

7-2009

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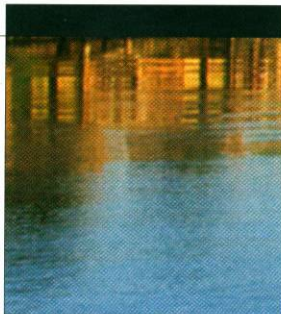
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## Recommended Citation

Jonathan G. Blattmachr, Mitchell M. Gans, and Elisabeth O. Madden, *Untangling Installment Payments of Estate Tax Under Section 6166*, 36 Est. Plan. 3 (2009)

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# Untangling Installment Payments of Estate Tax Under Section 6166

Section 6166 is an extremely complicated provision using different tests and having different rules apply for different purposes. And, as this article explains, little case law has developed under Section 6166.

JONATHAN G. BLATTMACHR, MITCHELL M. GANS, AND ELISABETH O. MADDEN, ATTORNEYS

Usually, the U.S. estate tax must be paid within nine months after a decedent's death or penalties may be imposed.<sup>1</sup> If an estate qualifies, however, it may elect to obtain an automatic extension, under IRC Section 6166, to defer the payment of that portion of the U.S. estate tax which is attributable to the inclusion in the gross estate of certain closely held business interests. For example, if 40% of the decedent's adjusted gross estate consists of an interest in a qualifying business, then 40% of the federal estate tax may be deferred pursuant to Section 6166. Generally, if the estate qualifies, it may elect to defer the payment of the estate tax for five years after the normal nine month payment due date, paying annual interest only. From that fifth anniversary to the 14th anniversary, the estate pays one-tenth of the estate tax due (together with interest on the amount of tax unpaid) each year.

A portion of the interest may be payable at only 2% per year, with the balance at 45% of the "usual" underpayment of tax interest rate under Section 6621. For example, if the estate is in an effective 45% estate tax bracket and the interest rate under Section 6621 is 6%, the effective (after-tax cost) interest rate on the amount deferred under Section 6166 (above the amount upon which the interest rate is 2%) would be 2.7% (that is,  $.06 \times .45$ ). This

interest is not deductible for either estate or income tax purposes.<sup>2</sup> Some states also permit comparable deferral of payment privileges.<sup>3</sup>

Deferral of payment of estate tax pursuant to Section 6166 is available only to the estate of a decedent who was, at the time of his or her death, a citizen or domiciliary of the United States—that is, a person whose worldwide estate is included in his or her United States gross estate.<sup>4</sup> Although the section makes reference to "resident," the term means domiciliary.<sup>5</sup>

Three requirements must be met in order for the estate to elect to defer estate tax pursuant Section 6166, and this article will discuss each one in detail. First, the enterprise must be an active trade or business carried on as a proprietorship, partnership, or corporation rather than a mere management vehicle. Second, the business must be "closely held," meaning (1) the business must be a proprietorship (which means that the decedent owns 100% of the

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enterprise); (2) it must have 45 or fewer shareholders (although under current law the maximum number of shareholders will be reduced to 15 for years after 2010), if the business is a corporation, or 45 or fewer partners (although under current law the maximum number of partners will be reduced to 15 for years after 2010), if it is a partnership;<sup>6</sup> or (3) the decedent's gross estate must include 20% or more of the value of the voting stock, if the business is a corporation,<sup>7</sup> or 20% of more of the capital interests, if it is a partnership.<sup>8</sup> Third, more than 35% of the adjusted gross estate of the decedent must be composed of interests in the active closely held business.

Lastly, this article will consider the complications in determining if an election to defer tax under Section 6166 should even be sought and will discuss when an election under Section 6166 may be terminated.

### The 'active business' requirement

To elect deferral of payment of estate tax under Section 6166, the decedent's gross estate must include a trade or business carried on as a proprietorship, a partnership, or corporation. Although neither Section 6166 nor any Regulation promulgated under it requires that

the decedent's interest be in one or more "active" businesses, it seems certain that such an active nature is required to be able to defer tax pursuant to the section.

Pronouncements by the IRS indicate that it views the section as applying only to interests in an active business.<sup>9</sup> Essentially, these pronouncements require that the business be a trade or business carrying on a manufacturing, mercantile or service enterprise rather than a mere management vehicle. For example, if the decedent owns 20% in value of the voting stock of a company that manufactures boats for sale to the public, such a company almost certainly would qualify. In other cases, where there is not manufacturing, mercantile or services provided, the result is less clear. As commentators have indicated, precisely how the IRS applies these broad standards to distinguish between active trades or businesses and management vehicles is not easy to discern.<sup>10</sup>

### Certain holding company interests.

It is important to note that a holding corporation, even if it owns another business or businesses, is not an active business for purposes of Section 6166. However, an interest in the decedent's gross estate in

a holding corporation may qualify for deferral of payment of estate tax under the section if the holding corporation in turn owns interests in one or more active corporations.

Under Section 6166(b)(8), if the executor so elects, the portion of the stock of any holding company which represents direct ownership (or indirect ownership through one or more other holding companies) by such company in an active business is treated as stock in such active business. In other words, the stock owned by the corporate holding company (stock of which is included in the decedent's estate) is, in essence, treated as shares of an active business in the decedent's estate. It is important to note that, if the executor makes that election, no interest on the estate tax deferred is payable at the low 2% annual rate but only at the rate of 45% of the underpayment of tax rate, and there is no five-year deferral of payment of the estate tax.

**Stock in certain lending and financing companies.** If the executor so elects, stock in a "qualifying lending and finance business" is treated as stock in an active trade or business.<sup>11</sup> A business is a qualifying lending and finance business if (1) based on all the facts and cir-

<sup>1</sup> See Sections 6151 and 6075(a).

<sup>2</sup> Sections 2053(c)(1)(D) and 163(k).

<sup>3</sup> See, e.g., N.Y. Tax Law § 997.

<sup>4</sup> Section 6166(a).

<sup>5</sup> See Reg. 20.0-1(b)(1).

<sup>6</sup> If a limited liability company ("LLC") is not disregarded (that is, it has more than one owner), it will be treated for federal income tax purposes as a partnership unless it has elected to be treated as a corporation. Although it is not certain, and although income and estate tax provisions need not be consistently construed, it seems likely that an LLC that is treated as a partnership for income tax purposes will be treated as a partnership for purposes of Section 6166. It is possible, nevertheless, that, even if an LLC is treated as a partnership for income tax purposes, it might be treated as a corporation for purposes of Section 6166. Although the closely held tests for partnerships and corporations are similar, the tests are not the same and might result in an entity that is treated as a corporation not meet-

ing the minimum ownership test even though it might meet it if treated as a partnership and vice versa. For example, consider an LLC that has two types of ownership interests, only one of which has management rights. Assume that the decedent owns 15% of the interests in the LLC that include management rights and 5% of the interests that are nonmanagement interests. If only the management rights are treated as voting stock for purposes of Section 6166, then it seems the estate will not meet the minimum ownership test if the LLC is treated as a corporation. In any event, if the business is in the form of an LLC, it may be sensible to test it both as a partnership and as a corporation. In any case, it seems beyond question that an interest in an LLC may constitute a qualifying business interest for purposes of Section 6166 even though it is neither a partnership nor a corporation in a traditional sense. See, e.g., Rev. Rul. 2006-34, 2006-1 CB 1171.

<sup>7</sup> The 20% or more of all voting stock does not consider nonvoting stock. For example, a deced-

ent might hold at death 25% of the voting stock interests in a corporation (making it closely held for purposes of Section 6166(b)(1)(C)(i)) but that ownership may represent less than 20% of the total value of the corporation because others hold nonvoting stock in it. In this example, however, the corporation would still be considered closely held.

<sup>8</sup> The 20% or more of capital interests in a partnership does not consider profits interests. For example, a decedent might hold at death 25% of the capital interests in a partnership (making it closely held for purposes of Section 6166(b)(1)(B)(i)) but that ownership may represent less than 20% of the total value of the partnership because others hold income interests (as opposed to capital interests) in the partnership.

<sup>9</sup> See, e.g., Rev. Rul. 61-55, 1961-1 CB 713; Rev. Rul. 75-365, 1975-2 CB 471; Rev. Rul. 75-366, 1975-2 CB 472; Rev. Rul. 75-367, 1975-2 CB 473.

<sup>10</sup> See, e.g., Hirschson, "Postmortem Estate Planning," 7 Rev. Tax'n Individuals 283 (1983).

<sup>11</sup> Section 6166(b)(10).



cumstances immediately before the date of the decedent's death, there was substantial activity with respect to the lending and finance business; or (2) during at least three of the five taxable years ending before the date of the decedent's death, such business had at least one full-time employee substantially all of whose services were the active management of such business, ten full-time, nonowner employees substantially all of whose services were directly related to such business, and \$5 million in gross receipts from a lending and finance business, which means a trade or business of—(i) making loans, (ii) purchasing or discounting accounts receivable, notes, or installment obligations, (iii) engaging in rental and leasing of real and tangible personal property, including entering into leases and purchasing, servicing, and disposing of leases and leased assets, (iv) rendering services or making facilities available in the ordinary course of a lending or finance business, and (v) rendering services or

making facilities available in connection with activities described in (i) through (iv) carried on by the corporation rendering services or making facilities available, or another corporation which is a member of the same affiliated group (as defined in Section 1504 without regard to Section 1504(b)(3)).

A qualifying lending and finance business does not include any interest in an entity if the stock or debt of such entity or a controlled group (as defined in Section 267(f)(1)) of which such entity was a member was readily tradable on an established securities market or secondary market (as defined by the Secretary of the Treasury) at any time within three years before the date of the decedent's death.

If the executor makes the election to treat a qualifying lending and finance business as an active business for purposes of Section 6166, the five-year deferral for payment of the deferred tax will not apply and the executor may elect to pay the tax due in only up to five installment payments as opposed to up to ten. Moreover, few, if any,

enterprises will constitute such a qualifying lending and finance business on account of the "tight" definition of such a business.

**Holding companies not in corporate form.** There is no guidance as to whether or when an interest in a holding company which is in a form other than that of a corporation, such as a holding partnership, may qualify under Section 6166. A reasonable case might be made that an interest in a holding company in a noncorporate form should qualify as it should be considered an integral part of the active companies it owns.<sup>12</sup> On the other hand, the IRS might argue that, because Section 6166 has a special rule for a holding corporation (and if the interest in the decedent's gross estate for which deferral is sought is a holding corporation, the deferral period is reduced and no portion of the deferred tax is subject to the 2% interest charge) and has none for any other type of holding entity, no form of holding company other than that in corporate form may qualify.

<sup>12</sup> See discussion, *infra*, under "More than one entity treated as a single business."

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### *Sample private letter rulings.*

Although under Section 6110(k)(3), neither a private letter ruling nor a National Office technical advice memorandum ("TAM") may be cited or used as precedent, several such rulings may be instructive in helping to determine, in some cases, whether the decedent's ownership in assets or an entity will qualify by finding that the activities constitute an active closely held business.

In Ltr. Rul. 8446009, the IRS ruled that the decedent's interest in a farm and cattle operation did not constitute a closely held business the estate tax on which could be deferred pursuant to Section 6166 because the decedent did not engage in any significant activity with regard to cattle raising or farming during a period of over two years prior to his death, nor was there any active involvement provided by persons under his control. This is to be contrasted with TAM 9635004, in which the IRS concluded that the land directly owned by the decedent but which was used for cattle ranching by a partnership of which the decedent was a partner constituted a closely held business under Section 6166 because the land was used in an active business enterprise in which the decedent was an active participant. In Ltr. Rul. 8020143, the IRS found that the value of the decedent's farmland constituted a closely held business under Section 6166 where the property was rented to a sharecropper but the decedent paid for part of the operating costs and determined what crops would be planted and when they would be brought to market.<sup>13</sup>

In Ltr. Rul. 8514037, the IRS ruled that the decedent's interest in promissory notes held by the decedent from sales by the decedent of land did not constitute a closely held business the estate tax on which could be deferred pursuant to Section 6166 because the only

activity of the decedent in reference to the assets was the collection of payments. On the other hand, in Ltr. Rul. 200114005, the IRS concluded that a decedent's interest in 82 residential units, which the decedent managed and maintained, and the insurance proceeds received for rental property destroyed by fire constituted one closely held business (except for the units occupied by the decedent and his child) and qualified as a closely held business for purposes of Section 6166.

Similarly, the IRS found in Ltr. Rul. 199929025 that the decedent's interest in 33 rental properties and a wholly owned corporation constituted a single business that qualified as closely held for purposes of Section 6166 where the decedent provided significant services to the properties' tenant and the wholly owned corporation provided management services for the properties. Nevertheless, in Ltr. Rul. 8451014, the land that the decedent rented to one of his closely held corporations was held by the IRS not to constitute a closely held business for purposes of Section 6166 because, according to the IRS, all the decedent did was collect rent, where the closely held corporation paid all the expenses to operate and maintain the real estate and its employees managed the property.

The most informative authority (compared to letter rulings and TAMs which cannot be cited or used as precedent) from the IRS about its views on this topic to date seems to be Rev. Rul. 2006-34.<sup>14</sup> In the Ruling, the IRS presents five situations. It deals with questions of agents of the decedent, independent contractors, and active as opposed to passive activities. Specifically, Rev. Rul. 2006-34 addresses the question of whether real property used by an entity and owned in part by the decedent was active or passive. The Ruling indicates that, if

the corporation or entity hires third parties to manage the property, the decedent does not satisfy the "active" requirement and the estate may not elect to defer the payment of estate tax under Section 6166.

In situation 1, the decedent owned rental real property in his own name and was personally involved in the management and rental of the property. The Ruling concludes that the estate qualifies for a deferral of payment of tax under Section 6166. In situation 2, the decedent owned real property in his own name. The decedent had a third party, an unrelated corporation, manage the real property. The Ruling contends that the estate may not defer estate tax pursuant to Section 6166. However, in situation 3, the decedent owned a 20% interest in the corporation hired to do the management services. In that situation, the Ruling concludes that deferral of payment of tax pursuant to Section 6166 is permitted. In situation 4, the decedent owned a 1% general partnership interest and a 20% limited partnership interest in the partnership that owned the real estate. As a general partner, the decedent managed the property. The Ruling concludes that the estate qualifies under Section 6166 to defer payment of estate tax.

In situation 5, the decedent owned 100% of the stock in a car dealership corporation. In addition, the decedent directly owned real estate that the decedent leased to the corporation on a triple net lease basis, under which the corporation's employees managed and repaired the property. The IRS concludes with respect to situation 5: "In addition, [the] Real Property...was used exclusively in the [car dealership] business under a

<sup>13</sup> The IRS stated in this letter ruling: "The involvement by the decedent in the operation of the farms extended beyond mere maintenance and repair; the decisions made by the decedent directly affected his proportionate return."

<sup>14</sup> 2006-1 CB 1171.



net lease from [the decedent]. As in Situation 3, because [the decedent] owned a significant interest in [the car dealership business], whose activities with regard to [the] Real Property...constituted active management, [the decedent]'s interest in [the] Real Property...also qualifies as an interest in a closely held business."

The IRS states that the fact that a third-party agent is used to do some of the activities is not problematic to making the election under Section 6166 so long as it does not reduce the business to a mere investment. The IRS adds: "The fact that some of the activities are conducted by third parties such as independent contractors who are neither agents nor employees of the decedent, partnership, LLC or corporation, will not prevent the business from qualifying as an active trade or business so long as these third-party activities are not of such a nature that the activities of the decedent, partnership, LLC or corporation (and their respective agents and employees) are reduced to the level of merely holding investment property \*\*\* Often, day-to-day real estate operations and activities are performed by independent contractors, such as property management companies. If a decedent, partnership, LLC, or corporation uses an unrelated property management company to perform most of the activities associated with the real estate interests, that fact suggests that an active trade or business does not exist."

In Rev. Rul. 2006-34, the IRS lists the following factors to be considered in determining if the decedent's actions are sufficiently active so that the decedent's interest in the business may permit the estate to defer estate tax under Section 6166: "To determine whether a decedent's interest in real property is an interest in an asset used in an active trade or business, the Service will consider all the facts and circumstances,

including the activities of agents and employees, the activities of management companies or other third parties, and the decedent's ownership interest in any management company or other third party. The Service will consider the following nonexclusive list of factors:

- The amount of time the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) devoted to the trade or business;
- Whether an office was maintained from which the activities of the decedent, partnership, LLC, or corporation were conducted or coordinated, and whether the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) maintained regular business hours for that purpose;
- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) was actively involved in finding new tenants and negotiating and executing leases;
- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) provided landscaping, grounds care, or

other services beyond the mere furnishing of leased premises;

- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and
- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) handled tenant repair requests and complaints."

Thus, it seems that no single factor is dispositive in determining whether a decedent's activities with respect to real property (or the activities of a partnership, LLC, or corporation through which the decedent owns the real property) will cause the business to be treated as an active one for purposes of deferring estate tax pursuant to Section 6166. Rev. Rul. 2006-34 indicates that the decedent's active management of the property will allow it to qualify for deferred payment of estate tax under Section 6166, assuming all other requirements are met.

The Ruling further indicates that actions of the decedent's own agents

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and employees will be treated as actions of the decedent for this purpose. Moreover, it appears that as long as the decedent owns a significant (e.g., 20% or greater) interest in the entity that manages the property, he or she may be treated as engaging in active management of the property which may allow it to qualify under Section 6166. The IRS indicates that the fact that a third party is used to do some of the management activities will not necessarily foreclose the property being managed from qualifying under the section as long as it does not reduce the business to a mere investment by the decedent.

**Management of investments activities.** Although, as mentioned, no clear test has been yet developed to determine if the business is active or not, it seems that any manufacturing, mercantile or service business will qualify if it is manufacturing for sale to the general public or providing mercantile (e.g., banking) or business services to the general public, even if the decedent is not an active participant. For example, it seems as though the active management of "other people's" money through a closely held company should constitute an active closely held business for purposes of Section 6166, such as where the decedent owns an interest in a publicly traded investment banking firm or a private one.<sup>15</sup>

No authority definitely states whether management of a portfolio belonging to the decedent could constitute an active business. It seems reasonably certain that, if the decedent's business actively manages the securities and bond portfolios for others (e.g., is a "full service" and "full-time" investment advisory firm), it should constitute an active business, at least if the decedent himself or herself ran the business on a full-time basis.

On the other hand, if the decedent actively managed only his or her own securities and bond portfolios, such as through a (family) limited partnership, there may be a significant risk that the IRS would contend that the enterprise does not constitute an active business for purposes of Section 6166.

### The 'closely held' requirement

**Certain constructive ownership rules.** It seems that all the interests in the active closely held business included in the gross estate are aggregated to determine if the minimum ownership requirement will be met. Hence, if the decedent held at death a general power of appointment over a trust that holds 15% of the capital interests in an active partnership (which would be included in the decedent's gross estate under Section 2041) and the decedent directly owned 10% (which would be included in the decedent's gross estate under Section 2033), the minimum ownership requirement would be met. Additionally, there are certain constructive ownership rules that may apply for purposes of the minimum ownership or maximum number of partners or shareholders tests.

**Husband and wife treated as one if interest commonly held.** In determining the number of partners (or shareholders) for purposes of the closely held requirement under Section 6166(b)(1), all interests held by an individual and his or her spouse as community property, as tenants by the entirety, joint tenants with rights of survivorship or as tenants in common are treated as held by the decedent. Hence, the decedent's spouse is not treated as another partner or shareholder by reason of such ownership (although he or she might be considered as a partner or shareholder by reason of other ownership).<sup>16</sup>

This spousal common ownership rule applies not only to the decedent but to all married partners and shareholders who hold interests with their spouses as community property, tenants by the entirety, joint tenants, or tenants in common. It appears that this constructive ownership rule applies automatically and no election is required for it to apply.<sup>17</sup>

The common spousal ownership rule of Section 6166(b)(2)(B) does not apply for purposes of the 20% minimum voting stock test. It appears that the only way the decedent's spouse's voting stock may be treated as comprising part of the decedent's gross estate for purposes of the 20% minimum voting stock ownership test is by having the executor make a Section 6166(b)(7) election and, if made, such an election will cause all of the spouse's voting stock to be treated as though it were part of the decedent's gross estate, not just the stock held in common ownership with the decedent.

In other words, the "automatic" spousal common ownership rule applies only for purposes of determining the number of shareholders or partners; it does not apply for purposes of determining if the decedent's estate includes 20% of more in value of the voting stock of the corporation or 20% or more of the capital interests in a partnership. The spouse's voting stock in a corporation or capital interests in a partnership will be considered as part of the decedent's estate for the 20% minimum ownership tests only

<sup>15</sup> For example, if the decedent owned 20% in value of the voting stock in a public investment banking firm, such as Goldman Sachs or Morgan Stanley, it seems that the decedent's interest will qualify for deferral under Section 6166 if that interest exceeds 35% of the decedent's adjusted gross estate.

<sup>16</sup> Section 6166(b)(2)(B).

<sup>17</sup> See Professional Staff of the Joint Committee on Taxation of the Congress, General Explanation of the Revenue Act of 1978 289 (1979) (hereinafter, "General Explanation").



if the election under Section 6166(b)(7) is made and that election will cause the interests of other members of the decedent's family also to be treated as being part of the decedent's estate for purposes of the 20% tests.

*Interests held by estates, trusts, other partnerships or corporations.* In addition, under Section 6166(b)(2)(C), 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. The purpose of this rule is to prevent several individuals (or other taxpayers) from contributing their interests in a business to one partnership, for example, so as to reduce the number of partners or shareholders for purposes of the closely held tests for partnerships and corporations under Section 6166(b)(1)(B)(ii) and 6166(b)(1)(C)(ii)—that is, causing a corporation or partnership to be treated as closely held if it has 45 or fewer shareholders or partners.<sup>18</sup>

This rule also seems to apply automatically, without any election. It appears to apply not only to the decedent and the decedent's family members but to any other partner or shareholder. Therefore, if a third party and each of his or her children held stock in the corporation which they contributed to a partnership, the partnership would not be treated as one shareholder for purposes of determining if the corporation had fewer than 46 shareholders. Rather, the third party and each of his or her children would be treated as shareholders for purposes of the maxi-

mum number of owners tests under Section 6166(b)(1)(C)(ii).

A person is treated as a beneficiary of any trust under the constructive ownership rule of Section 6166(b)(2)(C) only if such person has a "present interest" in the trust. The term "present interest" is not defined. It may not have the same meaning as "present interest" for purposes of the gift tax annual exclusion under Section 2503(b).

There is no guidance as to when or how constructive ownership from a decedent's estate occurs. It may be that stock or a partnership interest held in an estate of another person of which the decedent was, at death, the sole residuary legatee is treated under Section 6166(b)(2)(C) as held by the decedent. The estate constructive ownership rule likely may apply if the stock (or partnership interest) held by the estate is specifically bequeathed to someone.

For example, suppose that another shareholder of the corporation or partner in the partnership is the specific legatee of additional shares in the corporation or partnership interests in the partnership. These shares held by the estate presumably would be attributed to him or her for determining the number of shareholders in the corporation or number of partners in the partnership for purposes of Section 6166(b)(1). That would seem to reduce the number of shareholders (or partners) if the estate's shares or partnership interests are attributed to another person who otherwise is a shareholder or partner. On the other hand, if multiple individuals who are not otherwise shareholders or partners are legatees of the estate, the number of shareholders or partners increases, thereby reducing the chances of there having been 45 or fewer shareholders or partners when the decedent died.

*Stock or partnership interests held by family members.* Under Section 6166(b)(2)(D), stock (although, as explained below, only nonpublicly-traded stock) and partnership interests held by any member of the decedent's family (which is defined in Section 267(c)(4) as the individual's brothers and sisters, whether by the whole or half blood, spouse, ancestors and lineal descendants) are treated as held by the decedent for purposes of determining if the decedent's gross estate includes at least 20% of the capital interests in a partnership (so it is treated as closely held under Section 6166(b)(1)(B)(i)) or at least 20% of the voting stock in a corporation (so it is treated as closely held under Section 6166(b)(1)(C)(i)).<sup>19</sup>

According to the General Explanation of the Revenue Act of 1978, prepared by the Professional Staff of the Joint Committee on Taxation of the Congress (the "Blue Book"), the rule of attributing the family members' stock or partnership interests to the decedent applies only if the decedent's executor makes the election under Section 6166(b)(7).<sup>20</sup> If the election is made, however, the estate may not pay any portion of interest on the deferred estate tax at a 2% annual interest rate and the estate may not elect to pay interest only for the first five years of the deferred period, as are normally permitted under Section 6166. In any case, the Section 6166(b)(7) election may be made only with respect to stock that is not "readily tradable," meaning "stock for which, at the time of the decedent's death, there was no market on a stock exchange or in an over-the-counter market."

However, although Section 6166(b)(7) provides that the decedent's executor may elect for partnership interests held by family members of the decedent to be attributed to the decedent for pur-

<sup>18</sup> See General Explanation, *supra* note 17, at 289.

<sup>19</sup> It also appears that attribution will apply to a trust of which a family member, as defined in Section 267(c)(4), is a beneficiary. See Ltr. Rul. 9301014.

<sup>20</sup> See General Explanation, *supra* note 17, at 289.



poses of the minimum 20% capital interests or voting stock tests of Section 6166(b)(1), that election and attribution rule do not appear to apply for purposes of determining the number of partners of a partnership or the number of shareholders of a corporation.

**Voting stock and 'in value.'** Section 6166 does not provide a definition of "voting stock." In some cases, it likely will be clear whether the stock is voting or not. In others, such as where the owners of a certain class of the stock may vote on only certain matters but not others, it may not be clear. Also, in determining if the decedent's gross estate includes at least 20% in value of the voting stock, it is not certain whether or to what extent stock options or similar interests convertible to voting stock are to be considered. Similarly, it is uncertain whether nonvoting stock that may be converted, at the election of the shareholder, into voting stock is to be considered.

According to the Code, the minimum ownership for purposes of Section 6166 is not met merely because the decedent's gross estate includes (or, by election or otherwise, is deemed to include) 20% of more of the voting stock of the corporation, but only if the estate includes (or is deemed to include) 20% or more *in value* of the voting stock. No authority indicates what rules or conventions are used to make that determination. It seems apparent, though, that the value of the decedent's interest in the business for purposes of Section 6166(c) is its estate tax value.

Section 6166(b)(4) provides that "[f]or purposes of this section, value shall be value determined for purposes of chapter 11 (relating to estate tax)."<sup>21</sup> Hence, if the decedent (combined, as explained above, in some cases with the interests of the de-

cedent's spouse or other family members) holds a minority interest, it may be worth less than 20% of the total value of the business even if the decedent (combined, as explained above, in some cases with the interests of the decedent's spouse or other family members) represents at least 20% of all interests in the business. The values used to determine if the decedent's gross estate includes at least 20% of the value of the active closely held business would reflect the value of any real estate elected to be specially valued pursuant to Section 2032A and would be determined using alternate valuation estate tax values if the alternate valuation date is elected under Section 2032.<sup>22</sup>

### The 35% test

In order for an estate to be permitted to defer the payment of estate tax on an active closely held business interest that is included in the decedent's gross estate, the business must be more than 35% of the decedent's adjusted gross estate.<sup>23</sup> "Passive assets" are excluded from the value of the active closely held business for purposes of this test.<sup>24</sup> And the attribution rules under Section 6166(b) from a decedent's spouse and, by election, from certain family members do not seem to apply for purposes of the more-than-35% test of Section 6166(a). Similarly, the interests of the spouse or other family members attributed to the decedent under Section 6166(b)

are not considered in determining the percentage of the tax that may be deferred under Section 6166(a).

The decedent's adjusted gross estate is the gross estate reduced by funeral expenses, costs of administration and claims allowable under Section 2053 (whether or not they are deducted for estate tax purposes or for income tax purposes), and losses allowable under Section 2054.<sup>25</sup> The value of all the decedent's interests in an active closely held partnership and the value of all the decedent's stock in a closely held corporation are used to determine if the value of the closely held business (or businesses if they may be combined) exceeds 35% of the decedent's adjusted gross estate.

**Treatment of passive assets.** Subject to the special rules for certain corporate holding companies and qualifying lending and finance companies, passive assets (that is, those owned by the active business(es) but not used to conduct the active trade or business) are ignored for purposes of determining whether the more-than-35% threshold is met and for purposes of determining the portion of estate tax that may be deferred.<sup>26</sup> For example, marketable securities or cash not used in carrying on the trade or business are not considered part of the active business. In effect, these come out of the "numerator" but stay in the "denominator" of the fraction

<sup>21</sup> Of course, the interests of other family members that are attributed to the decedent are not in the decedent's gross estate, in fact, and, therefore, have no estate tax values. Presumably, these family member interests will be valued as though they were included in the gross estate. Even if the combined interests of decedent and family members represent a majority interest in the corporation, it may be that the decedent's interest alone is a minority interest and will be valued for estate tax purposes with a lack of control discount. How, if at all, that would affect whether the voting stock of the decedent and the family members' voting stock will constitute at least 20% in value of the total voting stock is uncertain.

<sup>22</sup> For example, assume the decedent's estate (combined, as explained above, in some cases with the interests of the decedent's spouse

or other family members) holds 25% of the interests in a corporation. However, if the interests of the decedent (and those of the decedent's family members which are combined for purposes of Section 6166(c)) in the corporation represent a minority interest in the corporation, the stock may well be valued for estate tax purposes with discounts causing it to be worth less than 20% of the total value of the corporation. *Cf.*, e.g., Obermer, 238 F. Supp. 29, 15 AFTR2d 1288 (DC Ha., 1964) (valuing a 50% interest in a holding corporation with one-third discount for lack of control and marketability).

<sup>23</sup> Section 6166(a).

<sup>24</sup> Section 6166(b)(9).

<sup>25</sup> Section 6166(b)(6).

<sup>26</sup> Section 6166(b)(9).



which needs to be calculated to see if the more-than-35% test is met (as well as for purposes of determining the portion of the federal estate tax that may be deferred).

Nevertheless, some complicated rules allow certain assets that otherwise would be treated as passive ones to be considered. For example, stock held by an active business in a corporation is a passive asset unless the stock is treated as held by the decedent through a special election under Section 6166(b)(8) with respect to the decedent's ownership in a holding corporation and such stock that is treated as so held by the decedent is in an active business.

Also, if the active business is a corporation and it owns 20% or more in value of the voting stock of another corporation (or such corporation has 45 or fewer shareholders) and 80% or more of the value of the assets (excluding the value of the stock owned by the active business which is in the form of a corporation) of such other (subsidiary) corporation is attributable to assets used in carrying on a trade or business, then such other corporation is treated as part of the active business which is itself in the form of a corporation.

**More than one entity treated as a single business.** Under Section 6166(c), interests in two or more active closely held businesses may be combined, in some cases, to determine if the more-than-35% threshold is met and for purposes of determining the percentage of estate tax that may be deferred. In order for businesses to be combined, 20% or more of the *total value* of each such business must

be included in determining the value of the decedent's gross estate. It should be emphasized that this is a different 20% test than may be used to determine if the business is closely held. For those tests, only capital interests in a partnership and only voting stock in a corporation are considered.

For purposes of combining businesses for purposes of the more-than-35% test, not only must each such business be closely held (meeting either the 20% or more of the capital interest or voting stock test or the 45 or fewer owners test), but at least 20% of the total value of each business must be included in the decedent's estate. The spousal common ownership rule is used for this 20% or more of this total value of business test.<sup>27</sup> The family member attribution rule of Section 6166(b)(7) may also be used for the combined businesses test if elected.<sup>28</sup>

It seems that a partnership and a corporation together may be considered as one business.<sup>29</sup> It is uncertain when two or more entities may be considered one business. It seems likely that if they are, in fact, in one business, they should be treated as one for purposes of Section 6166, including whether the estate tax value of the business exceeds 35% of the decedent's adjusted gross estate without regard to the combined businesses test of Section 6166(c). That might be the case where the decedent operates a ready-mix cement business and the cement trucks are owned by one entity (such as an LLC), the plants are owned by separate corporations, and the operating company (that is, the one that takes orders from customers, orders supplies and collects from customers) is owned by a partnership. In many of these cases, of course, the decedent (and, perhaps, members of his or her family) will own 100% of each entity.

In some situations, it may be difficult to determine if the decedent's

estate includes 20% or more of the total value of each such business so that it could be combined with other business interests included in the decedent's estate, for purposes of the more-than-35% threshold and for purposes of determining the portion of the estate tax that may be deferred. That difficulty may arise if the decedent owns a different percentage interest in the various entities that comprise the single business. A competent appraiser, however, should be able to make the determination.

A complication may arise where there is both a corporation and a partnership that together comprise the single business, as is the case in Reg. 20.6166A-3(d), Example 3. One of the tests to determine whether a partnership is closely held is whether the decedent's gross estate includes at least 20% of the

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<sup>27</sup> See Section 6166(c) (second sentence).

<sup>28</sup> See Section 6166(b)(7)(A)(i).

<sup>29</sup> See Reg. 20.6166A-3(d), Example 3 ("The B Corporation stock and the interest in the partnership together make up the interest in the closely held business which was included in the decedent's gross estate.").



capital interests in a partnership. One of the tests to determine whether a corporation is closely held is whether the decedent's gross estate includes at least 20% of the voting stock in a corporation.

Because both a corporation and partnership are involved, it may be uncertain what test should be used to determine if the 20% minimum ownership rule is met for purposes of the closely held test of Section 6166(b)(1). If each test for each entity is met, then no issue seems to arise. Perhaps, the partnership should be tested using the partnership closely held tests and the corporation should be tested using the corporation closely held tests, using the attribution rules applicable to determining whether the 20% test is met. It seems that it may be reasonably argued that, because more than one entity is involved in the business, the business should be treated as a partnership and the entire business tested using the closely held tests for partnerships—that is, the two entities (even if one is a corporation) formed a partnership. However, there is no authority that supports that argument.

***Limited impact of election to attribute other family members' interests to the decedent.***

Although the election under Section 6166(b)(7) permits the interests held by family members to be treated as held by the decedent for purposes of combined closely held businesses under Section 6166(c), the interests held by such family members are not considered for purposes of determining if the more-than-35% threshold is met or for purposes of determining the percentage of tax that may be deferred.

For example, if the decedent's gross estate includes 18% of the voting stock of Corporation No. 1 and 19% of the voting stock of Corporation No. 2 and each has

more than 45 shareholders, neither would qualify as a closely held business under Section 6166(b)(1) because that section requires that the decedent's gross estate hold at least 20% of the voting stock in the corporation (or there be fewer than 46 shareholders). However, if 10% of the voting stock of each corporation is held by the decedent's children and if the executor makes the election under Section 6166(b)(7), the decedent's gross estate will be deemed to hold 28% and 29% respectively of the voting stock for purposes of Section 6166(b)(1) and each corporation will be considered closely held.

Moreover, if the decedent and the decedent's children hold at least 20% of the total value of each corporation, it seems that the decedent's interests in the two corporations may be combined for purposes of the more-than-35% threshold and for purposes of the percentage of estate tax that may be deferred. If, however, the decedent's interest in Corporation No. 1 (excluding the interests of the decedent's children) represents 20% of the adjusted gross estate and the decedent's interest in Corporation No. 2 (again excluding the interests of the decedent's children) represents 12% of the adjusted gross estate, then, although the interests in the two corporations may be combined pursuant to Section 6166(c), they do not comprise more than 35% of the decedent's adjusted gross estate but only 32%. This is the result even if the executor has made the Section 6166(b)(7) election and even if, combined with the children's interests, they would exceed 35% of the decedent's adjusted gross estate.

Lastly, it is important to note that even if the decedent's interests (excluding the interests held by the decedent's family members) alone comprise more than 35% of the adjusted gross estate, the amount

of the tax deferred is calculated without regard to the interests held by family members of the decedent even if the executor has made the Section 6166(b)(7) election.

***Limited application of spousal common ownership rule.***

As also mentioned previously, interests held by the decedent and the decedent's spouse as community property, joint tenants, tenants by the entirety or tenants in common are considered for purposes of combining businesses under Section 6166(c). Again, however, the interests of the spouse apparently are not used for purposes of determining if the more-than-35% threshold is met or the amount of tax that may be deferred. Although no authority expressly so concludes, the section prescribes circumstances when the spouse's interest is to be considered (e.g., for purposes of determining the number of partners or shareholders and for purposes of combining the decedent's business interests) but does not provide for the spouse's interest in community property or commonly held property to be considered for purposes of the more-than-35% threshold or for purposes of determining the amount of tax that may be deferred.

***Transfers within three years of death.***

Although, in general, property transferred by a decedent within three years of death is not included in the decedent's estate, Section 2035(a) requires such property to be so included if (1) the decedent made a transfer of an interest in property (or relinquished a power over property) within three years of death, and (2) the value of the property would have been included in the gross estate under any of Section 2036 (relating to certain transfers with a retained income interest or control over the beneficial enjoyment of property), Sec-



tion 2037 (relating to certain reversionary interests), Section 2038 (relating to certain powers over the beneficial enjoyment of property) or Section 2042 (relating to proceeds of insurance on the decedent's life) if the transfer or relinquishment had not been made.

Hence, if the decedent made any such transfer, such property would comprise part of the decedent's adjusted gross estate and, therefore, be used in determining if the value of the active closely held business included in the decedent's gross estate exceeds 35% of the decedent's adjusted gross estate. However, Section 2035(c)(2) requires that the value of the active closely held business included in the gross estate also exceed more than 35% of the adjusted gross estate, excluding those assets included under Section 2035(a) from the adjusted gross estate.

Therefore, if any property is included under Section 2035(a), two calculations must be performed for an active closely held business: (1) the estate tax value of the active closely held business interest (which would include any interest in the active closely held business that is included in the decedent's gross estate under Section 2035(a)) divided by the decedent's adjusted gross estate (which would include any property that is included in the decedent's gross estate under Section 2035(a)), and (2) the estate tax value of the active closely held business interest (excluding any interest in the active closely held busi-

ness that is included in the decedent's gross estate under Section 2035(a)) divided by the decedent's adjusted gross estate (excluding any property that is included in the decedent's gross estate under Section 2035(a)). To qualify, both calculations must exceed 35% in order for the estate's active business interest to meet the more-than-35%-of-the-adjusted-gross-estate test.

### To elect or not to elect

**Benefits of the election.** Making an election under Section 6166 may prevent the forced liquidation of the business or other assets. It permits the business to attempt to earn enough revenue to distribute to the estate to pay the tax over time. It also provides the estate with an opportunity to earn more on its assets than the interest it pays on the tax. For example, if the annual net interest cost of interest on the deferred tax is 2.7% (that is,  $.45 \times .06$  interest underpayment of tax rate), the estate might be readily and safely able to earn more either income tax-free or after income tax.

One potential effect of the election is that it keeps the estate "open" for administration purposes, which may mean additional legal and other costs. However, this perceived disadvantage may well provide significant additional benefits, for tax reasons.

A decedent's estate is treated as an estate for income and certain excise tax purposes during the entire time that the deferral of payment period lasts.<sup>30</sup> The result is the avoidance of a loss of S corporation status if the estate holds shares in an S corporation (whether or not that is the business or one of the businesses which qualifies under Section 6166), because a decedent's estate is an eligible S shareholder and those who succeed to the ownership of the estate may not be an

eligible S shareholder.<sup>31</sup> And the receipt of the shares by the successors may cause the corporation to lose S status later on.

Deferral may also avoid certain limitations on the income tax deduction for payments to charity from trusts, which limitations do not apply to a decedent's estate.<sup>32</sup> Furthermore, as long as the estate remains open, the estate is permitted to take a charitable "set aside" income tax deduction that is available to estates but not to trusts.<sup>33</sup> In addition, as indicated, an estate or trust is permitted a charitable income tax deduction for payments of its gross estate to even a foreign charity; U.S. individual taxpayers are permitted the deduction only if paid to a U.S. charity.

Keeping the estate open also limits or avoids the application of certain "private foundation" excise tax rules which may apply not only to foundations but also to other entities such as charitable remainder trusts and charitable lead trusts.<sup>34</sup> This rule may be important, for example, to avoid the so-called excess business holding rule of Section 4943, which essentially limits the percentage of a business that a private foundation and, in some cases, a charitable lead trust may hold (otherwise, the entity will

<sup>30</sup> See Reg. 1.641(b)-3 and Reg. 53.4947-1.

<sup>31</sup> Section 1361(b)(1).

<sup>32</sup> See, e.g., Section 681 (limiting the charitable deduction of a trust on its unrelated business income to the deduction limitations under Section 170(b) applicable to individuals); Section 642(c) (providing that the income tax deduction for an estate or trust applies only to the entity's gross income set aside, but only for estates and certain "pre-1969" trusts, or paid for a charitable purpose, without regard to whether the charitable entity is a U.S. or foreign entity, pursuant to the terms of the governing instrument).

<sup>33</sup> Section 642(c).

<sup>34</sup> See Section 4947(b); Reg. 53.4947-1.

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face significant taxes which are similar to penalties).

Keeping the estate open also permits a deferral of the annual payments required to be made from charitable lead trusts (described in Section 170(f)(2)(B)) and charitable remainder trusts (described in Section 664).<sup>35</sup> It also extends the time for disqualified persons, defined in Section 4946, to acquire assets from a decedent's estate or revocable trust that otherwise are payable to a private foundation or other entity (such as a charitable lead or remainder trust) subject to excise taxes under Chapter 42 of the Code without exposing the acquisition to the self-dealing taxes under Section 4941.<sup>36</sup>

Those benefits alone may more than offset the additional administration expenses incurred in keeping the estate open. As a result, the election under Section 6166 should be carefully explored in many cases.<sup>37</sup>

**Alternatives.** An alternative to Section 6166 may be to borrow the funds needed to pay estate tax from a commercial lender. The interest paid to the commercial lender, unlike the interest paid to the IRS under Section 6166, is deductible, as a general rule, for estate tax purposes or, possibly, for income tax purposes. It usually is appropriate to compare the net after-tax cost of borrowing from a commercial lender to the cost of deferring the tax under Section 6166 or Section 6161 (relating to an extension for a reasonable cause).

Generally, a commercial loan may be callable (that is, must be paid) at some point by a commercial lender (e.g., the lender will not guarantee that the loan will remain outstanding for ten or 14 years as it may be with an extension to pay pursuant to Section 6161 or Section 6166, respectively). Moreover, it often is difficult to arrange

a commercial loan at a fixed rate (although there may be exceptions, such as for loans secured by real estate or resulting from a so-called interest rate swap). The rates charged by a commercial lender may increase, in part on account of perceived reduction in value of the collateral pledged to secure the commercial loan. In some cases, the terms associated with a commercial loan will provide for a penalty if the loan is prepaid before its due date. Such a penalty will not apply to a loan from the government under Section 6161 or 6166.

**Other aspects of borrowing to pay estate tax.** Interest paid on a loan that is "actually and necessarily" incurred in the administration of the estate is deductible under Section 2053(a) as a cost of administering the estate.<sup>38</sup> Interest incurred on a loan, for example, to pay federal estate tax generally is deductible for estate tax purposes but usually only as the interest is actually paid.<sup>39</sup>

In fact, the ability to deduct interest due in the future without having to take into account the fact that the present value of the interest obligation is less than the nominal amount of the interest obligation can be significant. Put differently, an obligation to pay one dollar of interest in ten years should not produce a current deduction of one dollar, but rather a current deduction of the

present value of the obligation. Yet, under current law, a current deduction of one dollar is available without regard to the fact that the one-dollar obligation may not be discharged for many years.

For example, consider an estate that has only illiquid and unmarketable assets and that borrows \$10 million from a commercial lender (e.g., a bank) in order to pay its estate tax nine months after the decedent's death. The loan provides for interest at 6% payable annually and the principal due in full at the end of the ten years. The \$600,000 of interest paid in the tenth year is deductible, in effect, as of nine months after the decedent's death—thereby generating an immediate estate tax savings. If it is assumed that the present value of the obligation to pay \$600,000 of interest in year ten is only \$335,000, the real after-tax cost (in present value terms) of the cost of the interest is only \$65,000 (\$335,000 minus the immediate tax savings of \$270,000 (i.e., 45% of \$600,000)).

To the extent that the \$10 million could be invested in year ten to produce, in present value terms, more than \$65,000 on an after-income-tax basis, the borrowing produces an economic profit. Note that the income tax rate may well be less than the 45% estate tax rate and that this differential contributes to the economic profit. Note also that, even if the loan proceeds are invested in tax-exempt

<sup>35</sup> See, e.g., Reg. 1.664-1(a)(5).

<sup>36</sup> See Reg. 53.4941(d)-1(b)(3).

<sup>37</sup> See Chief Couns. Adv. Mem. 200909047 (2/27/09) ("Regulation § 20.6166-1(c)(1) provides the procedures for making an election to pay a deficiency in installments under § 6166(h) of the Code, where no election, including a protective election, has been made under Code § 6166(a). Neither the statute nor regulations require that the estate tax return must have been timely filed in order to make an election to pay that portion of the deficiency attributable to the closely held business interest in installments. Therefore, the fact that the estate tax return was not timely filed will not, in and of itself, prevent an executor from electing to pay a deficiency in installments. Section 6166(h) of the Code, however, provides that an executor may not elect to pay a defi-

ciency in installments if the deficiency is due (1) to negligence, (2) to intentional disregard of rules and regulations, or (3) to fraud with intent to evade tax. This limitation has been in all the variations of § 6166 since the first version was enacted in 1958.")

<sup>38</sup> Reg. 20.2053-3(a); see *Estate of Grant*, 294 F.3d 352, 89 AFTR2d 2002-3063 (CA-2, 2002); *Estate of Millikin*, 125 F.3d 339, 80 AFTR2d 97-6347 (CA-6, 1997); *Estate of Love*, 923 F.2d 335, 67 AFTR2d 91-1171 (CA-4, 1991); *Marcius v. DeWitt*, 704 F.2d 1227, 52 AFTR2d 83-6399 (CA-11, 1983); *Hibernia Bank*, 581 F.2d 741, 42 AFTR2d 78-6510 (CA-9, 1978); *Pitner*, 388 F.2d 651, 21 AFTR2d 1571 (CA-5, 1967).

<sup>39</sup> See, e.g., *Estate of Bahr*, 68 TC 74 (1977), acq.; Rev. Rul. 78-125, 1978-1 CB 292; Rev. Proc. 81-27, 1981-1 CB 548.



bonds, the interest deduction taken pursuant to Section 2053 for estate tax purposes should not be adversely affected by the income-tax disallowance rule in Section 265. Thus, the estate could earn significantly less than the cost of the interest expense and still make an economic profit by undertaking the borrowing.

Quite aside from any such economic profit, the borrowing may make sense, for the cost of liquidating assets may be significant. Selling assets under a compulsion (e.g., in the proverbial "fire sale" to raise cash to pay taxes or another debt that is due) often results in an appreciably lower sales price than if the assets are sold "in due course." A loan may allow a more "orderly" sale.

However, because the deduction will be disallowed in the absence of sufficient liquidity need or other "actual and necessary" reason, taxpayers must exercise caution in deciding whether to borrow (as opposed to "borrowing" from the IRS pursuant to Section 6166 or 6161).<sup>40</sup> In addition, it is almost certain that the cost of administering the estate will increase if the borrowing is undertaken. For example, if the interest will be paid beyond the third anniversary of the filing due date of the return, the estate likely will have to file a refund claim in order to deduct, for estate tax purposes, the interest paid after the third anniversary.<sup>41</sup>

One exception to the requirement of filing a refund claim for interest paid on a commercial loan seems

to be available for a so-called *Graegin* loan. In *Estate of Graegin*,<sup>42</sup> the estate was allowed to deduct all interest that would be payable under a term loan from a commercial lender that could not be prepaid. Apparently, on account of the certainty that the interest would be paid (because, even if the loan were prepaid, the full interest that would have been due, if it were not prepaid, must be paid as part of the terms of the loan), the interest was permitted to be deducted even before it became payable. This, of course, results in immediate cash in hand for the estate (i.e., the tax savings are in effect received when the return is filed).

Two other factors also may favor a *Graegin* loan as opposed to a loan where it may be prepaid and the interest deducted only as it is paid. First, with a *Graegin* loan, less tax, which ultimately would be recovered by the allowance of the deduction for interest as it is paid, need be advanced to the IRS, meaning that that cash stays with the estate or its business and further liquidity problems may be avoided. For example, assume the taxable estate (without regard to any interest deduction on any amount loaned to pay the estate tax) is \$20 million and the estate is in a 50% effective estate tax bracket and needs to borrow \$10 million to pay the estate tax (a \$20 million taxable estate times a 50% tax rate), upon which loan it will pay 5% each year, with the entire \$10 million loan to be repaid at the end of ten years.

If the estate borrows under a *Graegin* loan arrangement, it will receive an upfront deduction of \$5 million (that is, \$500,000 of annual interest for ten years), reducing the amount it must pay to the IRS by \$2,500,000. Hence, it need not borrow \$10 million because it will owe less. Although it may seem that the estate need borrow only \$7,500,000 (because its estate tax liability is reduced by the upfront \$2,500,000 interest deduction that will be due on the \$10 million loan taken), the issue is more complex than that: as the amount borrowed is reduced, the amount of the interest deduction is similarly reduced, which in turn reduces the amount of the estate tax deduction. That is a type of "interrelated" calculation.<sup>43</sup>

At a 50% estate tax bracket, if the borrowing arrangement is a *Graegin* loan, the estate will owe \$8 million in estate tax, because the interest due over ten years at 5% on \$8 million would be \$4 million, which at a 50% estate tax bracket would reduce the taxable estate to \$16 million and estate tax to \$8 million, and that will be the amount the estate pays over to the IRS. If it is not a *Graegin* loan, the estate will need to borrow \$10 million, as it will have no upfront interest deduction as it would in the case of a *Graegin* loan. Although the estate will eventually recover \$2 million (or more)<sup>44</sup> in estate tax (with interest) from the IRS on account of the interest it pays on the borrowing, the estate's cash flow management obviously is quite different.

However, as far as the present value of the interest is concerned, it does not matter whether the interest is deductible as paid or taken upfront as in the case of a *Graegin* loan (other than the fact that the estate enjoys an immediate cash savings if the deduction can be taken at the time the return is filed). Only if the interest obligation could be

<sup>40</sup> The IRS will defer the payment of estate tax under Section 6161 only if it finds there is a reasonable cause for the deferral, meaning it is unlikely the IRS would attempt to disallow the interest paid to the IRS.

<sup>41</sup> Because the interest paid on the tax deferred under Section 6161 is not deductible, it will be unnecessary to file refund claims to claim interest deductions.

<sup>42</sup> TCM 1988-477.

<sup>43</sup> An interrelated calculation is one where the variables are dependent upon and affect each other; as one variable changes, it affects a second which affects the first, which then again affects the second and so on. In this case, the

amount borrowed to pay estate tax (the first variable) affects the amount of interest due (the second variable) on the first variable, which interest (the second variable) in turn affects the estate tax due (the first variable) which, in turn, affects the interest and so on.

<sup>44</sup> The reason the estate may recover more than \$2 million in estate tax is that it is borrowing \$10 million in the non-*Graegin* loan arrangement rather than \$8 million and therefore will incur more interest. However, exactly how much more interest and, therefore, the size of its estate tax recovery depends on whether the estate files (and the IRS allows) a refund claim as the interest is paid.



eliminated (by reason of the lender permitting the loan to be prepaid without the interest charge) would the *Graegin* loan offer any additional advantage (i.e., if the loan could be cancelled and the interest obligation eliminated, the estate would enjoy the advantage of an interest deduction with respect to an interest obligation that is never in fact discharged). To the extent that the estate is able to modify the loan agreement by prepaying despite the no-prepayment clause through the payment of damages to the lender, this advantage could be realized. Assuming, however, that prepayment will not occur, it would seem that the only direct "financial" advantages inherent in a *Graegin* loan are that it obviates the need to file a refund claim as the interest is paid and it produces extra cash at the time the return is due.

Second, although the estate will recover the \$2 million (or more) in estate tax with interest payable under Section 6621(b)(2), the estate (or its business) may be able to earn more on the \$2 million.

It is also worth noting that a complication with a *Graegin* loan is fixing the interest rate. Many commercial lenders will not charge a fixed interest rate but will lend only at a fluctuating rate such as prime or LIBOR rate from time to time during the term of the loan. To determine how much interest, in fact, will be paid on the *Graegin* loan so that it can all be deducted upfront, the loan will have to be at a fixed rate. Perhaps, a fixed rate could be arranged for a loan backed by real estate (as, traditionally, commercial lenders have made fixed interest loans on real estate) or by having the borrower (or more likely the lender arranging for the borrower) conduct an interest rate swap, under which a third party will agree (usually through other counterparties) to lend at a fixed rate in exchange

for being liable to pay interest at the fluctuating rate. That may increase the interest rate charged.

### Termination of the election

The estate may elect to prepay the estate tax, in whole or in part, at any time without penalty or premium if the tax has been deferred under Section 6166. Moreover, the payment of the deferred estate tax is accelerated upon demand of the IRS if the tax or interest is not paid when due, although if such tax or interest is paid within six months of the due date, acceleration does not apply but penalties may be imposed.<sup>45</sup>

Under Section 6166(g)(2), the deferral privilege is also lost to the extent that the estate has "undistributed net income" for any tax year ending on or after the due date for the first tax installment payment (as opposed to the first interest installment payment), which generally is the fifth anniversary of the normal nine months after death payment date.

In addition, under Section 6166(g)(1), complete acceleration of payment of unpaid tax and interest occurs if the aggregate dispositions of, or withdrawals from, the business equal or exceed 50% of the value of the interest in the business. This is a "cliff" rule: no acceleration occurs if the dispositions or withdrawals are less than 50% but, once they equal or exceed 50%, the entire Section 6166 deferral privilege is lost.

There is one exception to the 50% disposition/withdrawal rule: withdrawals do not trigger acceleration if shares of stock in the corporation which is the business with respect to which the election is made are redeemed pursuant to Section 303. Section 303 allows an estate to withdraw money or property (up to an amount equal to the sum of death taxes, funeral charges and administration expenses but not debts of

the decedent) by the redemption of stock and to have the money or property withdrawn treated as proceeds of a sale rather than a dividend.

### Conclusion

Section 6166 is an extremely complicated provision using different tests and having different rules apply for different purposes. And, as is apparent from this article, little case law has developed under Section 6166. One reason is that, as a general rule, if the IRS denied the extension to pay, the taxpayer could not go to court to have the IRS's decision overturned. This is the general rule because, in most cases, a taxpayer may go to court only to prevent the assessment of tax. When an election under Section 6166 is sought, the tax has already been assessed (generally, by the act of filing the U.S. estate tax return). The only question is when it must be paid. Usually, the IRS may collect tax when it is assessed.

In 1997, Section 7479 was enacted, which permits a decedent's estate to commence an action for declaratory judgment in the U.S. Tax Court for a determination of whether it may defer (or to continue to defer) the payment of tax pursuant to Section 6166 without the necessity of first paying the tax. Therefore, if the IRS refuses the deferral under Section 6166, the estate, in certain cases, may have the Tax Court determine if the estate qualifies. During the period that the case is pending before the court, the IRS cannot collect the tax.<sup>46</sup> Nonetheless, there are many unanswered questions about Section 6166, and it may be anticipated the case law surrounding Section 6166 eventually will develop in the future. ■

<sup>45</sup> See Section 6166(g)(3).

<sup>46</sup> Section 7479.