.

c. PLR 8134018 reached the same result where a bank handled the decedent’s property under a general power of attorney.

\(^{12}\) DC Pa, 92-2 USTC ¶ 60,108.
D. Mechanics of the § 6166 Election.

1. Election.

a. The election under § 6166 is made by attaching to a timely filed estate tax return a notice of election.\(^\text{13}\)

(1) Notwithstanding that reasonable cause exists for the late filing of an estate tax return, the benefits of § 6166 are not available on a late filed estate tax return.

b. Under Treas. Reg. § 20.6166-1(b), the notice of election\(^\text{14}\) should contain the following information:

(1) The decedent’s name and taxpayer identification number;

(2) The amount of tax that is to be paid in installments;

(3) The date selected for the payment of the first installment;

(4) The number of annual installments in which the tax is to be paid;

(5) The properties shown on the estate tax return that constitutes a closely held business interest (identified by schedule and item number); and

(6) The facts that form the basis for the personal representative’s conclusion that the estate qualifies for payment of the estate tax in installments.

c. If the notice of election does not state the amount of tax to be paid in installments, the date selected for payment of the first installment, or the number of installments, the election is presumed to be for the maximum amount so payable and for payment thereof in ten equal installments, the first of which is due on the date that is five years after the date prescribed in § 6151(a) for payment of the first installment of the deferred estate tax.\(^\text{15}\)

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\(^\text{13}\) § 6166(d).

\(^\text{14}\) An example of an election under § 6166 can be found in Gopman and McCawley, 832 T.M., Estate Tax Payments and Liabilities, Worksheet.

\(^\text{15}\) Reg. § 20.6166-1(b).
d. It is preferable that the notice of election be executed by the personal representative. If the attorney for the estate in all matters executes the notice of election, it may be a valid election under § 6166 notwithstanding that the attorney had no power of attorney on file with the IRS.16


a. After an election under § 6166 has been filed, the IRS will review the election to determine whether it is in accord with the requirements of § 6166.

(1) If the IRS determines that the election is in accord, no notice is issued.

(2) Thus, a personal representative should assume that the election is acceptable if not advised to the contrary.

b. Where it appears after examination that an election under § 6166 does not meet the § 6166 requirements, the personal representative will be given the opportunity of an appeals conference.

(1) If the personal representative loses at appeals, there was no provision for judicial review of the decision before 1997.

(2) The Taxpayer Relief Act of 1997 added § 7479 that authorizes the Tax Court to issue declaratory judgments with the respect whether a § 6166 election may be made or whether the extension has ceased to apply.

c. If an estate elected deferral under § 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.

(1) Congress cured this problem in 1998 with the addition of § 7422(j) that allows an estate that has made a § 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.

16 PLR 8124050.
3. Amount of Tax Deferred and Interest Rates.

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

\[
\text{Net Federal Estate} \times \frac{\text{Closely Held Business Amount}}{\text{Tax Payable}} \times \frac{\text{Adjusted Gross Estate}}{100}
\]

b. The estate tax attributable to the first $1,170,000 value of closely held business interest (indexed for inflation) will bear interest at the rate of 2%.\(^{17}\)

(1) The interest rate on the balance of the estate tax extended under § 6166 bears interest at a rate equal to 45% of the interest rate applicable to underpayments of tax.\(^{18}\)

(2) In both instances, the interest is compounded daily.\(^{19}\)

(a) The 55% reduction in interest occurred in 1997 when Congress eliminated the estate and income tax deduction for interest paid on estate taxes deferred under § 6166.

(b) Notwithstanding that the estate tax rate at the time of the reduction was 55% and the estate tax rate has decreased since 1997, Congress has not adjusted the reduction in interest rate.\(^{20}\)

c. If the closely held business amount is in excess of $1,170,000, the IRS prorates the 2% rate and 45% of the general underpayment interest rate.\(^{21}\)

(1) Under this position, it is not possible to pay down the amount of estate tax attributable to the closely held business amount in excess of $1,170,000,

\(^{17}\) § 6601(j).
\(^{18}\) § 6601(j)(1)(B).
\(^{19}\) § 6622(a).
\(^{20}\) For decedents dying before 1998, the interest rate on the unpaid tax was 4% on the first $1,000,000 of closely held business amount. The interest rate on the balance of the tax deferred was the IRS general underpayment interest rate. Rev. Proc. 98-15, 1998-4 I.R.B. 25 sets forth the steps to be followed to take advantage of the new § 6166 lower interest rates on the deferred payment of estate taxes for those individuals who died before January 1, 1998.
\(^{21}\) § 6601(j)(3).
leaving only the amount entitled to the 2% interest rate.

(2) It is possible, however, to elect § 6166 treatment for only $1,170,000 worth of closely held business amount and thereby avoid the higher interest rate.

(3) 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.

d. Before 1998, the applicable credit amount reduced the estate tax eligible for the bargain 4% (now 2%) interest rate.

(1) 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 2% interest rate applies.

e. If the time for payment of estate tax is extended under § 6166 and a deficiency is assessed after the estate has timely made one or more annual interest payments, at what rate does interest accrue on unpaid interest that should have been paid on each past annual interest payment date?

(1) Because interest is part of the tax under § 6601(a), the IRS ruled in Rev. Rul. 89-32\(^{22}\) that interest accrues at the prevailing rate under § 6601(e).

(2) Moreover, the prevailing rate accrues from the date the interest should have been paid under § 6166(f)(1) if the return had shown the correct tax liability.

(3) The IRS noted that this ruling clarifies and amplifies Rev. Rul. 67-161.\(^{23}\)

4. Election in Case of Deficiency.

a. If there is a deficiency in tax after examination by the IRS and the estate qualifies under § 6166, the personal


\(^{23}\) 1967-1 C.B. 342.
representative may elect to pay the deficiency in installments. 24

(1) This election is available notwithstanding that the personal representative did not make an election when the return was filed.

(2) 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. 25

(3) The election must be made not later than 60 days after request for payment of the deficiency. 26

b. 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. 27

(1) If the personal representative made a protective election under § 6166 when the return was filed, the entire amount of the deficiency may be deferred under certain circumstances.

c. Rev. Rul. 81-294 28 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.

(1) The IRS ruled in technical advice that an election to pay estate tax in installments under § 6166 does not mean that the entire tax is deemed paid with the final installment, and § 6511(b)(2) limits refunds to tax actually paid within the two years before the refund claim. 29

E. Acceleration of Deferred Tax.


a. A distribution, sale, exchange or other disposition of 50% or more of the value of decedent's interest

24 § 6166(h).
25 § 6166(h)(1).
26 § 6166(h)(2).
27 § 6166(h)(3).
29 TAM 9828002.
in the closely held business will accelerate all unpaid tax deferred under § 6166.  

(1) Note that it is 50% or more in value of the interest in closely held business as of the date of the decedent's death.

b. A mere change in form is not construed to be a disposition.

(1) Thus, a sole proprietorship may be incorporated without accelerating the unpaid tax.

(2) But, the issuance of corporate debentures in the incorporation of a sole proprietorship is considered a disposition.

(3) The exchange of estate assets for an interest as a limited partner in a limited partnership is not a disposition.

c. A withdrawal of 50% or more of the value of the closely held business will also accelerate the unpaid tax.

(1) Under certain circumstances, a redemption under § 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.

(2) This issue is discussed in more detail later in this outline.

d. A liquidation of a corporation that is subject to a § 6166 election may be a disposition.

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30 § 6166(g).
31 PLR 8113120.
32 See Rev. Rul. 66-62, 1966-1 C.B. 272; PLRs 8108090; 8103066; 8105063; 7724045; 7721043; 7807104; 7825029; and 7929055.
33 PLR 8220119.
34 PLR 8131030. Other asset for asset exchanges are permitted if the newly acquired asset is used in the same business as the asset exchanged. PLRs 8326052, 8304032, 8248102, 8138068, and 7825029.
35 Reg. § 20.6166-3(d).
36 Rev. Rul. 72-188, 1972-1 C.B. 383
(1) 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.\(^{37}\)

(2) If the liquidation results in a distribution of assets to shareholders so that the shareholders will conduct separate businesses, there is a disposition under \(\S\) 6166 and the unpaid tax may be accelerated.\(^{38}\)

e. Although transfer of property to a beneficiary does not accelerate the payment of unpaid tax deferred under \(\S\) 6166, a subsequent transfer by the beneficiary does accelerate payment.\(^{39}\)

(1) As long as the closely held business is transferred to a family member (within the meaning of \(\S\) 267(c)(4)), the death of a beneficiary during the deferral period no longer accelerates the unpaid tax.\(^{40}\)

f. 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.\(^{41}\)

g. The IRS ruled in Rev. Rul. 89-4\(^{42}\) 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 \(\S\) 6166(g)(1)(A).

h. In PLR 200043031, the IRS 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 \(\S\) 6166.

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\(^{38}\) PLR 8131031.

\(^{39}\) Reg. \(\S\) 20.6166-3(e)(1).

\(^{40}\) \(\S\) 6166(g)(1)(D).

\(^{41}\) \(\S\) 6166(g)(2).

\(^{42}\) 1989 C.B. 298.
2. Acceleration of Tax and Redemptions under § 303.

a. Section 303 permits a redemption by a corporation of stock owned by a deceased shareholder to the extent of death taxes (including interest), funeral expenses, and administration expenses with respect to the estate of the deceased shareholder without the redemption being treated as a dividend.

(1) Section 303 is attractive and can allow distributions from the corporation with minimum income tax consequences if: (i) the corporation will be the source of cash for the payment of estate taxes and costs of administration, and (ii) stock in the corporation is to be distributed to family or trusts for their benefit.

(2) Section 303 is discussed in detail later in this paper.

b. There is a time restriction on the availability of a redemption under § 303.43

(1) 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 § 303.

(2) If the redemption is made outside four years after the date of the decedent’s death, § 303 is available only to the extent of the lesser of the aggregate of the amounts that remain unpaid immediately before the redemption, or the aggregate of the amounts that are paid during the one-year period beginning on the date of the redemption.44

c. To obtain the maximum benefit from § 6166, the deferral period should be maximized.

(1) But this creates problems with a redemption under § 303 and the four-year time limitation.

(2) In general, the maximum benefits under § 6166 can be obtained if there are a series of redemptions.

43 § 303(b)(1)(A).
44 § 303(b)(4).
(3) 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.

(4) A redemption under § 303 would be followed by an installment payment under § 6166.\(^4^5\)

d. One pitfall that the practitioner must be cautious about is the acceleration of deferred estate taxes under § 6166 because of a redemption under § 303.

(1) As pointed out above, there is an acceleration of the unpaid federal estate taxes deferred under § 6166 if more than 50% is withdrawn from the closely held business.

(2) Section 6166(g)(1)(B) provides a safe harbor for a redemption under § 303 if there is paid an amount of tax equal to the value of property and cash withdrawn from the corporation.

(3) It should be noted, however, that the value of the closely held business amount under § 6166 is reduced relating back to the date of the decedent’s death.

(4) This means that an earlier disposal of a portion of the corporation that was within the 50% safety zone may no longer be within the safety zone.\(^4^6\)

e. Rev. Rul. 86-54, modifying Rev. Rul. 71-188, provides an explanation of the application of §§ 303 and 6166 when shares of stock are redeemed and an election to pay the estate tax in installments is made.

3. Acceleration of Tax and Failure to Pay Installment of Unpaid Tax.

a. Treas. Reg. § 20.6166(c), which provides that the failure to pay any installment of tax accelerates the payment of

\(^{4^5}\) PLR 8204129 involves a series of redemptions under § 303 and the effect on a § 6166 election.

the unpaid tax, was held invalid in *Delguzzi v. United States*.\(^{47}\)

(1) Section 6166(g)(3) was amended as described below as a result of the decision in *Delguzzi*.

(2) In light of *Delguzzi*, the IRS issued Rev. Rul. 82-120.\(^{48}\)

(3) 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.

b. Under amended § 6166(g)(3), the failure to pay any unpaid tax within six months from the date the late payment is due will now accelerate the payment of the unpaid tax.\(^{49}\)

(1) 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 2% interest rate will be lost with respect to the late payment, and a penalty of 5% per month is assessed on the late payment.

F. **Special Rules and Miscellaneous Matters.**

1. Section 6166(i) provides that if an interest in a closely held business is the subject of a direct skip that occurs at the same time as, and as a result of, the decedent’s death, any GST tax imposed by § 2601 on the transfer of the interest is treated for purposes of § 6166 as if it were an additional estate tax, and is, therefore, eligible for installment payment treatment.

2. Section 6503(d) extends the statute of limitations for the period of any extension of time for payment granted under § 6166.

3. Section 2035(c)(2) provides that an estate will be treated as meeting the 35% of adjusted gross estate requirement of § 6166(a)(1) only if it would meet the test both by including interests transferred within three years of death and by excluding interests transferred within three years of death.

\(^{47}\) 80-2 USTC ¶ 13,364 (W.D. Wash. 1980).

\(^{48}\) 1982-1 C.B. 203.

\(^{49}\) § 6166(g)(3).
4. Because the IRS only allows the tax on prior transfers credit to be determined with respect to the tax actually paid, it is necessary to file a claim for refund as each payment is made under § 6166.\(^{50}\)

\[\text{a. Interest will be paid from the date of the return on any overpayment resulting from the increase in the credit.}\]

5. The amount of the estate tax charitable deduction may be reduced by the amount of interest payable on federal estate taxes deferred under § 6166 if the interest expense reduces the amount passing to the charity under the decedent's will.\(^{51}\)

G. **Lien to Secure the § 6166 Deferred Estate Tax.**

1. A personal representative has personal liability for unpaid estate tax to the extent the personal representative distributes assets to the beneficiaries.\(^{52}\)

\[\text{a. Because the general estate tax lien extends for a period of ten years from the decedent’s death and the § 6166 deferral period can last up to 14 years, an election under § 6166 results in the creation of a lien under § 6324A in favor of the United States on all § 6166 property.}\(^{53}\)

2. A personal representative who seeks to be discharged from personal liability from the unpaid estate tax may either post a bond under § 2204 (general fiduciary discharge) and § 6165 or elect to place a lien on the § 6166 property.

\[\text{a. The equity in the property pledged must exceed the amount of tax due plus interest.}\]

\[\text{b. The Regulations sets forth the requirements for creation of the lien, which requires consent of the parties who hold an interest in the property pledged.}\(^{54}\)

\[\text{c. When the lien is filed, the lien serves as collateral to secure the unpaid portion of the deferred estate tax liability.}\]

\(^{50}\) TAM 8301007.

\(^{51}\) Rev. Rul. 82-6, 1982-1 C.B. 137.

\(^{52}\) § 6324(a)(2).

\(^{53}\) Section 6166 lien property is defined in § 6324A(b) as property expected to survive the deferral period and were designated in the § 6166 election agreement.

\(^{54}\) Treas. Reg. § 301.6324A-1.
H. Suggested Legislative Changes to § 6166.\textsuperscript{55}

1. Although § 6166 provides benefits in many instances, § 6166 is outdated.
   a. Business owners now use business entities and business structures that were not contemplated when § 6166 was enacted.
   b. In addition, there are other miscellaneous issues concerning § 6166 that need to be addressed.

   a. 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.
   b. Notwithstanding that in many instances limited liability companies are the preferred form of business entity, § 6166 has no reference to limited liability companies.
   c. Congress should expand the definition of a business entity to include all forms of doing business including limited liability companies and Massachusetts business trusts.
   d. If Congress amends § 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.

(1) For example, an individual must own 20% of the total capital interest in a partnership\textsuperscript{56}, but only 20% of the total voting stock of a corporation in order to qualify for § 6166 treatment.\textsuperscript{57}

(a) There is no perceived reason for this distinction between corporations and partnerships and it should be eliminated.

\textsuperscript{55} 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.

\textsuperscript{56} IRC § 6166(b)(1)(B)(i).

\textsuperscript{57} IRC § 6166(b)(1)(C)(i).
3. Treating Multiple Business Entities as a Single Enterprise.
   a. Many business owners conduct business operations in multiple entities, some as brother-sister entities, and some as tiered parent-subsidiary entities.
   b. Because it is not clear under § 6166 whether these entities qualify for § 6166 treatment, the IRS has had to rule in many private letter rulings on a case-by-case basis, preventing relief in some instances and resulting in inconsistent treatment of taxpayers58.
   c. A holding company structure presents numerous issues some of which have not been answered.
      (1) What is the level of activity required by a subsidiary in order to qualify as a closely held business under § 6166?
      (2) Are intra-company loans considered passive assets for purposes of § 6166(b)(9)?
   d. Because § 6166(b)(8) uses the term “company” in describing personal holding entities, is the application of this provision limited to corporate entities?
      (1) Although it is not clear from the statutory language, § 6166(b)(8) should also apply to partnerships and limited liability companies.59
   e. Congress should also amend § 6166 to provide that directly owned entities (brother-sister entities) and indirectly owned entities (parent-subsidaries) be combined in determining whether the combined business entity meets the qualification tests under § 6166.
      (1) This amendment would accommodate modern business practices.

4. Definition of Active Trade or Business.
   a. Section 6166 requires that to qualify for estate tax deferral the closely held business must conduct a trade or business.

58 See Technical Advice Memoranda 8219007 and 8134012 and Private Letter Rulings 8448006 and 8130175. R.E. Moore (DC) 87-2 USTC ¶ 13,741
b. In addition, § 6166 provides there is no estate tax deferral for the estate tax attributable to passive assets.60

(1) Unfortunately, § 6166 does not contain a definition of either an active trade or business or a passive asset.

(2) When an individual conducts a business in multiple entities, it is not clear what assets are passive.

(3) This lack of clear definitions has resulted in numerous IRS rulings determining on a case-by-case basis what is an active trade or business, resulting in inconsistent treatment from taxpayer to taxpayer.

(4) This is particularly troublesome for real estate entrepreneurs.

(5) 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 § 6166.

(a) The IRS has ruled for and against taxpayers in these circumstances and it is difficult to predict the IRS’s position.61

5. Late Elections.

a. Section 6166 does not allow late elections.62

b. Because this prohibition can create hardships in certain instances, it is recommended that § 6166 be amended to permit late elections.

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60 IRC § 6166(b)(9).
61 Private Letter Rulings 200339001, 200006034, 8451014, 8140020, and 7917006.
62 IRC § 6166(d).

a. Section 6166 describes the personal representative must post a bond with surety for the unpaid tax.

b. If the personal representative does not post a bond, the personal representative alternatively may provide a lien on property acceptable to the IRS.

(1) 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.

(2) While it is important to ensure that the deferred estate tax be paid, the determination of adequate security should not be left to the discretion of the IRS auditing agent without guidance.

(3) 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.

c. Congress should amend §6166 to provide guidance as to the proper security for the unpaid deferred tax.

(1) One approach is to limit the security to the assets included in the gross estate and not the assets owned by business entity.

(2) This approach should allow the business to raise capital using assets owned by the business entity as collateral for loans.

(3) Without guidance, the successors to the business owner will not be able to plan on meeting the future capital needs of the business.

III. REDEMPTIONS UNDER § 303

A. Introduction.

1. Under §301, a distribution of property by a corporation to a shareholder with respect to the corporation’s own stock is treated

63 IRC § 6324A.
as a dividend unless it is treated as a distribution in part or in full payment in exchange for the corporation’s stock (in other words, a redemption treated as a sale or exchange).

2. Under § 302(b), a redemption will be treated as a sale or exchange if:
   a. It is not equivalent to a dividend;
   b. It is a substantially disproportionate redemption of stock;
   c. It is a termination of the shareholder’s interest (a complete redemption of all of the stock of the corporation owned by the shareholder); or
   d. It is a redemption from a non-corporate shareholder in a partial liquidation.

3. A substantially disproportionate redemption is a redemption in which the shareholder’s ownership of all of the voting stock of the corporation and the value of all common stock, whether voting or non-voting, after the redemption is less than 80% of the ownership of such stock before the redemption and, after the redemption, the shareholder owns less than 50% of the total combined voting power of all classes of stock entitled to vote. § 302(b)(2)(B) and (C).
   a. A substantially disproportionate redemption does not include any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution that (in the aggregate) is not substantially disproportionate with respect to the shareholder. § 302(b)(2)(D).
   b. The attribution rules discussed below apply for purposes of determining whether the 50% and 80% tests have been satisfied. § 302(c)(1).
   c. Example: Tom Jones owns 120 of the 200 outstanding common voting shares of Acme Corporation, or 60% of the total. On January 15, 2002, Acme redeems 30 of Tom’s shares, leaving him owning 90 of the 170 common voting shares outstanding after the redemption, or 52.9% of the total. Because Tom’s percentage of ownership after the redemption is 52.9%, the 50% test is not satisfied. Because 52.9% is greater than 48%, which is 80% of the 60% of Acme’s shares Tom owned prior to the redemption, the 80% test is not satisfied. If, instead, Acme had redeemed 41 of Tom’s
shares, his ownership percentage after the redemption would be 49.7% (79 divided by 159), which would satisfy the 50% test, but would not satisfy the 80% test, because 49.7% is greater than 48%. However, if Acme had redeemed 47 of Tom’s shares, he would only own 47.7% of the outstanding shares (73 divided by 153), which would satisfy both the 50% test and the 80% test, and consequently would qualify for sale or exchange treatment as a substantially disproportionate redemption.

4. In order for a redemption not to be treated as equivalent to a dividend, there must be a meaningful reduction of the shareholder’s interest in the corporation. United States v. Davis, 397 U.S. 301, 313 (1970).

a. Because there is no bright line to judge whether or not a redemption will be treated as not essentially equivalent to a dividend, this method of qualifying for sale or exchange treatment is not a viable planning technique.

5. For purposes of determining whether a redemption qualifies for sale or exchange treatment, the constructive ownership rules under § 318(a) apply.

a. Under the family attribution rules, an individual is considered as owning the stock owned, directly or indirectly, by or for his or her spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and his or her children, grandchildren, and parents.

(1) A legally adopted child of an individual is treated as a child of the individual by blood.

b. Stock owned, directly or indirectly, by or for a partnership or an estate is considered as owned proportionately by its partners and beneficiaries.

c. Stock owned, directly or indirectly, by or for a trust (other than an employees’ trust described in § 401(a), which is exempt from tax under § 501(a)), is considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in the trust.

d. Stock owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under grantor trust rules is considered as owned by the person.
e. If 50% or more value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person is considered as owning the stock owned, directly or indirectly, by or for the corporation, in the proportion that the value of the stock the person so owns bears to the value of all of the stock in the corporation.

f. Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate is considered as owned by the partnership or estate.

g. Stock owned, directly or indirectly, by or for a beneficiary of a trust (other than an employees’ trust) is considered as owned by the trust, unless the beneficiary’s interest in the trust is a remote contingent interest.

(1) A contingent interest of a beneficiary in a trust will be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5% or less of the value of the trust property.

h. Stock owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust that is treated as a grantor trust is considered as owned by the trust.

i. If 50% or more of the value of the stock in a corporation is owned, directly or indirectly, by or for any other person, the corporation is considered as owning the stock owned, directly or indirectly, by or for such person.

j. If any person has an option to acquire stock, the stock is considered as owned by the person.

(1) An option to acquire such an option, and each one of a series of such options, is considered as an option to acquire such stock.

k. Under the so-called operating rules, stock constructively owned by a person by reason of the application of the constructive ownership rules is considered as actually owned by the person except that stock constructively owned by an individual by reason of the family attribution rules is not considered as owned by the individual for purposes of making another the constructive owner of the stock and stock constructively owned by a partnership,
estate, trust, or corporation is not considered as owned by it in order to make another partner, beneficiary, or shareholder a constructive owner of such stock.

(1) If an individual is treated as owning stock under the family attribution rules and the option attribution rules, the individual will be treated as owning the stock under the option attribution rules.

1. For purposes of applying the constructive ownership rules, an S corporation is treated as a partnership and shareholders of the S corporation are treated as partners of such partnership except for purposes of determining whether the stock in the S corporation is constructively owned by any person.

(1) If a person does not own 50% or more of the value of the stock of an S corporation, he or she will not be treated as owning stock held by the S corporation.

6. Waiver of the family attribution rules:

a. Under § 302(c)(2), the family attribution rules will not apply in determining whether there has been a sale or exchange if:

(1) Immediately after the distribution, the distributee has no interest in the corporation (including an interest as an officer, director, or employee) other than an interest as a creditor;

(2) The distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within ten years from the date of such distribution; and

(3) The distributee files an agreement to notify the IRS of any such acquisition during such ten-year period and to retain records that may be necessary to apply these requirements.

b. The waiver does not apply if:

(1) Any portion of the stock redeemed was acquired, directly or indirectly, within the ten-year period ending on the date of the distribution by the distributee from a person the ownership of whose
stock would (at the time of distribution) be attributable to the distributee under the constructive ownership rules under § 318(a); or

(2) Any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under the constructive ownership rules and the person acquired any stock in the corporation, directly or indirectly, from the distributee within the ten-year period ending on the date of the distribution, unless the stock so acquired from the distributee is redeemed in the same transaction;

(3) Unless the acquisition or disposition by the distributee did not have as one of its principal purposes the avoidance of federal income tax.

c. The attribution rules attributing to a partnership, estate, trust, or corporation stock constructively owned by a partner, beneficiary, or shareholder under the family attribution rules may be waived if the entity and each related person satisfies the requirements for the waiver of the family attribution rules and each related person agrees to be jointly and severally liable for any deficiency (including interest and additions to tax) resulting from an acquisition during the ten-year period described above. § 302(c)(2)(C).

(1) For example, if A dies owning 50% of the 1,000 outstanding shares of XYZ corporation and his son owns the balance of the outstanding shares, A's estate could not qualify for sale or exchange treatment if A's son is a beneficiary of the estate, but if A's widow (the mother of A's son) is a beneficiary, but not A's son, then A's estate, A's widow and A's son could waive the family attribution rules that would attribute A's son's shares to A's widow and then from her to A's estate.

7. A partial liquidation as defined in § 302(b)(4) is generally not applicable when planning for the redemption of the shares of a family member.

8. As long as § 1014 applies to adjust the basis of the shares of stock owned by a decedent at death to their fair market value
(presumably until 2010, unless the carryover basis provisions that will take effect after 2009 are subsequently repealed), a redemption that is treated as a sale or exchange will generally involve no taxable income to the estate or beneficiary whose stock is being redeemed, except to the extent that the value of the shares has increased from the date of death.

a. In most cases, the redemption price will be fixed at the date of death, and, even if the value of the shares has increased, the beneficiary or estate will often be receiving a purchase price equal to the fair market value of the stock at the date of death.

9. If the redemption is not treated as a sale or exchange, then the beneficiary or estate will be taxed on the distribution of property from the corporation as dividend income, i.e., ordinary income, to the extent of the corporation's earnings and profits.

a. The basis of the beneficiary or the estate for any shares of stock of the corporation it retains will be increased by the basis of the stock that was redeemed.

b. If the beneficiary or estate does not own any shares of stock after the redemption, then the shares of stock of those persons whose ownership was attributed to the beneficiary or the estate will be increased pro rata by the basis of the stock that was redeemed.

Treas. Reg. § 1.302-2(c).

B. Section 303.

1. Notwithstanding the general rule under § 302, a distribution of property to a shareholder by a corporation in redemption of part or all of the stock of the corporation that is included in determining the gross estate of the decedent will be treated as a sale or exchange, even though it does not satisfy any of the requirements under § 302(b), but only to the extent that the distribution does not exceed the sum of:

a. The estate, inheritance, legacy, and succession taxes (including any interest collected as part of such taxes) imposed because of such decedent's death; and

b. The amount of funeral and administration expenses allowable as deductions to the estate under § 2053 (or § 2106 in the case of the estate of a decedent non-resident, not a citizen of the United States).
§ 303(a).

2. In order to qualify for sale or exchange treatment under § 303, the value of all of the stock of the corporation that is included in determining the value of the decedent's estate must exceed 35% of the excess of the value of the gross estate of the decedent over the sum of the amounts allowable as a deduction under §§ 2053 and 2054. § 303(b)(2)(A).

a. For purposes of satisfying the more-than-35% test, stock of two or more corporations will be treated as the stock of a single corporation if the decedent owned 20% or more of the value of the outstanding stock of each corporation. § 303(b)(2)(B).

b. For this purpose, stock that at the decedent's death represents the surviving spouse's interest in property held by the decedent and the surviving spouse as community property or as joint tenants, tenants by the entirety, or tenants in common is treated as having been included in determining the value of the decedent's gross estate. Id.

3. Because the statute refers to "allowable" deductions, such amounts reduce the gross estate for purposes of the 35% requirement and the amount that qualifies for sale or exchange treatment regardless of whether they are actually claimed as a deduction on the estate tax return (in other words, they are claimed as deductions on the estate's income tax return instead).

4. Sale or exchange treatment will only apply to amounts distributed:

a. Within the period of the statute of limitations for the assessment of the federal estate tax (determined without the application of any provision other than § 6501(a)), or within 90 days after the expiration of such period (which is generally three years after the due date of the estate tax return);

b. If a petition for redetermination of a deficiency in such estate tax has been filed with the Tax Court within the time prescribed in § 6213, at any time before the expiration of 60 days after the decision of the Tax Court becomes final; or

c. If an election has been made under § 6166, within the time determined under § 6166 for the payment of the installments if such time is later than 60 days after the decision of the Tax Court in a tax case discussed above.
In the case of redemptions made more than four years after the decedent’s death, sale or exchange treatment will only apply to the extent of the lesser of the amount of taxes or funeral and administration expenses that remain unpaid immediately before the distribution or the aggregate of such amounts that are paid during the one-year period beginning on the date of the distribution.

§ 303(b)(1) and (4).

5. Section 303 will apply to a distribution by a corporation only to the extent that the interest of the shareholder is reduced directly (or through a binding obligation to contribute) by any payment of the estate’s death taxes and funeral and administration expenses. § 303(b)(3).

6. Stock will not qualify for sale or exchange treatment if the stock is redeemed from a shareholder who has acquired the stock by gift or purchase from any person to whom such stock passed from the decedent or who has acquired the stock from the executor in satisfaction of a specific bequest. Treas. Reg. § 1.303-2(f).

7. A redemption of stock will qualify for sale or exchange treatment if the stock was received in exchange for stock that would have been eligible for sale or exchange treatment if the new stock’s basis is determined by reference to the basis of the old stock (in other words, stock was received in a tax-free exchange). § 303(c).

8. If stock in a corporation is subject to the generation-skipping transfer tax as the result of the death of an individual, the stock will be deemed to be included in the estate of the individual and taxes imposed because of the generation-skipping transfer will be treated as imposed because of the individual’s death, the period of distribution will be measured from the date of the generation-skipping transfer, and the relationship of the stock to the decedent’s estate will be measured with reference solely to the amount of the generation-skipping transfer. § 303(d).

a. In other words, for purposes of satisfying the more-than-35% test, the value of the stock will be compared with the value of all of the assets that were subject to the generation-skipping transfer tax as a result of the death of the individual.

9. Under § 537(a)(2), dealing with the reasonable needs of a business for which accumulations may be made without incurring the
accumulated earnings tax, the reasonable needs of the business include § 303 redemption needs of the business, which means, with respect to the taxable year of the corporation in which a shareholder of the corporation died or any taxable year thereafter, the amount needed (or reasonably anticipated to be needed) to make a redemption of stock included in the gross estate of the decedent (but not in excess of the maximum amount of stock to which § 303(a) may apply). § 537(b)(1).

10. If there is more than one distribution in redemption of stock that qualifies for sale or exchange treatment under § 303, the distributions are applied against the total amount that qualifies for treatment under § 303 in the order in which the distributions are made, and all distributions in redemption of such stock are taken into account, including distributions that under another provision of the Internal Revenue Code are treated as sale or exchanges. Treas. Reg. § 1.303-2(g).

Example.

(1) The adjusted gross estate of Decedent Smith has a stock in Enterprise Corporation. The estate qualifies for a § 303 redemption because the value of the stock exceeds 35% of the gross estate less expenses and debts allowable as a deduction under §§ 2053 and 2054. The estate has $800,000 of federal estate and state death taxes and funeral and administrative expenses. Enterprise Corporation has 3,900 outstanding common voting shares, of which 2,000 are owned by the estate. Each share is valued at $1,000.

(2) 800 shares of the estate are redeemed on January 15, 2002, reducing the outstanding shares of Enterprise Corporation to 3,100 and the shares owned by the estate to 1,200. Because the value of the shares redeemed is $800,000, the amount of taxes and administrative expenses, the redemption automatically qualifies under § 303 for sale or exchange treatment.

(3) On February 1, 2003, Enterprise Corporation redeems 300 of the estate’s remaining shares, leaving 2,800 outstanding shares, of which 900 are owned by the estate.
After the first redemption, the estate owned 38.7% of the total shares of Enterprise Corporation. After the second redemption, the estate owned 32.1% of the total shares of Enterprise Corporation. Although the second redemption satisfies the 50% test under § 302(b)(2), because the estate owns less than 50% of the outstanding shares of Enterprise Corporation after the redemption, it does not satisfy the 80% test, because 80% of 38.7% is 30.96%, which is less than the 32.1% owned by the estate after the second redemption. Therefore, the second redemption will be taxed as a dividend under § 301.

If Enterprise Corporation had instead only redeemed 100 shares of the estate’s stock in the first redemption, the first redemption would still have automatically qualified under § 303, since the $100,000 received would have been less than the $800,000 of taxes and administrative expenses. The estate would then own 1,900 of the 3,800 shares outstanding, or 50% of the total.

If Enterprise Corporation then redeemed 1,000 shares of the remaining stock of the estate, $700,000 of the second redemption would have qualified automatically under § 303, while the remaining $300,000 would have qualified as a substantially disproportionate redemption of stock, because the second redemption would satisfy both the 50% test and the 80% test. After the second redemption, the estate would own 32.1% of the total outstanding shares, which is less than 40% (80% of the 50% of the total outstanding shares owned by the estate before the second redemption).

IV. RELATED AND THIRD PARTY LOANS

A. In General.

1. Section 2053(a)(2) allows a deduction for administration expenses that are allowable by the law of the jurisdiction in which the estate is being administered.

a. Treas. Reg. § 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.”
b. If the loan is not necessary to the proper administration of an estate, interest on the loan is not deductible as an administration expense.\(^{64}\)

2. Treas. Reg. § 20.2053-1(b)(3) prohibits a deduction taken upon the basis of a vague or uncertain estimate.

a. 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 liability is ascertained, relief may be sought by a petition to the Tax Court or a claim for refund.”

3. Interest on loans incurred by an estate to pay its estate tax obligation in a single payment have been held to constitute a deductible administration expense, even though the estate could have elected to pay the tax in installments under § 6166 pursuant to the terms of the stock restriction agreement.\(^{65}\)

a. In PLR 200020011, the IRS ruled that interest attributable to a loan obtained from a commercial lender to pay off federal estate taxes deferred under § 6166 is deductible as an administration expense under § 2053(a)(2).

b. In Rev. Rul. 84-75,\(^{66}\) the personal representative had borrowed funds to pay the estate tax so as to avoid a forced sale of estate assets.

(1) The IRS 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 § 2053(a)(2).

(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.

(3) The IRS ruled that interest could only be deducted after the interest accrued and any estimate of future interest was not deductible.

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\(^{64}\) 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.


\(^{66}\) 1984-1 C.B. 193.
4. If the interest on the unpaid estate tax is taken as an estate tax deduction, the IRS will only allow the deduction as the interest is paid.67

   a. 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 is paid.

   b. The amended returns must be filed within the applicable statute of limitations, which is three years from the date of filing or two years from the date of payment of estate tax.68

   c. If interest is paid after the applicable statute of limitations, the estate cannot obtain a refund of estate tax.

B. Nondeductibility of § 6166 Interest Payments.

1. When the Taxpayer Relief Act of 1997 reduced the interest rate to 2% and 45% of the general underpayment rate, the Act also eliminated the deductibility of the interest for both federal estate and income tax purposes.

   a. For decedents dying before 1998, 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.

      (1) Thus, for decedents dying before 1998, it is necessary to file an amended estate tax return as each interest payment is made.

      (2) TAM 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.

   b. The issue for many estates of decedents dying before 1998 will be whether the lower interest rate under § 6166 is more economical than borrowing from a third party and deducting the interest as an estate tax deduction under § 2053.

68 § 6511.
(1) In the present economic environment (the underpayment interest rate for the last quarter of 2005 is 7.0% and the underpayment interest rate is decreased by 55% notwithstanding that the maximum estate tax rate is 47% in 2005), § 6166 should be more attractive to most taxpayers than third party borrowing.

(2) Some estates may prefer third party borrowing so as to avoid the § 6166 lien requirements.

2. Commissioner v. Hubert\(^69\) held in a plurality decision that the marital and charitable bequests 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.

   a. Regulations have been issued addressing the Hubert issue.\(^70\)

C. Third Party Borrowing with Estate Tax Deduction for Interest Payments.

   1. General Description.

      a. Electing the benefits of § 6166 is not the only long-term borrowing option available to the personal representative of a business owner’s estate.

      b. Another option available to the personal representative is borrowing from a third party, including borrowing from an entity controlled by the decedent’s estate or beneficiaries.

      c. A personal representative of a business owner’s estate may prefer not to elect the benefits of § 6166, but to borrow funds from a third party to pay the federal estate tax.

      d. Borrowing from a third party may allow the personal representative to deduct the interest payments as a cost of administration under § 2053(a)(2).

      e. 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.

\(^69\) 520 U.S. 93 (1997).

(1) This technique is based on the Tax Court memorandum decision in *Estate of Graegin*.

2. *Estate of Graegin*.
   
a. *Estate of Graegin v. Commissioner* involved the deductibility of a balloon payment of interest due upon the maturity of a loan incurred to pay Federal estate taxes.
   
b. The issue was whether the interest was a deductible administration expense under § 2053(a)(2).
   
c. Facts.
   
   (1) The assets in Mr. Graegin's estate consisted primarily of stock in a closely held corporation.
   
   (2) After payment of state inheritance taxes and other expenses, the estate had $20,000 of liquid assets remaining.
   
   (3) 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.
   
   (4) The term of the promissory note evidencing the loan was 15 years and the interest rate was 15% simple interest (equal to the prime rate on the date of the loan).
   
      (a) The 15-year term was selected because it was the life expectancy of the income beneficiary of the trust.
   
   (5) 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.
   
   (6) The estate requested and obtained the approval of the local probate court for the personal representatives to enter into the loan.

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71 T. C. Memo. 1988-477.
(7) The estate deducted the amount of the single-interest payment due upon maturity of the note ($459,491) on the federal estate tax return as a cost of administration.

(8) The IRS 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.

(9) The estate pursued the deduction in Tax Court.

d. 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.

(1) 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 § 2053(a)(2).

3. The Position of the IRS Post-Graegin.


(1) In the Memorandum, the IRS 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.

(2) In order to be deductible, the interest must be certain to be paid, and the amount must be subject to reasonable estimation.

(3) Because the loan in Graegin was found by the Tax Court not to be uncertain, the IRS stated that the result in Graegin was not inconsistent with the arguments advanced by the IRS.

b. In the Litigation Guideline Memorandum, the IRS raised additional arguments to challenge a situation similar to Graegin.
(1) The loan must be bona fide and financing between related entities is subject to stricter scrutiny than arms’ length dealings.

(a) If the underlying loan arrangement is not bona fide, there can be no deduction allowed for the interest on the debt.

(2) The related lender should accrue interest income so that the tax treatment is consistent between the lender and the borrower.

(3) Also, the IRS 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.

4. Rulings by the IRS.

a. PLR 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.

(1) The loan was from a commercial bank and would provide for annual payment of both interest and principal over a specified term of years not to exceed seven years at a fixed rate of interest.

(2) The note also provided that principal and interest may not be prepaid.

(3) The IRS 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 IRS did not rule).

(4) The favorable ruling was conditioned on the estate obtaining approval for the proposed transaction from the appropriate local court.

b. PLR 199952039 reached a similar result.
5. Recent IRS TAM.

a. In the recent TAM 200513028, the IRS disallowed interest on a Graegin-style note executed by a partnership making a loan to the estate owning the partnership interest.

b. The facts in that TAM are as follows.

(1) The decedent formed a limited partnership and contributed assets to the partnership in exchange for a 2% general partnership interest and a 97% limited partnership interest.

(2) The decedent died 5 ½ years after formation of the partnership.

(3) The decedent’s estate consisted primarily of the decedent’s 97% interest in the limited partnership.

(4) Approximately 57.6% of the partnership assets consisted of publicly traded stocks, bonds, and cash.

(5) The remaining partnership assets consisted primarily of real property (17.5%) and installment sale notes (24.7%).

(6) 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.

(7) One of the decedent’s children and a third party were personal representatives of the decedent’s estate.

(8) 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.

(a) The promissory note matured 10 years from the date of the note.

(b) Prepayment of principal and interest was prohibited by the terms of the note.
(c) The estate's 97% limited partnership interest was pledged as security pursuant to a separate security agreement for the payment of the note.

(d) The interest rate was 1% above the prime interest rate.

(e) The TAM mentioned that the average interest rate for 15 year mortgage loans was 2% less than the prime interest rate at the time of the loan.

(9) On the federal estate tax return, the personal representatives claimed a cost of administration deduction under § 2053(a) for the amount of the interest payable over the 10-year term of the loan.

c. In the TAM, the IRS disallowed the interest deduction for the following reasons.

(1) The IRS did not believe that the loan was necessary to the administration of the estate.

(a) 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.

(b) The IRS stated there was clearly no fiduciary restraint on the child's ability to access the partnership funds.

(c) 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.

(2) In addition, the IRS believed it was questionable whether the estate would actually make the payments in accordance with the terms of the promissory note.

(3) Finally, if the estate did make the payments, there would be no change in the economic position of the parties involved.
(4) Accordingly, the IRS disallowed the interest expense.

V. PLANNING

A. Premortem Planning.

1. Transfer nonbusiness assets more than three years before death.
   a. The more-than-35% test must be satisfied by including any assets transferred by the decedent within three years of the decedent’s death, as well as by excluding such transfers.

2. Recognize that transfers of business interests will reduce the amount of estate tax that can be deferred and may cause the estate to fail the more-than-35% test.

3. Increase activities in connection with real property that is leased, including real property leased to other family owned entities.

4. Retain real property in the entity conducting an active trade or business (although this may not produce the best income tax or creditor protection result).

B. Post-Mortem Planning.

1. Determine if the estate qualifies for § 6166 treatment.

2. Determine if the family members are committed to holding the business interests until the estate tax has been paid and will not withdraw cash from the business if it would cause an acceleration of the payment of the tax.

3. Determine if there are better ways to pay the estate tax.
   a. A related party loan (Graegin loan).
   b. Third party loan.
   c. Use other assets in the estate (including the proceeds from the sale of other assets or life insurance policies).

4. Determine if the lien will hurt the business financially.

5. If a C Corporation, determine if the estate qualifies for sale or exchange treatment under § 303.