

# PLANNING FOR LIQUIDITY IN ESTATE HOLDING CLOSELY-HELD BUSINESS INTERESTS — LOANS

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## I. Introduction

In situations where an estate is comprised mostly of illiquid assets, such as in the case where the main asset of the estate is a closely-held business or real estate, the executor must find a way to fund the payment of estate administration expenses and estate taxes. One alternative for providing estate liquidity is to have the estate borrow the funds necessary to pay such amounts. There are various sources and a number of methods that can be used when borrowing money to pay for estate taxes: intra-family loans, loans from related business entities, third party loans, and “loans” from the Internal Revenue Service (“IRS”) under §§ 6161 and 6166 of the Internal Revenue Code of 1986, as amended (the “IRC”).

## II. Intra-Family, Entity or Third Party Loans

A. Deductibility of Interest on Non-IRS “Loans”. An estate encountering a lack of cash or other liquidity to pay for its estate tax obligations may borrow funds sufficient to pay such taxes. The estate may borrow funds from a number of sources: family members; family controlled entities, including closely-held businesses and insurance trusts established by the decedent; or a third party, such as a bank or other lending institution. One of the benefits of paying the estate tax with a loan is that interest on such a loan may be deductible as an administration expense of the estate if it meets the requirements of IRC § 2053(a)(2) and the regulations thereunder, which as a result reduces the total amount of estate taxes paid.<sup>1</sup> Interest may be deductible regardless of whether the loan is from a related party or a commercial bank as long as the interest expense meets the requirements of IRC § 2053(a)(2) and the loan is a true loan. (See discussion of “true loans” in subsection 2, below.) The estate has the burden of proving that such requirements are met.<sup>2</sup>

1. Section 2053(a)(2) Requirements. Pursuant to § 2053(a)(2) and the regulations thereunder, to deduct an expense as an administration expense, the expense must be (1) “payable out of property subject to claims and which are allowable by the law of the jurisdiction, . . ., under which the estate is being administered;”<sup>3</sup> (2) “ascertainable with reasonable certainty, and will be paid;”<sup>4</sup> and (3) “actually and necessarily incurred in the administration of the decedent’s estate” (i.e., expenses incurred in the collection of the assets, payment of debts, and distribution of property to the persons entitled to it).<sup>5</sup> Any expenditures incurred that are “not essential to the

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<sup>1</sup> *Estate of Todd v. Commissioner*, 56 T.C. 288, 295 (1971), acq., 1973 - 2 C.B. 4, where the loan was from a private party.

<sup>2</sup> *Id.*

<sup>3</sup> Treas. Reg. § 20.2053-1(a)(1).

<sup>4</sup> Treas. Reg. §§ 20.2053-1(a)(2)(ii) and 20.2053-1(b)(3).

<sup>5</sup> Treas. Reg. § 20.2053-3(a).

proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees” are not allowed as a deduction to the estate.<sup>6</sup>

The Tax Court has recognized that interest on a borrowing by an estate to pay estate taxes to prevent financial loss to the estate as result of a forced sale of illiquid assets is actually and necessarily incurred in the administration of an estate and allowable as a deduction under IRC § 2053(a)(2).<sup>7</sup> The interest, however, is only deductible to the extent that it has actually accrued.<sup>8</sup> In Rev. Rul. 84-75, 1984-1 C.B. 193, the IRS concluded that if the terms of an estate’s obligation allow repayment of the loan to be accelerated, the amount of the future interest that will be paid is indefinite because a premature repayment will stop the accrual of interest and, therefore, the amount of interest is not ascertainable with reasonable certainty. In such a case, the interest becomes deductible only as it accrues.<sup>9</sup> Revenue Procedure 81-27, 1981-2 C.B. 548, sets forth the procedure for recomputing the estate tax due as a result of a reduction in such tax by reason of the payment of interest on a borrowing as it accrues on the estate tax due.<sup>10</sup>

Where the Tax Court has concluded that an estate’s borrowing was not necessary to the administration of the estate, a deduction under IRC § 2053(a)(2) was not allowed.<sup>11</sup> In *Estate of Lasarzig v. Commissioner*, T.C. Memo 1999-307, the Tax Court did not allow a deduction for interest on a loan used to pay a QTIP trust’s share of estate tax liability, reasoning that the loan was not an administrative expense under IRC § 2053. In this case, the QTIP trust assets had been distributed to its beneficiaries, who in turn contributed the assets to their own family trusts. The family trusts obtained the loan to pay the estate tax obligations of the QTIP trust. The court found that the relationship between the family trusts and the estate was too remote. The assets of the QTIP trust were part of the gross estate; however, once distributed to the family trusts, those same assets no longer had any nexus to the estate.

The interest expense on such loans must be a permitted expense under local probate law; however, it does not matter that the interest expense is not deductible for state death tax purposes.<sup>12</sup> In addition, whether the interest expense is related to the payment of federal, state or foreign estate taxes does not affect the determination of whether the expense is deductible under IRC § 2053(a)(2) so long as it is an allowable expense under local probate law. The IRS, in Rev. Rul. 81-256, 1981-2 C.B. 183, concluded that interest accrued by an estate incurred on the state death tax liability is deductible under IRC § 2053(a)(2) to the extent such expense is available under local probate law.<sup>13</sup> Similarly, the IRS in Rev. Rul. 83-24, 1983-1 C.B. 229, concluded that interest paid to a foreign taxing authority as a result of a late payment of the foreign tax was

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<sup>6</sup> *Id.* *Hipp v. U.S.*, 72-1 USTC ¶ 12,824.

<sup>7</sup> *Estate of Todd v. Commissioner*, 56 T.C. 288, 295 (1971); *Estate of Huntington v. Commissioner*, 36 B.T.A. 698 (1937). See also Rev. Rul. 84-75, 1984-1 C.B. 193, Private Letter Ruling 9449011 and *Estate of McKee*, T.C. Memo 1996-362.

<sup>8</sup> Rev. Rul. 84-75, 1984-1 C.B. 193.

<sup>9</sup> *Id.*

<sup>10</sup> See Rev. Rul. 84-75, 1984-1 C.B. 193.

<sup>11</sup> *Hibernia Bank v. U.S.*, 75-2 USTC ¶ 13,102 aff’d by 581 F.2d 741 (9th Cir. 1978).

<sup>12</sup> See, e.g., Tech. Adv. Mem. 91-06-005 (Oct. 26, 1990) and Tech. Adv. Mem. 90-02-001 (Sept. 15, 1989), where the IRS determined that interest on loans obtained to pay estate tax and the interest accruing on any unpaid balance of the state inheritance tax, where the estate did not have sufficient liquidity to pay the federal estate tax, were deductible under IRC § 2053(a)(2) to the extent allowable under local probate law.

<sup>13</sup> See also, *Hipp v. U.S.*, 72-1 USTC ¶ 12,824.

deductible under IRC § 2053(a)(2) to the extent such expense is allowable under local probate law. However, interest on an estate tax deficiency which is subsequently refunded is not deductible as an administration expense as the interest has not been actually incurred.<sup>14</sup>

In Tech. Adv. Mem. 92-46-005 (July 27, 1992), the IRS concluded that administration expenses are incurred by the decedent's estate as a result of the decedent having a testamentary general power of appointment over property if such property is subject to the claims against the estate within the meaning of IRC § 2053(a)(2) and Treas. Reg. § 20.2053-1(a).

2. True Loans. One of the inquiries with respect to a loan funding the payment of estate taxes is whether the loan is true loan. A number of factors come into play when making this determination: Will the estate have to pay back the loan? Does the loan have economic effect? Is the interest rate a reasonable interest rate? Whether a distribution of funds is deemed to be a "true loan" turns on the intent of the estate at the time the distribution is made; that is, whether the estate and the "lender" actually anticipate repayment. This is essentially a factual determination, and the onus is on the estate to prove its intent. The court may look at various factors in determining intent, including the existence of promissory notes; collateral or interest payment provisions; whether and to what extent the "lender" is related to the estate; the treatment of such distributions in corporate records; any history of repayment of funds; and the estate's use of the funds.<sup>15</sup>

B. Deduction of Interest to be Paid on Loans to Pay Estate Taxes—"Graegin" Loans. As indicated above, interest may be deductible as it accrues. This requires the estate to follow the procedures set forth in Rev. Proc. 81-27 and file supplemental Form 706s as the interest expense accrues. This can result in the estate not receiving a refund of estate taxes previously paid if there is a subsequent reduction in the estate tax resulting from the allowance of the deduction of interest expense under IRC § 2053(a)(2) until after the final interest payment is made. One technique that has been used to reduce the federal estate tax on the initial filing of the estate tax return, thereby reducing the estate tax immediately, is for the estate to take out a loan the terms of which do not allow prepayment of the loan and require payment of interest for the entire term upon acceleration of the loan. The Tax Court in *Graegin v. Commissioner*, 56 T.C.M. 387 (1988), determined that a deduction by the estate of interest on a loan to the estate used to finance the payment of estate's federal estate tax liability, which interest had not been paid as of the time for filing the return, was deductible as an administrative expense under IRC § 2053(a)(2). The loan in this case was from a related entity<sup>16</sup> the terms of which included interest at the prime rate payable in a balloon payment of principal and interest 15 years from the date of the loan, which period was determined based on the decedent's life expectancy. The court concluded that the estate lacked liquidity, the interest expense was "actually and necessarily incurred," the loan was a genuine indebtedness, and the amount of the estimated interest expense

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<sup>14</sup> *Estate of O'Daniel v. U.S.*, 6 F.3d 321 (1993).

<sup>15</sup> See, e.g., *Busch et al. v. Commissioner*, 728 F.2d 945 (7th Cir., 1984) and *Tollefsen v. Commissioner*, 431 F.2d 511 (2d Cir., 1970).

<sup>16</sup> The loan was made by Graegin Corporation, a wholly owned subsidiary of Graegin Industries. Graegin Industries was a closely held business in which the decedent's revocable trust owned an approximately 96% interest in the voting preferred stock of the company. The decedent's son was President of both Graegin Corporation and Graegin Industries as well as a Co-Trustee the decedent's revocable trust for the benefit of the decedent's wife.

was both ascertainable and would be paid. Therefore, interest on the note was deductible as an administration expense under IRC § 2053(a)(2).

In similar cases, except that the loan was made to the estate by a commercial bank, the IRS in Priv. Ltr. Rul. 1999-52-039 (Sept. 30, 1999) and 1999-03-038 (Oct. 2, 1998), both relying on *Graegin*, concluded that the interest could be deducted on the estate tax return as an administration expense, provided that the expense was necessarily incurred in the administration of the estate and allowable under local law. In Priv. Ltr. Rul. 2000-20-011 (Feb. 15, 2000), the IRS concluded that where an estate makes an election under IRC § 6166(a) to defer payments of federal estate tax attributable to the value of a closely-held business and to pay such estate tax in installments, and where the estate then obtains a commercial loan to pay off the deferred taxes in full<sup>17</sup> and to avoid a forced sale of assets of the closely-held business to make such payments, the interest on that commercial loan may be deducted as an administration expense so long as the terms of the loan require that the loan may not be prepaid and that, in the event of a default, all the interest that would have been paid through the term of the loan will be accelerated. Therefore, the amount of interest deducted as an administration expense, including any prospective payments, is an amount ascertainable with reasonable certainty, and will be paid.

In Tech. Adv. Mem. 2005-13-028 (Sept. 15, 2004), the IRS determined that the interest on a loan similar to the one in *Graegin* from a related family limited partnership was not allowable as a deduction under IRC § 2053(a)(2). The IRS explained that since loan did not result in any economic benefit or detriment to the estate or the estate beneficiaries as obligors, the interest did not constitute a deductible administrative expense. The IRS focused on the facts that the family limited partnership had substantial liquid assets and the parties were the same on both sides of the transaction and that such parties' proportional interests in the family limited partnership and the estate were virtually identical.

### **III. Borrowing from the IRS**

#### **A. Late Payment of Estate Taxes.**

If an estate fails to pay the estate tax due by the date fixed for the payment of such tax, then the IRS will assess interest and penalties on such amount.<sup>18</sup> Interest expense is allowable under IRC § 2053(a)(2) without regard to the manner in which the expense is incurred.<sup>19</sup> Interest on a federal deficiency is deemed necessary to the administration of an estate and deductible under IRC § 2053(a)(2) to the extent allowable under local probate law.<sup>20</sup> The IRS in Rev. Rul. 81-154 did not, however, allow a deduction for the payment of a penalty imposed due to a late filing of a federal estate tax return and late payment of the federal estate tax. The IRS reasoned that part of the duty of an executor is to timely pay tax chargeable against the estate, so that the willful failure to file an estate tax return and pay such taxes is a breach of the executor's

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<sup>17</sup> The estate paid off the deferred taxes because the federal tax lien resulting from an election under IRC § 6166 made it difficult for the closely-held business to obtain operational lines of credit, which would be needed as the installment payments under IRC § 6166 would put a strain on the businesses cash flow.

<sup>18</sup> IRC §§ 6601 and 6651.

<sup>19</sup> *Bahr v. Comm'r*, 68 T.C. 74 (1977); Rev. Rul. 80-250, 1980-2 C.B. 278. See also, Rev. Rul. 78-125, 1978-1 C.B. 292 in which the IRS acquiesced to the Bahr decision.

<sup>20</sup> Rev. Rul. 79-252, 1979-2 C.B. 333.

fiduciary duty and, therefore, would not be an expense necessarily incurred in the administration of the estate. However, interest on a penalty has been allowed as a deduction.

B. Section 6161.

1. General Rule. Pursuant to IRC § 6161, the IRS may extend the time for the payment of the estate tax for a reasonable period not to exceed 12 months.<sup>21</sup>

- (a) Additional Extension for Estate Taxes. Section 6161 allows the IRS to extend the time for the payment of the estate tax for a reasonable period not to exceed 10 years from the date the estate tax is due<sup>22</sup> upon a showing of reasonable cause by the executor.<sup>23</sup> On December 4, 2008, the IRS issued IRS Interim Guidance (SBSE-05-1208-062) for Processing Requests for Extension of Time to File, Pay Federal Estate Taxes, which guidance sets forth the criteria for transfers of extension requests to Advisory, Insolvency and Quality Advisory staff and Campus Compliance Operations. The criteria listed in the guidance includes transfers of extension requests at certain liability thresholds, third requests for extensions and all extension requests to pay annual installments that are deferred under IRC § 61666. The guidance also includes guidance on evaluation of extension requests.<sup>24</sup> The IRS may also grant an extension, for reasonable cause, with respect to any payment of part of any installment of tax deferred under IRC § 6166 (including any part of a deficiency prorated to an installment under IRC § 6166).<sup>25</sup> In the case of an extension for payment of installments pursuant to IRC § 6166, if such an extension would result in any payments being made *after* the 10-year limit above, then such extension shall be no later than 12 months after the due date for the last installment under IRC § 6166.<sup>26</sup>
- (b) Extension of Time for Payment of Deficiency. In addition, the IRS, for reasonable cause, may extend the time for the payment of a deficiency of

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<sup>21</sup> IRC § 6161(a)(1).

<sup>22</sup> Estate tax returns must be filed within 9 months after the decedent's date of death. See IRC §6075(a). The estate tax must be paid by the last day fixed for the payment of the estate tax under IRC section 6075 determined without regard to any extension of time for filing the estate tax return. See IRC § 6151(a) and (c).

<sup>23</sup> IRC § 6161(a)(2). The Instructions for Form 4768 provide that the IRS may grant a discretionary extension for the payment of the estate tax or a deficiency for reasonable cause for 1 year at a time up to 10 years in the case of the payment of the estate tax and up to 4 years for the payment of a deficiency.

<sup>24</sup> For example, if a reasonable cause statement submitted by an executor provides details as to why the estate is unable to determine its liability or its liquid assets, then it may be reasonable for the IRS to limit approval of the extension of time to pay estate taxes to 6 months, with the expectation that the estate will have identified its tax liability and liquid asset by the end of that 6-month period. If further extension is needed, the executor may make an additional request using Form 4768. See "IRS Interim Guidance (SBSE-05-1208-062) for Processing Requests for Extension of Time to File, Pay Federal Estate Taxes," (December 4, 2008). Any request for an extension to pay estate taxes due which lacks a "reasonable cause statement" will be allowed 15 calendar days to provide such a statement. *Id.* The IRS employee reviewing the request will make the request for additional information to the executor of the estate. *Id.*

<sup>25</sup> *Id.* See Section III.C. for a discussion of IRC § 6166.

<sup>26</sup> *Id.*

the payment of the estate tax for a reasonable period not to exceed 4 years from the date payment of such deficiency was initially due.<sup>27</sup>

- (c) Extension of Time Prohibited. No extension of time for the payment of estate taxes will be granted “for any deficiency if the deficiency is due to negligence, to intentional disregard of rules and regulations, or to fraud with the intent to evade tax.”<sup>28</sup>
- (d) Application to Generation Skipping Transfer Tax. The IRS determined in Priv. Ltr. Rul. 93-14-050 (July 13, 1993) that IRC § 6161(a)(2) was available to defer payment of generation-skipping transfer taxes.

2. Reasonable Cause. Treasury Regulation § 20.6161-1(a)(1) provides that the district director or the director of a service center may grant an extension for the payment of the estate tax if an examination of all facts and circumstances shows that such application for extension is based on reasonable cause. The regulation goes on to provide examples of reasonable cause:

- (a) An estate includes liquid assets sufficient to pay the estate tax due; however, there is a delay in marshalling the liquid assets as they are located in several jurisdictions and are not immediately subject to the control of the executor.<sup>29</sup>
- (b) A substantial part of an estate includes assets consisting of the rights to receive payments in the future (i.e., annuities, copyright royalties, accounts receivables or contingent fees) and such assets do not provide sufficient present cash to pay the estate tax when due. In addition, the estate cannot borrow against these assets without inflicting a loss upon the estate.<sup>30</sup>
- (c) A substantial asset of an estate cannot be collected without litigation, therefore, the size of the gross estate is unascertainable at the time the estate tax is due.<sup>31</sup>
- (d) After a reasonable effort made by the executor to liquidate assets in the estate into cash, except for an interest in a closely-held business to which IRC § 6166 applies, an estate does not have sufficient assets to pay the entire estate tax due, to provide a reasonable allowance during the remaining administration period for the decedent’s widow and dependent children, and to satisfy claims against the estate that are due and payable

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<sup>27</sup> IRC § 6161(b)(2).

<sup>28</sup> IRC § 6161(b)(3).

<sup>29</sup> Treas. Reg. § 20.6161-1(a)(1), Ex. 1.

<sup>30</sup> Treas. Reg. § 20.6161-1(a)(1), Ex. 2.

<sup>31</sup> Treas. Reg. § 20.6161-1(a)(1), Ex. 3.

without borrowing funds at a higher rate of interest than is generally available.<sup>32</sup>

3. Payment of Interest. If the IRS grants an extension to pay estate taxes pursuant to IRC § 6161, the estate must pay interest on the estate tax owed during the extension period at the underpayment rate established under IRC § 6621.<sup>33</sup> In a Chief Counsel Advice Memorandum,<sup>34</sup> the IRS determined that interest on the estate tax that accrues during the extension period is nondeductible, personal interest under IRC § 163(h)(2). However, the interest paid by the estate during the extension period is deductible on the estate tax return as an administrative expense under IRC § 2053(a)(2) at such time as the interest accrues if the expense is an allowable expense under the laws of the jurisdiction in which the estate is being administered.<sup>35</sup> When the interest accrues and becomes deductible, the estate tax is recomputed and any refund due to the estate will be paid when the entire estate tax liability is paid.<sup>36</sup> Revenue Procedure 81-27, 1981-2 C.B. 548, sets forth the procedure for recomputing the estate tax due as a result of a reduction in the estate tax by reason of the payment of interest on the estate tax due. The IRS ruled in Tech. Adv. Mem. 92-41-002 that the procedure set forth in Rev. Rul. 81-27 is available to recompute the estate tax for interest payments under an IRC § 6161 extension.

4. Period of Limitations. The running of the period of limitations for the collection of estate taxes is suspended during the extension of the period of time granted for the payment of estate taxes under IRC §§ 6161(a)(2) and 6161(b)(2).<sup>37</sup>

5. Security. Pursuant to IRC § 6165, if an extension of time to pay estate taxes is granted, the IRS may require an estate to provide a bond for the amount to which the extension applies. The amount of the bond may not exceed double the amount of tax or deficiency so extended.<sup>38</sup>

6. Application for Extension. An application for an extension of time to pay the estate tax shall be in writing and shall include the following:

- (a) the period of extension requested;
- (b) a declaration that the application is made under the penalties of perjury; and
- (c) a statement of the reasonable cause, if applicable.

The request for an extension to pay the estate should be made on a Form 4768 and filed with the internal revenue office where the estate tax return must be filed on or prior to the due

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<sup>32</sup> Treas. Reg. § 20.6161-1(a)(1), Ex. 4.

<sup>33</sup> Treas. Reg. § 20.6161-1(c)(2); IRC § 6601.

<sup>34</sup> IRS Legal Memorandum 2008-36-027 (May 12, 2008).

<sup>35</sup> *Bahr v. Comm’r*, 68 T.C. 74 (1977); Rev. Rul. 80-250, 1980-2 C.B. 278. See also Rev. Rul. 78-125, 1978-1 C.B. 292, in which the IRS acquiesced to the Bahr decision.

<sup>36</sup> Rev. Rul. 80-250, 1980-2 C.B. 278.

<sup>37</sup> IRC §§ 6161(d)(1) and 6503(d).

<sup>38</sup> See also, Treas. Reg. §20.6165-1(a).

date for the payment of the return.<sup>39</sup> Any additional applications for an extension of time to pay the estate tax must be filed prior the expiration of the prior extension. The regulations provide that the IRS should notify the estate of the grant, denial or conditional grant of an extension within 30 days of its receipt of the application for extension. If the IRS denies the extension, Treas. Reg. § 20.6161-1(b) provides a procedure for the appeal of the IRS's decision.

C. Section 6166. The IRC permits certain estates which consist largely of an interest in a closely held business to elect to take a "loan" from the federal government for the payment of estate taxes. Section 6166 provides a "loan" to an estate by permitting the deferral of the payment of the estate taxes for a period of 5 years and thereafter making payments in equal annual installments over an additional 10 year period.

1. General. Pursuant to IRC § 6166(a) if the value of an interest in a closely-held business included in the gross estate of a U.S. citizen/resident decedent exceeds 35% of the adjusted gross estate,<sup>40</sup> the executor may choose to pay part or all of the estate tax in two or more, but no more than 10, equal payments. The maximum amount that can be paid in such installments will bear the same ratio to the estate tax imposed (reduced by credits against such tax) as the closely-held business amount<sup>41</sup> bears to the amount of the adjusted gross estate. The first payment shall be paid on or before the date not more than 5 years after the date fixed for payment of the estate tax. Succeeding payments shall be made no more than 1 year after each prior payment.

2. Interest in Closely Held Business. A decedent owned an interest in closely held business, if, immediately prior to the decedent's death, the decedent had (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 in such partnership is included in determining the gross estate of the decedent, or such partnership had 45 or fewer partners; or (C) stock in a corporation carrying on a trade or business if 20% or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or such corporation had 45 or fewer shareholders.<sup>42</sup>

(a) Trade or Business. The closely held business in which an estate has an interest must be a "trade or business".<sup>43</sup> The IRS pointed out in Priv. Ltr. Rul. 98-32-009, that IRC § 6166 was enacted to permit the deferral of the payment of the federal estate tax where, if such tax had to be paid at one time, it would be necessary to sell assets used in a going business and, thereby, disrupt or destroy the business enterprise. IRC § 6166 was not intended to protect continued management of income producing properties

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<sup>39</sup> Treas. Reg. §20.6161-1(b).

<sup>40</sup> The term "adjusted gross estate" means the value of the gross estate reduced by the sum of amounts allowable as a deduction under IRC §§ 2053 or 2054, which sum shall be determined on the basis of the facts and circumstances in existence on the date for filing the estate tax return (including extension, or if earlier, the date the return is filed). IRC § 6166(b)(6).

<sup>41</sup> The term "closely held business amount" means the value of the interest in a closely held business which qualifies under IRC § 6166(a)(1). IRC § 6166(b)(5).

<sup>42</sup> IRC § 6166(b)(1).

<sup>43</sup> *Id.*

or to permit deferral of tax merely because the payment of tax might require the sale of income-producing assets, except where they formed a part of an active enterprise producing business income rather than income solely from the ownership of property.<sup>44</sup> Congress intended that IRC § 6166 to apply only with respect to a business such as a manufacturing, mercantile, or service enterprise, as distinguished from management of investment assets.<sup>45</sup>

- (b) Passive Assets. The closely held business amount shall not include the value of that portion of such interest which is attributable to passive assets held by the business.<sup>46</sup> Generally, the term “passive asset” means any asset other than an asset used in carrying on a trade or business.<sup>47</sup> Accordingly, only those assets used in carrying on the trade or business are considered. For example, the portion of a business bank account that can be shown to represent nonbusiness funds will constitute part of the closely held business amount.<sup>48</sup> A passive asset also includes any stock in another corporation unless the stock is treated as held by the decedent by reason of a holding company election under IRC § 6166(b)(8) and qualifies under IRC § 6166(a)(1) as exceeding the 35% of the decedent’s adjusted gross estate.<sup>49</sup>
- (c) Farms. For purposes of the 35% requirement, an interest in a closely held farming business includes an interest in residential buildings and related improvements on the farm occupied on a regular basis by the owner or lessee of the farm or by employees for purposes of operating or maintaining the farm.<sup>50</sup>
- (d) Attribution Rules. In determining whether a decedent held a sufficient interest in a closely held business to take advantage of IRC § 6166 the following attribution rules apply:
  - (1) Stock or a partnership interest which is community property of a husband and wife (or income from such), or is held by a husband and wife as joint tenants, tenants by the entirety, or tenants in common, shall be treated as owned by one shareholder or one

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<sup>44</sup> Priv. Ltr. Rul. 98-32-009.

<sup>45</sup> *Id.* A number of revenue rulings as well as private letter rulings and technical advice memorandum that provide guidance on what entities qualify as closely held businesses under IRC § 6166.

<sup>46</sup> IRC § 6166(b)(9)(A).

<sup>47</sup> IRC § 6166(b)(9)(B)(i).

<sup>48</sup> Treas. Reg. § 20.6166A-2(c)(2).

<sup>49</sup> IRC § 6166(b)(9)(B)(ii). However, if (I) a corporation owns 20% or more in value of the voting stock of another corporation, or such other corporation has 45 or fewer shareholders, and (II) 80% or more of the value of the assets of each such corporation is attributable to assets used in carrying on a trade or business, then such corporations shall be treated as one corporation for purposes of determining whether stock should be treated as a passive asset. For purposes of applying subclause (II) to the corporation holding the stock of the other corporation, such stock shall not be taken into account.

<sup>50</sup> IRC § 6166(b)(3).

partner.<sup>51</sup> The application of this rule can reduce the number of shareholders or partners to make it easier to achieve the 45 or fewer partners or shareholders requirements of IRC §§ 6166(b)(1)(B)(ii) and 6166(b)(1)(C)(ii);

- (2) Property owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.<sup>52</sup> For purposes of the preceding sentence, a person shall be treated as a beneficiary of any trust only if such person has a present interest in the trust; and
- (3) All stock and all partnership interests held by the decedent or by any member of his family, within the meaning of IRC § 267(c)(4),<sup>53</sup> shall be treated as owned by the decedent.<sup>54</sup>

- (e) Additional Special Rules. In addition to the above rules with respect to closely held business interest, additional special rules apply to partnership interests<sup>55</sup> and stock which is not readily tradeable, stock in holding companies<sup>56</sup> and stock in qualifying lending and finance businesses.<sup>57</sup>
- (f) Real Estate as a Closely Held Business. Revenue Ruling 2006-34, 2006-1 C.B. 1171, examines the circumstances in which ownership of real estate will fall under the definition of “interest in a closely held business” under IRC § 6166. According to IRC § 6166(b)(9)(A), for the purposes of determining the value of an interest in a closely held business under IRC § 6166, such value may not include “passive assets” held by the business, where a passive asset is any asset not used in carrying on a trade or business. The IRS concluded in Rev. Rul. 2006-34 that IRC § 6166 applies only to active trades or businesses of the decedent, partnership, LLC or corporation, and not to “the mere management of investment assets.” Among other things, the IRS will look to the following factors in determining whether the ownership of real estate constitutes an active trade or business (for the purposes of IRC § 6166) or the management of investment assets: (1) the amount of time the decedent, or agents or

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<sup>51</sup> IRC § 6166(b)(2)(B).

<sup>52</sup> IRC § 6166(b)(2)(C).

<sup>53</sup> IRC § 267(c)(4) provides that the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

<sup>54</sup> IRC § 6166(b)(2)(D).

<sup>55</sup> IRC § 6166(b)(7) (provides for a special election that allows deferral on less favorable terms for certain estates that own capital interest in a partnership and any non-readily-tradable stock, which does not otherwise qualify under IRC § 6166(a)(1)).

<sup>56</sup> IRC § 6166(b)(8) (provides for a special election that allows deferral on less favorable terms for certain estates that own stock in a holding company).

<sup>57</sup> IRC § 6166(b)(10) (provides for a special election that allows deferral on less favorable terms for certain estates that own stock in a qualifying lending or finance business).

employees of the decedent, partnership, LLC or corporation, devoted to the business; (2) whether and office was maintained for related business activities and whether such office kept regular business hours; (3) the extent to which the decedent, or agents or employees of the decedent, partnership, LLC or corporation, were actively involved in finding tenants and negotiating leases; (4) the extent to which the decedent, or agents or employees of the decedent, partnership, LLC or corporation, provided services at the property (e.g., landscaping, snow removal, etc.) beyond merely the furnishing of the premises to a lessee; (5) the extent to which the decedent, or agents or employees of the decedent, partnership, LLC or corporation, made, arranged for, or supervised repairs to the premises (including repairs performed by independent contractors); and (6) the extent to which the decedent, or agents or employees of the decedent, partnership, LLC or corporation, handled tenant repair requests. While none of the above factors are on their own dispositive of an interest in a closely held business for IRC § 6166 purposes, to the extent the decedent's use of independent contractors or a property management company reduces the decedent's (or agents or employees of the decedent, partnership, LLC or corporation) involvement to the level of merely holding the property for investment, the IRS will not allow the interest to qualify under IRC § 6166. Additionally, Revenue Ruling 2006-34 provides a number of explanatory examples of IRS determinations regarding inclusion of business interests under IRC § 6166.

3. Special rule for interest in two or more closely held businesses. Interest in two or more closely held businesses, 20% or more of the total value of each of which is included in determining the value of the decedent's gross estate, shall be treated as an interest in a single closely held business. For purposes of said 20% requirement, an interest in a closely held business which 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 shall be treated as having been included in determining the value of the decedent's gross estate.

4. Election. An election to extend payment of the estate tax under IRC § 6166 shall be made not later than the time the estate tax return is required to be filed, including extensions of time granted for filing.<sup>58</sup> If the election under IRC § 6166 is made at the time the estate tax return is filed, then the election shall apply to both the tax due and to certain deficiencies.<sup>59</sup> If the election is made after the estate tax return is filed, then up to the full amount of certain later deficiencies may be paid in installments, but no amount of the tax determined to be due in the return may be paid in such installments.<sup>60</sup>

(a) Notice of Election. Treasury Regulation § 20.6166-1(b) states that an election under IRC § 6166(a) shall be made by attaching a notice of

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<sup>58</sup> IRC § 6166(d).

<sup>59</sup> Treas. Reg. §20.6166-1(a)

<sup>60</sup> *Id.*

election to the timely filed estate tax return. This notice must include the following information:

- (1) Name and taxpayer identification number of the decedent;
- (2) Amount of tax to be paid in installments;<sup>61</sup>
- (3) Date of the first installment;<sup>62</sup>
- (4) Number of annual installments in which the tax is to be paid;
- (5) List of properties shown on the estate tax return that constitute the closely held business interests; and
- (6) The facts which contributed to the determination that the estate is eligible for payment of estate taxes in installments.

- (b) Acceptance or Rejection of Election. Revenue Procedure 79-55, 1979-2 C.B. 539, sets forth the procedure for processing elections made under IRC § 6166, which provides that the IRS<sup>63</sup> is responsible for determining whether an IRC § 6166 election meets the applicable requirements. If the election meets the requirements, no notice that the requirements have been met will be sent to the estate. If the election is rejected, the estate will be notified and the executor may request consideration by the Appeals Office. The appellate determination will be regarded as the IRS's final decision. While the election is under consideration in examination or Appeals, an executor may request that the issue be referred to the National Office for technical advice on the grounds that a lack of uniformity exists as to the disposition of the issue or the issue is so unusual or complex as to warrant review by the National Office.

Prior to 1997, the Tax Court did not have jurisdiction over the denial of an IRC § 6166 election.<sup>64</sup> The Taxpayer Relief Act of 1997 added IRC § 7479, which allow estates to seek a declaratory judgment from the Tax Court with respect to whether an IRC § 6166 election has been made, or whether the extension of time for payment has ceased to apply. However,

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<sup>61</sup> Absent this information, there is a presumption that the election shall be for the maximum amount payable, to be paid in 10 equal installments beginning on the date which is 5 years after the date prescribed for payment of the estate tax on the estate tax return.

<sup>62</sup> An executor may defer the initial payment of tax, but not interest, for up to 5 years from the date prescribed for payment of the estate tax on the estate tax return. The first installment of tax need not be on the annual anniversary of the original due date for payment; however, it must fall on the date in any month which corresponds to the day of the month determined on the estate tax return.

<sup>63</sup> Rev. Proc. 72-55 refers to the "district director", however this position was eliminated from the IRS in its restructuring pursuant to the 1998 IRS Restructuring and Reform Act.

<sup>64</sup> See *Estate of Meyer v. Commissioner*, 84 T.C. 560 (1985).

the Tax Court shall not issue a declaratory judgment unless the estate has exhausted all administrative remedies.<sup>65</sup>

- (c) Surety Bond or Lien. The IRS can require the estate to furnish a bond, which bond will not exceed twice the amount for which the extension was granted, pursuant to IRC § 6165<sup>66</sup> or a special lien on § 6166 lien property in favor of the United States pursuant to IRC § 6324A.<sup>67</sup> In 2002 the IRS implemented a policy requiring a surety bond or a special lien under IRC § 6234A as a prerequisite to making an election under IRC § 6166.<sup>68</sup> In *Estate of Roski v. Commissioner*, 128 T.C. 113 (2007), the Tax Court held that the IRS could not universally require estates electing to defer tax payments under IRC § 6166 and that such a requirement must be determined on a case-by-case basis depending on whether the estate is likely to fail to make payments after the expiration of the automatic federal estate tax lien under IRC § 6324(a). Internal Revenue Service Notice 2007-90, 2007-46 I.R.B. 1003, addresses the interim IRS procedures for determining on a case-by-case basis whether a surety bond or special lien is required for estates that have made an election to defer payment of estate taxes under IRC § 6166. During the period in which the IRS is devising a permanent system for making these determinations, the IRS will look to the following three factors to make the determination, based on information contained in the estate tax return, attachments to the return, information obtained during an audit and other available information as further enumerated in the Notice. First, the IRS will consider the nature of the closely held business pursuant to which the election was made, as well as the nature of the business's assets, relevant market factors that may impact the business, financial history and managerial experience of the business. Second, the IRS will consider the expected manner and ability of making annual tax and interest payments and the likelihood of making such payments. Third, the IRS will consider the business's history of compliance with federal tax requirements. The IRS has requested comments on the pending procedures for determining the need for a surety bond or a tax lien pursuant to IRC § 6166 elections.
- (d) "2 Percent Portion". If an election is made under IRC § 6166, then a special interest rate of 2% per year is imposed on the "2 percent portion" of the extended tax payments.<sup>69</sup> The "2 percent portion" is the lesser of (i) the amount of the tentative tax which would be determined under the rate schedule set forth in IRC § 2001(c) if the amount with respect to which such tentative tax is to be computed were the sum of \$1,000,000, adjusted

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<sup>65</sup> IRC § 7479(b)(2). See Rev. Proc. 2005-33, 2005-1 C.B. 1231 for IRS guidance on exhausting remedies prior to seeking a declaratory judgment pursuant to IRC § 7479.

<sup>66</sup> See IRC § 6166(k)(1).

<sup>67</sup> See IRC § 6166(k)(2).

<sup>68</sup> Internal Revenue Service Notice 2007-90, 2007-46 I.R.B. 1003.

<sup>69</sup> See IRC § 6601(j).

for inflation (i.e., for 2009, \$1,330,000), and the applicable exclusion amount in effect under IRC § 2010(c) (which, for 2009, is \$3,500,000), reduced by the applicable credit amount in effect under IRC § 2010(c), or (ii) the amount of the tax extended under IRC § 6166.<sup>70</sup> Any tax not subject to the special 2% rate is subject to a rate equal to 45% of the annual interest rate established under IRC § 6621.<sup>71</sup> In light of this special 2% rate, however, the estate may not take a deduction on interest paid under IRC § 6166 for estate or income tax purposes.<sup>72</sup> With each installment payment of tax under IRC § 6166, a proportionate amount of both the “2 percent portion” and the tax subject to the 45% tax rate is reduced.<sup>73</sup>

- (e) Deficiencies. Under IRC § 6166(a) and Treas. Reg. § 20.6166(c)(1), if a deficiency is assessed and no election was made at the time the estate tax return was filed, an executor may elect to pay that amount of the deficiency attributable to the closely held business interest in installments,<sup>74</sup> provided that the estate qualifies for the IRC § 6166 election pursuant to the final determination of estate taxes (or agreed to after an examination of the return). In such case, only that portion of the deficiency attributable to the closely held business interest may be paid in installments under IRC § 6166.<sup>75</sup> The notice of such an election must be submitted to the IRS office where the estate tax return was filed no more than 60 days after the issuance of notice and demand for payment of the deficiency, and it must contain the same information as in subsection (a), above.<sup>76</sup> Additionally, the notice must be accompanied by payment in the amount of tax and accrued interest<sup>77</sup> the date for payment of which has already arrived, plus any amount of unpaid tax and interest not attributable to the closely held business interest and neither eligible for extension nor previously extended under any other section of the IRC.<sup>78</sup>

Under Treas. Reg. § 20.6166(c)(2), if the executor makes an IRC § 6166(a) election (excluding a protective election) simultaneously with the filing of the estate tax return and a deficiency is later assessed, then the amount of deficiency allocable to the closely held business interest (but not accrued interest thereon) will be divided equally among the installments under the IRC § 6166(a) election, and to the extent the date for payment of any such installment has already passed, such allocable portion of deficiency shall be due and payable upon notice and demand.

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<sup>70</sup> See IRC § 6601(j)(2) and (3).

<sup>71</sup> See IRC § 6601(j)(1).

<sup>72</sup> See IRC § 2053(c)(1)(D).

<sup>73</sup> See IRC § 6601(j)(4).

<sup>74</sup> IRC § 6166(h).

<sup>75</sup> IRC § 6166(a) and Treas. Reg. § 20.6166-1(c)(3).

<sup>76</sup> IRC § 6166(a)(2) and Treas. Reg. § 20.6166(c)(1).

<sup>77</sup> Computation of interest payable in installments under IRC § 6166 is governed by the terms of IRC §§ 6601(j) and 6621. See Treas. Reg. 20.6166-1(f).

<sup>78</sup> *Id.* Treas. Reg. § 20.6166(c)(1).

- (f) Protective Election. An executor may make a “protective election” to defer that portion of estate tax attributable to the closely held business interest remaining unpaid at the time the final amount of tax is determined and/or any deficiency attributable to the closely held business interest by filing a preliminary notice of election with the estate tax return.<sup>79</sup> No more than 60 days after the final determination of estate taxes (or agreed to after an examination of the return), a final notice shall be filed including the information described above for an ordinary IRC § 6166(a) election.<sup>80</sup> Such final notice shall be submitted at the IRS office where the estate tax return was filed and accompanied by payment in the amount of tax and accrued interest the date for payment of which has already arrived, plus any amount of unpaid tax and interest not attributable to the closely held business interest and neither eligible for extension nor previously extended under any other section of the IRC.<sup>81</sup> Such a deferral is contingent on the final amounts meeting the requirements of IRC § 6166.<sup>82</sup>

5. Proration of deficiency to installments. If an election is made under IRC § 6166(a), to pay any part of the estate tax in installments and a deficiency has been assessed, the deficiency shall (subject to the limitation provided by 6166(a)(2)) be prorated to the installments payable under IRC §6166(a).<sup>83</sup> The part of the deficiency prorated to any installment not yet due and payable shall be collected at the same time as, and as a part of, such installment.<sup>84</sup> The part of the deficiency so prorated to any installment already due and payable shall be paid upon notice and demand from the Secretary.<sup>85</sup>

6. Time for payment of interest. If the time for payment of any amount of tax has been extended under IRC § 6166, then interest is payable pursuant to IRC § 6601 on any unpaid portion of such amount:

- (a) Interest for first 5 years. During the first 5 years after the date fixed for payment of the estate tax in accordance with IRC § 6151 (a) interest shall be paid annually.<sup>86</sup>
- (b) Interest for periods after first 5 years. After the first 5 years, or such shorter period selected by the executor pursuant to IRC § 6166(a)(3), interest payable on any unpaid portion of such amount shall be paid annually at the same time as, and as a part of, each installment payment of the tax.<sup>87</sup>

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<sup>79</sup> Treas. Reg. §61661-1(d).

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> Rules governing extensions pursuant to a protective election are found in IRC §§ 6161 and 6163.

<sup>83</sup> IRC §6166(e).

<sup>84</sup> *Id.*

<sup>85</sup> *Id.* This subsection, however, shall not apply if the deficiency is due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax.

<sup>86</sup> IRC §§ 6166(f)(1) and 6166(f)(4).

<sup>87</sup> IRC § 6166(f)(2) and 6166(f)(4).

- (c) Interest in the case of certain deficiencies. In the case of a deficiency which has been assessed after the close of the first 5-year period, or such shorter period selected by the executor pursuant to IRC § 6166(a)(3), interest attributable to such 5-year period, or such shorter period, as the case may be, and interest assigned after the first 5 years, or such shorter period, as the case may be, to any installment the date for payment of which has arrived on or before the date of the assessment of the deficiency, shall be paid upon notice and demand from the Secretary.<sup>88</sup>

7. Acceleration of payment. The extension of time for payment of estate taxes under IRC § 6166 terminates and the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary if there is (i) a disposition of the decedent's closely held business interest or a withdrawal of funds from the business, (ii) undistributed net income in the estate, or (iii) a failure to make payment of principal or interest on any installment.<sup>89</sup>

- (a) Disposition of interest; withdrawal of funds from business.

- (1) If fifty percent or more of any portion of an interest in a closely held business is distributed, sold, exchanged, or otherwise disposed of, or fifty percent or more of the value of the closely held business interest is withdrawn from the trade or business in money and other property attributable to such an interest, the deferral is terminated and the payment of tax is accelerated.<sup>90</sup>
- (2) For purposes of determining the fifty percent withdrawal amount, a redemption that qualifies under IRC § 303 is not treated as a distribution or withdrawal if an amount equal to the § 303 redemption distribution is paid on the remaining balance of the federal estate tax on or before the date fixed for the first installment of the deferred estate tax due after the § 303 redemption distribution, or if earlier, on the date that is one year from the date of the § 303 redemption distribution.<sup>91</sup> For purposes of any subsequent determination of a fifty percent withdrawal amount, the value of the closely held business interest is reduced by the value of the stock redeemed in the § 303 redemption.<sup>92</sup>
- (3) Corporate reorganizations and tax-free exchanges under IRC §§ 368(a)(1)(D), 368(a)(1)(E), and 368(a)(1)(F) do not accelerate the payment of the deferred estate tax.<sup>93</sup> Any stock received in such

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<sup>88</sup> IRC § 6166(f)(3) and 6166(f)(4).

<sup>89</sup> IRC § 6166(g).

<sup>90</sup> IRC § 6166(g)(1)(A).

<sup>91</sup> IRC § 6166(g)(1)(B).

<sup>92</sup> *Id.*

<sup>93</sup> IRC § 6166(g)(1)(C).

an exchange shall be treated as an interest qualifying under IRC § 6166(a)(1).<sup>94</sup>

(4) The transfer of property of the decedent to a person entitled by reason of the decedent's death to receive such property under the decedent's will, intestate succession, or a trust created by the decedent does not accelerate the payment of the deferred estate tax.<sup>95</sup> In addition, subsequent transfers of the property by reason of death of the person who received the property from the decedent does not trigger acceleration so long as each transfer is to a member of the family (within the meaning of IRC § 267(c)(4)) of the transferor in such transfer.<sup>96</sup>

(b) Undistributed income of estate. If an election is made under this section and the estate has undistributed net income for any taxable year ending on or after the due date for the first installment, the executor shall, on or before the date prescribed by law for filing the income tax return for such taxable year (including extensions thereof), pay an amount equal to such undistributed net income in liquidation of the unpaid portion of the tax payable in installments.<sup>97</sup>

(c) Failure to make payment of principal or interest. If any payment of principal or interest is not paid on or before the date fixed for its payment by this section (including any extension of time), the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary.<sup>98</sup> However, no acceleration occurs if the estate pays the delinquent amount (calculated without the benefit of the favorable 2% interest rate under IRC § 6601(j)) within 6 months of the date of notice and demand from the Secretary.<sup>99</sup> In addition, to avoid acceleration the estate must pay a penalty equal to 5% of the amount due for each month, or partial month, after notice and demand and before payment of the delinquent amount.<sup>100</sup>

8. Special rule for certain direct skips. To the extent that an interest in a closely held business is the subject of a direct skip (within the meaning of IRC §2612(c)) occurring at the same time as and as a result of the decedent's death, then for purposes of IRC § 6166(a)(1) any

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<sup>94</sup> *Id.*

<sup>95</sup> IRC § 6166(g)(1)(D).

<sup>96</sup> *Id.*

<sup>97</sup> IRC § 6166(g)(2).

<sup>98</sup> IRC § 6166(g)(3).

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

generation-skipping transfer tax imposed by IRC § 2601 on the transfer of such interest shall be treated as if it were additional estate tax imposed by IRC §2001.<sup>101</sup>

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<sup>101</sup> IRC § 6166(i).