Section 6166: Preserving the Family Business or Family Farm Through Estate Tax Deferral

by

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SECTION 6166: PRESERVING THE FAMILY BUSINESS OR FAMILY FARM THROUGH ESTATE TAX DEFERRAL

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I. INTRODUCTION

In estates substantially comprised of a closely held business, the executor is faced with the difficult problem of raising sufficient cash to pay the various costs and taxes, especially when it will be in the best interests of the estate and the heirs to preserve the business. Typically, the largest expense is the federal estate tax which is due within nine months of the date of death. Faced with the dilemma of immediate payment, the estate is generally forced to sell the business or to sell many of the assets resulting in either the termination or a substantial contraction of the business. If the estate or the heirs borrow using the business or assets as security, high interest rates and substantial restrictions may be expected from private lenders. Recognizing this problem, Congress, with the announced purpose of preserving closely held businesses and maintaining the free enterprise system, included in the Small Business Tax Revision Act of 1958[1] a provision for estate tax deferral designed to permit an estate to pay out of earnings over several years at a modest interest rate the estate tax attributable to the closely held business.[2] This provision is now section 6166 of the *Internal Revenue Code.*

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1. Act of Sept. 2, 1958, Pub. L. No. 85-866, §§ 201-06, 72 Stat. 1676-85.
2. *Id.* § 206, 72 Stat. 1681.

For many years section 6166 appears to have been largely ignored. But now that closely held business interests, especially farm enterprises with rapidly appreciating real estate, have become increasingly more valuable in absolute dollar amounts and with the federal estate tax rates, exemptions, and deductions having remained static, the advantages and necessities presented by extending the time for payment of federal estate taxes deserve careful study and consideration by both the estate planner and the probate attorney. As would be expected, there has been an increased awareness and use of the deferral election.[3] This article will discuss generally the advantages and disadvantages of deferral followed by a more precise study of the types of business interests which qualify, the procedure for making the election, the situations that lead to partial or total acceleration of the deferred tax, and the interrelationship of the deferral election with probate practice and procedure. Opportunities will be noted where pre-mortem planning may be used to assure qualification for the deferral, to increase the amount which may be deferred, and to prepare for the more orderly use of the election after death. The steps which might be taken to mitigate those situations where use of the election may be inadvisable or unfeasible will also be examined.

A. *Relative Merits of Deferral*

The typical advantages and disadvantages of estate tax deferral are obvious and fairly easy to summarize. Deferral during inflation means the tax will be subsequently paid with "cheaper" dollars. The tax deferred will itself be available to earn income during the period of deferral and any appreciation in value of the assets which otherwise would have been sold will benefit the estate or heirs. The deferral period can be used to expand the time during which to seek purchasers for the business interest or to liquidate and market the assets in an orderly manner. Additionally, section 6166 presents a financing opportunity; that is, section 6166 represents a "loan" for up to approximately ten years at a relatively low interest rate and eligibility for this "loan" in no way depends on the financial condition of the business. There is also the opportunity to preserve the estate as an additional taxpayer with resulting income tax savings during the deferral period.

On the other hand, the use of section 6166 requires additional time and effort by the executor and his attorney, prolongs administration of the estate, and may subject the executor to risks of personal liability should the business fail during the deferral period. Deferral may also result in depriving certain heirs of the immediate use of and income from the property by delaying distribution during the deferral period. These concepts, and other more subtle

3. This increased awareness and use of section 6166 can be seen in the recent flurry of revenue rulings. Within the last year there have been approximately as many rulings directly concerning this provision as there were from the effective date of section 6166 on September 2, 1958, until mid-1975.

considerations, can be more fully appreciated after an in-depth examination of section 6166.

B. *Hypothetical Family Farm Estate*

Section 6166 is fairly simple and straightforward in its approach and concept, but its application can become fairly complex under some circumstances. To illustrate and explain many of the formulas and calculations required in determining qualification for, and preservation of, the election and the amounts of the installment payments, the authors believe it would be helpful to hypothesize a fairly typical estate which includes a closely held farm business which was being operated as a sole proprietorship. The following is an outline of this hypothetical estate broken down into "business" and "nonbusiness" categories and a computation of the expected federal estate taxes. It is assumed that the assets are all unencumbered and that the bulk of the debts and loans is represented by an unsecured loan which was used for nonfarm purposes.[4]

Business Assets	
320 acres (F.M.V. $1,000 an acre)	$ 320,000
Machinery	50,000
Livestock	50,000
Grain, Feed	40,000
Growing Crops	25,000
Miscellaneous	15,000
	$ 500,000
Nonbusiness Assets	
Nonfarm Real Estate	30,000
Stocks, Bonds	30,000
Insurance	40,000
Miscellaneous Personalty	20,000
	$ 120,000
Debts and Loans	$ 130,000
Gross Estate	$ 620,000
Less Debts and Loans	130,000
Less Administration Costs	30,000
Adjusted Gross Estate	$ 460,000
Less $60,000 Personal Exemption	60,000
Taxable Estate	$ 400,000
Gross Federal Estate Tax	113,700
Less State Death Tax Credit	8,700
Net Federal Estate Tax	$ 105,000

The cash required to "close" this estate is estimated as follows:

4. For a discussion of the significance of the various types of debts in computing the value of the closely held business, see text accompanying notes 29 and 30 *infra*.

Debts and Loans	$ 130,000
Federal Estate Tax	105,000
State Inheritance Tax	11,000
Administration Expenses	30,000
Total Cash Required	$ 276,000

The sale of all the nonfarm assets and application of the sale proceeds and the insurance proceeds would still leave a "deficit" of $156,000. It is thus quite obvious that the taxes, costs and debts could only be paid by selling substantially all the operating assets or possibly by additional borrowing using the real estate as security. Following the discussion of qualification and the procedure involved with making the election, the section of this article concerning the computation of the amount eligible to be deferred will show how section 6166 can defer a portion of the federal estate tax sufficiently to avoid the need for an immediate sale or substantial loan.

II. Qualification for Section 6166

The requirements for qualification to pay the federal estate tax in installments are set forth in the following excerpt from section 6166(a):

> If the value of an interest in a closely held business which is included in determining the gross estate of a decedent who was (at the date of his death) a citizen or resident of the United States exceeds either—
>
> (1) 35 percent of the value of the gross estate of such decedent, or
>
> (2) 50 percent of the taxable estate of such decedent,
>
> the executor may elect to pay part or all of the tax imposed by section 2001 in two or more (but not exceeding 10) equal installments.[5]

The requirements included in the above-quoted statute will be examined in the following paragraphs.

A. *Citizenship and Residency Requirement*

The first requirement of section 6166(a) is that the decedent must be a citizen or resident of the United States at the time of his death. This requirement, while involving the legal intricacies of determining "citizenship" and "residence," generally presents few problems from a practical standpoint.

B. *Interest in a Closely Held Business*

A further requirement of section 6166(a) is that the decedent must have an "interest in a closely held business," the value of which is included in his

5. Int. Rev. Code of 1954, § 6166(a). Several terms are used generically throughout this article and should be read as including other and narrower descriptions. For example, the term executor would also include an administrator, and the term distributee would include devisee, legatee and other beneficiaries.

gross estate. Section 6166(a) does not require that the decedent own or possess an interest in a closely held business but it does require that the interest be "included in determining the gross estate of the decedent." Thus, an interest in a closely held business which is included in the decedent's gross estate as a gift in contemplation of death, a retained life estate, or a revocable trust, is included in determining the decedent's "ownership" of a closely held business.[6]

The term "interest in a closely held business" is specifically defined in section 6166(c) to include all forms of business operations; that is, proprietorships, partnerships, and corporations that are carrying on a trade or business at the time immediately before the decedent's death. A proprietorship, by its very nature, is a closely held business, and thus will qualify under section 6166(c) as an interest in a closely held business.[7]

An interest in a partnership[8] will qualify as an interest in a closely held business provided that (1) 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, *or*, (2) the partnership had ten or less partners.[9] While the above requirements seem rather straightforward, additional comments are warranted. The 20 percent or more capital interest which must be included in determining the gross estate is based upon the decedent's "capital interest" in the partnership and not upon his profit interest. In determining the number of partners in the partnership, it appears that all types of partners will be included. The term "partner," while not defined in section 6166, is defined elsewhere in the *Code* as being any member of a syndicate, group, pool, joint venture or organization.[10] This definition would apparently include both general and limited partners.

A stock interest in a corporation[11] will qualify as an interest in a closely held business provided that (1) 20 percent or more in value of the voting stock of the corporation is included in determining the gross estate of the decedent, or (2) the corporation had ten or less shareholders.[12] The 20 percent test requires 20 percent in value (not voting power) of the voting stock interest in the corporation which may include both the value of the common stock and preferred stock depending on the voting rights of the particular class of stock.[13]

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6. *See* INT. REV. CODE OF 1954, §§ 2035, 2038, 2041. *Cf.* Treas. Reg. § 20.6166-3(e)(4) (1960).

7. INT. REV. CODE OF 1954, § 6166(c)(1).

8. The term partnership as used in section 6166 apparently means a partnership as defined in section 7701(a)(2) which would include a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation or venture is carried on and which is not, within the meaning of this title, a trust or estate or a corporation.

9. INT. REV. CODE OF 1954, § 6166(c)(2).

10. *Id.* § 7701(a)(2).

11. The term corporation as used in section 6166 apparently means a corporation defined in section 7701(a)(3) which provides that a corporation includes associations, joint stock companies and insurance companies. See Treasury Regulation section 301.7701-2 regarding the definition of "association."

12. INT. REV. CODE OF 1954, § 6166(c)(3).

13. *Id.* § 6166(a); Treas. Reg. § 20.6166-2(a)(3) (1960).

The term "shareholder" encompassed in the alternative test apparently includes all holders of stock, both voting and nonvoting, and may include holders of debt instruments in a thinly capitalized corporation.

The number of partners of a partnership or shareholders of a corporation for purposes of the above tests is determined as of the time immediately before the decedent's death and the decedent must be counted as a partner or a shareholder.[14] Where an interest as a partner in a partnership or stock interest in a corporation is the community property of a husband and wife, both the husband and the wife are counted as partners or shareholders.[15] Likewise, if stock in a corporation is held in co-ownership either as co-owners, tenants in common, tenants by entirety or joint tenants, each co-owner, tenant in common, tenant by the entirety or joint tenant is counted as an individual shareholder.[16]

In addition to the above requirements, every proprietorship, partnership or corporation must also be "carried on as a trade or business" immediately before the decedent's death. Neither section 6166 nor the *Internal Revenue Code* defines the term "trade or business" in this context, causing uncertainty as to the availability of the election to defer for some business interests. It would appear from a strict reading of the *Code* that the term "trade or business" for purposes of section 6166 would logically encompass the same or similar activities that have been judicially determined to encompass a "trade or business" under section 162. However, the Internal Revenue Service in *Revenue Ruling* 61-55[17] (the first published revenue ruling regarding the "trade or business" requirement of section 6166) attempted to restrict the definition of trade or business. In that ruling the Service was requested to rule on whether certain working interests in oil and gas properties and certain royalty interests in oil and gas properties qualified as a "trade or business" for purposes of section 6166. The Service arbitrarily concluded that the "ownership, exploration, development and operation of oil and gas properties" constituted a trade or business within the meaning of section 6166. The Service further ruled that "the mere ownership of royalty interests" did not constitute a section 6166 "trade or business."

The above ruling, however, failed to adequately clarify the meaning of "trade or business" for purposes of section 6166, since the ruling merely established the proposition that mere ownership of royalty interests did not constitute trade or business. Such a ruling was arguably consistent with the definition of "trade or business" under section 162.[18] However, the more widely accepted interpretation of *Revenue Ruling* 61-55 was that it effectively

14. INT. REV. CODE OF 1954, § 6166(c).
15. Treas. Reg. § 20.6166-2(b) (1960).
16. *Id.*
17. Rev. Rul. 61-55, 1961-1 CUM. BULL. 713.
18. *See* Higgins v. Commissioner, 312 U.S. 212 (1941). In *Higgins*, ownership or management of securities in a corporation did not constitute a trade or business under section 162. Ownership of royalty interests in oil or gas properties appears similar to the ownership and management of securities in a corporation.

imposed an active/passive test to the trade or business requirement of section 6166.[19] While this active/passive interpretation of the "trade or business" requirement is arguably supported by the legislative history of section 6166,[20] it is also apparent that when Congress has intended to impose an active/passive test, it has used explicit language to effectuate its purposes.[21]

In an attempt to clarify and solidify its position, the Service has issued a series of three recent revenue rulings which firmly evidence its intent to impose an active/passive trade or business requirement for section 6166. In *Revenue Ruling* 75-365,[22] a decedent had conducted a business consisting of rental commercial property, rental farm property and notes receivable. The decedent maintained a fully equipped business office to collect rental payments on the commercial and farm properties, receive payments on notes receivable, negotiate leases, make occasional loans and by contract directed the maintenance of his properties. He additionally maintained records and regular office hours.

All the other requirements necessary to qualify for section 6166 were met. The Service ruled, however, that the management of these properties did *not* constitute a closely held business because the decedent was not carrying on a trade or business within the intent of section 6166. The essence of the Service's position is contained in the following excerpt:

> Section 6166 of the Code in certain cases permits the deferral of the payment of the Federal estate tax where, in order to pay the tax, it would be necessary to sell assets used in a going business and thus disrupt or destroy the business enterprise. This section was not intended to protect continued management of income producing properties or to permit deferral of the tax merely because the payment of the tax might make necessary 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. The disposition of one or more of the income producing properties would involve no hardship since it would not affect the management of, or threaten the income from, the properties remaining.
>
> What amounts to a "trade or business carried on" within the meaning of the statutory language of section 6166(c)(1) of the Code ("an interest as a proprietor in a trade or business carried on as a proprietorship"), should not be determined merely by reference to a broad definition of what "business" is or to a case-law definition of the term for purposes of some other section of the Code such as section 162, but should be found in keeping with the intent of the legislature in enacting section 6166. Although the management of rental

19. Rosenberg, *Paying the Estate Tax in Installments: Planning to Use and Working with Section 6166*, 39 J. TAX. 302 (1973); Levine, *Installment Payment of Estate Tax*, 1965 PRENTICE-HALL TAX IDEAS ¶ 26,006.

20. The House Ways and Means Committee Report, in discussing the purpose of section 6166, makes reference to the term "business enterprise" which arguably applies only to a "going concern" active business. H.R. No. 2198, 85th Cong., 2d Sess. (1958).

21. *Cf.* INT. REV. CODE OF 1954, §§ 355(b) ("active trade or business" required in division reorganization), 1372(e)(5) ("passive investment income" may cause small business corporation (Subchapter S) election to terminate).

22. Rev. Rul. 75-365, 1975-34 INT. REV. BULL. 24.

> property by the owner may, for some purposes, be considered the conduct of business in the case of a sole proprietorship, section 6166 was intended to apply only with regard to a business such as a manufacturing, mercantile, or service enterprise, as distinguished from management of investment assets. . . .
>
> It follows that the mere grouping together of income-producing assets from which a decedent obtained income only through ownership of the property rather than from the conduct of a business, in and of itself, does not amount to an interest in a closely held business within the intent of the statute.[23]

While *Revenue Ruling* 75-365 indicated that property rented for cash would not qualify as a trade or business for section 6166, it did not address the question of whether other types of rental arrangements would qualify as a "trade or business." This question was partially answered in *Revenue Ruling* 75-366[24] regarding share crop leasing. The facts present in this ruling involved a decedent who owned farm real estate which was operated by a tenant. Pursuant to the agreement the decedent received 40 percent of the crops and paid 40 percent of the expenses. The decedent had participated with the tenant in important management decisions such as what crops to plant, what fields to plant, how to utilize subsidy programs, and what steps to take to control weeds. The decedent had lived several miles from the farms but he had made almost daily visits to inspect and discuss farm operations. Under these circumstances, the Service ruled that the farm real estate constituted a closely held business since the decedent participated in the management of the farm operation and his income was based upon farm operations rather than being merely a fixed rental.[25]

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23. *Id.*

24. Rev. Rul. 75-366, 1975-34 INT. REV. BULL. 25.

25. Based on *Revenue Ruling* 75-365 and *Revenue Ruling* 75-366, it is apparent that a strict cash rent lease of a building or farm land will not qualify as a trade or business within the meaning of section 6166, whereas a share crop leasing arrangement with the landlord exercising management decisions and visiting the farm daily; that is, materially participating in the management of the operation of farm, will qualify. The qualification of rental arrangements that fall between these two extremes has not been clearly defined. However, based upon the active/passive test announced by the IRS, it appears that some guidelines regarding the degree of landlord participation necessary to avoid the "passive" rental label may be obtained from the provisions of the *Code* relating to Small Business Corporations (sections 1371-79) and Self-Employment Tax (sections 1401-03).

Section 1372(e)(5) provides that an election to be taxed as a Subchapter S corporation will terminate if a corporation has gross receipts of more than 20 percent of which is "passive investment income." Passive investment income is defined to include gross receipts from rents.

However, Revenue Ruling 61-112, 1961-1 CUM. BULL. 399 provides that where a corporation receives income pursuant to a share crop lease arrangement in which the corporation receives one-third of the proceeds of the sale of the crops and the president *materially participates* in management decisions regarding the farm operations, the rental income will not be considered passive income.

While the above ruling helps to define some of the activities required to participate materially in the farming operation, the ruling cites for further support *Revenue Ruling* 57-58, 1957-1 CUM. BULL. 270. This ruling concerns income subject to self-employment tax. Section 1402(a)(1) provides that real estate rental, including share crop rental, are excluded from the definition of net earnings from self-employment. There is an exemption within section 1402(a)(1) which provides that net earnings from self-employment will

The third ruling, *Revenue Ruling* 75-367,[26] merely applies the principles outlined in the two prior rulings to a situation in which the decedent owned (1) 100 percent of the stock in a Subchapter S corporation which built homes on land owned and developed by the decedent; (2) land which was being held for the purpose of building homes; (3) a business office and warehouse used by both the corporation and the decedent; (4) eight homes rented by the decedent for which he collected rents, made the mortgage payments and made all necessary repairs and provided the maintenance; and (5) other investment assets. The Service held, after reciting the general principles of *Revenue Ruling* 61-51 and *Revenue Ruling* 75-365, that only the stock of the Subchapter S corporation, the land, the business office and the warehouse qualified as "interests in a closely held business." The eight rental homes and the investment assets did not qualify because the decedent was merely managing "investment assets" and such activity did not constitute an active trade or business.

From the above rulings, it is evident that the Service, despite any direct legislative authority or supporting history, has imposed an active trade or business requirement in determining whether a decedent's business qualified as

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include rental income received pursuant to an arrangement between an owner and a tenant which provides that the tenant shall produce agricultural commodities and that the owner will *materially participate* in the production or management of the production of such agricultural commodities. *Revenue Ruling* 57-58 attempts to define by words and examples what material participation consists of. The ruling basically provides that a landlord shall be deemed to materially participate in the production or management of the farm if he:

(1) Periodically advises or consults with the tenant regarding the production of agricultural commodities.
(2) Periodically inspects the production activities of the farm.
(3) Furnishes a substantial portion of the machinery, implements, or livestock used in the production activities or assumes the financial responsibility for a substantial portion of the expenses involved in production.

In addition to *Revenue Ruling* 57-58, *Treasury Regulation* section 1.1402(a)-4(b)(3) promulgated pursuant to section 1402 provides an additional discussion regarding material participation. To the extent that a landlord materially participates in the production or management of a farm under section 1402, it appears that his business activity will constitute an "active" business and, therefore, a closely held business within section 6166. If the landlord desires the benefits of section 6166, he should, therefore, follow the guidelines of *Revenue Ruling* 57-58 and *Treasury Regulation* section 1.1402(a)-4(b)(3) as closely as possible. Additionally, he should maintain very detailed records regarding his participation, which could take the form of a diary indicating time, dates and places of discussion with tenants, the substance of the discussions, and work actually performed by the landlord.

Material participation also has the added benefit that growing crops and livestock constitute items of property and not items of income in respect of a decedent under section 691. Thus, the decedent's estate in effect gets a stepped up basis at death. Crop shares of a landlord who does not materially participate are items of income in respect of a decedent with the result that they are included in the estate's or heir's gross income when collected. *See* Rev. Rul. 64-289, 1964-2 CUM. BULL. 173, *modifying* Rev. Rul. 58-436, 1958-2 CUM. BULL. 366.

However, it should be noted that a conflicting consideration is created by the active/passive test for purposes of determining qualification under section 6166 and avoiding section 691 treatment, especially as applied to rental properties. Any steps to assure qualification for the estate tax deferrment may subject the owner to self-employment tax. Conversely, if the landlord attempts to avoid the payment of self-employment tax, he probably has jeopardized the estate tax deferral.

26. Rev. Rul. 75-367, 1975-34 INT. REV. BULL. 26.

an interest in a closely held business for purposes of section 6166. Thus, if a planner wants to qualify for estate tax deferral he would be well advised to provide for and document his client's activity in the business.

C. *Percentage Limitation*

Another requirement of section 6166 (a) to qualify for deferred estate tax treatment is that the value of the closely held business must exceed (1) 35 percent of the value of the gross estate of the decedent or (2) 50 percent of the taxable estate of such decedent.[27] It is important to note that the above percentage limitations are to be applied with respect to the *value* of the decedent's interest in the closely held business that is included in his gross estate. This value is apparently *not* limited to the decedent's capital interest in a partnership or voting stock interest in a corporation but rather includes any equity interest in the partnership or corporation that is included in the decedent's gross estate. With respect to a corporation, the value of the decedent's interest would include not only voting common stock, but also non-voting common stock, preferred stock, and other equity instruments. The value requirement, however, would not include a debt interest which the decedent may have with the corporation unless the debt is characterized as equity under section 385.

When planning to assure the later availability of section 6166, the planner should note that the form of the business entity may affect the value of the entity for purposes of the percentage limitation requirement. The regulations to section 6166 provide that:

> in a case where an interest in a partnership or stock of a corporation qualifies as an interest in a closely held business the decedent's entire interest in the partnership, or the decedent's entire holding of stock in the corporation, constitutes an interest in a closely held business even though a portion of the partnership or corporate assets is used for a purpose other than the carrying on of a trade or business.[28]

However, in the case of a trade or business carried on as a proprietorship, the regulations provide that "the interest in the closely held business includes *only* those assets of the decedent which were actually utilized by him in the trade or business."[29] While the above-cited regulations are concerned with the determination of whether or not the closely held business is "carrying on a trade or business," it appears that the regulation also applies in determining the value of a closely held business both for purposes of the percentage test and the amount of the federal estate tax deferred. If the decedent has an interest in a closely held business which is a partnership or corporation that meets the requirements of section 6166(c) but does not meet the 35 percent or 50 percent test of section 6166(a), it may be possible to increase the value of the closely

27. INT. REV. CODE OF 1954, § 6166(a).
28. Treas. Reg. § 20.6166-2(c)(2) (1960).
29. *Id.* (emphasis added).

held business by transferring non-trade or nonbusiness assets to the corporation before the death of the decedent, and thereby meet the percentage limitation test. For example, in the hypothetical estate established earlier in this article, assuming that the value of the nonbusiness real estate was $930,000 (increasing the gross estate to $1,520,000 and the taxable estate to $1,300,000), the interest in the proprietorship would not qualify under section 6166 since the value of the proprietorship interest would be less than 35 percent of the gross estate ($500,000 divided by $1,520,000 or 32.89 percent) and less than 50 percent of the taxable estate ($500,000 divided by $1,300,000 or 38.46 percent). However, if the business assets were held in a partnership or corporation it may be possible for the decedent to transfer to the corporation nonbusiness real estate or nonbusiness assets in order to qualify for section 6166 since it is not necessary that all the assets of the corporation be utilized in the trade or business.[30] If a transfer of $50,000 of nonbusiness real estate or other assets were made, the value of the closely held business would be $550,000 which would be greater than 35 percent of the gross estate ($550,000 divided by $1,520,000 = 36.18 percent) and thus the percentage limitation could be met. If the valuation of some or all of the assets is open to doubt, an even larger amount of nonbusiness assets could be transferred. It should be noted, though, that the transfer of the nonbusiness assets to the corporation may jeopardize the "trade or business" nature of the closely held business. Thus, if the entire $930,000 of nonbusiness real estate had been transferred to the corporation, it is conceivable that the Service could allege that the corporation is no longer carrying on a trade or business.

Once the closely held business interest has been valued, it must be compared with the gross estate and taxable estate in order to determine if it meets the 35 percent or 50 percent limitation. It is important in making this comparison that all assets which are used in determining the estate for federal estate tax purposes be considered, including gifts in contemplation of death, retained life estates, reversionary interests, revocable trusts and similar interests. It is likewise important that a proper valuation be given both to the closely held business interest and to the remaining assets of the gross estate. An adjustment in valuation could result in a failure to meet the 35 percent or 50 percent limitation. Additionally, if an executor wants to qualify a business interest for estate tax deferral, he should consider deducting all administration expenses on the estate tax return in order to reduce the taxable estate.[31] The alternate valuation may also be helpful depending upon relative changes in value of the business and nonbusiness assets.[32] If the estate will have a marital deduction, the business assets could be allocated to the non-marital share, which would also increase their percentage of the taxable estate.[33]

30. *Id.*
31. INT. REV. CODE OF 1954, §§ 642(g), 2053.
32. *Id.* § 2032.
33. *Id.* § 2056.

Finally, if an estate consists of interests in two or more closely held businesses, each of which independently meets the requirements of section 6166(c), it may be possible to treat the value of the combined interests as a single closely held business interest.[34] In order for two or more business interests to be treated as an interest in a single closely held business, there must be included in determining the decedent's gross estate more than 50 percent of the total value of each business. It should be noted that the test is based on the value of each business and thus for corporations the value computations would include voting and nonvoting stock. Unless the "more than 50 percent" test is met, each closely held business interest must separately meet the 35 percent or 50 percent test in order to qualify for the estate tax deferral. This requirement of more than 50 percent inclusion could disqualify the estates of many decedents who are members of several two-member partnerships or two-shareholder corporations, if a 50 percent interest is owned by each member.

III. Determining the Amount to be Deferred

If the conditions for qualification are met, the executor may elect to pay part or all of the estate tax in two or more, but not exceeding ten, equal installments. Section 6166(b) provides that the maximum amount of estate tax that can be paid in installments is an amount which bears the same ratio to the estate tax, as reduced by credits against such tax, as the value of the interest in the qualifying closely held business bears to the value of the gross estate. If A equals the amount of the estate tax that can be paid in installments, and B equals the gross estate tax reduced by credits, and C equals the value of the closely held business interest which is included in the gross estate and D equals the value of the gross estate, then the amount of the estate tax that can be paid in installments can be algebraically computed as follows:[35]

$$A = \frac{C}{D} \times B$$

Applying this formula to the hypothetical estate, the amount of estate tax that can be deferred would be calculated as follows:

$$A = \frac{\$500{,}000}{\$620{,}000} \times \$105{,}000$$

$$A = \$84{,}677$$

From the above computations, it is apparent that the amount of estate tax that can be deferred is the amount of estate tax attributable to the value of the closely held business and the greater the difference between the value of the interest in the closely held business and the gross estate, the smaller the percentage of the estate tax that can be deferred.

34. *Id.* § 6166(d), Treas. Reg. § 20.6166-2(d) (1960).
35. Treas. Reg. § 20.6166-1(b) (1972).

Thus, it is possible to increase the amount of estate tax subject to installment payments by decreasing the difference between the value of the interest in the closely held business and the value of the gross estate. This may be done by a number of different maneuvers:

(1) The gross estate may be reduced by paying some debts prior to death.

(2) The value of the interest in a closely held business, where the closely held business interest consists of an interest in a partnership or a corporation, may be increased by adding nonbusiness assets to the partnership or corporation.[36]

(3) Gifts may be made from nonbusiness assets rather than business assets, if possible, thereby reducing the gross estate.

(4) The type of debt incurred may affect the value of the gross estate. For example, if in the hypothetical estate the $130,000 of debts and loans were a purchase money mortgage against the business real estate for which the decedent was not personally liable, the business value would be $370,000 and the gross estate would be $490,000 ($620,000 — $130,000). The amount eligible to be paid in installments would be $79,286 ($370,000/$490,000 multiplied by $105,000). When the decedent is personally liable for the debts and loans, the gross estate includes the entire assets of the business and the amount of estate tax eligible to be paid in installments would be $84,677 ($500,000/$620,000 multiplied by $105,000).

Section 6166(f) provides that an election to pay any part of the estate tax in installments, if timely made, shall also apply to any deficiency that is assessed, provided that such deficiency is not due to negligence, intentional disregard of rules and regulations or fraud with intent to evade tax. The amount of the deficiency which may be paid in installments may not exceed the difference between the amount of tax which the executor elected to pay in installments and the maximum amount of tax which the executor could have elected to pay in installments on the basis of a return which reflects the adjustments which resulted in the deficiency.[37] The deficiency is allocated equally to all installments and the amount due when the deficiency is determined will depend on the number of installments already paid and the number of installments not yet due.[38]

IV. Making the Election

A. *Timing*

Once it has been determined that the gross estate includes an interest in a closely held business which meets the qualification of sections 6166(a) and 6166(c), the executor may elect to pay a portion of the estate tax attributable

36. *Id.* § 20.6166-2(c); *see also* discussion at text accompanying notes 29 and 30 *supra.*

37. *Id.* § 20.6166-1(d).

38. *Id.*

to the value of the interest in the closely held business in two or more (but not exceeding ten) equal installments.[39] The election must be filed not later than the time prescribed by section 6075(a) for the filing of estate tax return, presently nine months, unless an extension of time to file the return is granted, in which event the election must be filed with a timely return in accordance with the terms of the extension.[40]

B. *Form of Election*

Section 6166(a) provides that the election shall be made in such manner as the Secretary or his delegate shall prescribe by regulations. The regulations provide that the election may be in the form of a letter addressed to the District Director.[41] The letter should contain the following:

(1) Amount of tax to be paid in installments.

(2) Total number of installments (including the first installment to be paid with the estate tax return) in which the tax will be paid.

(3) Description of properties in the gross estate which constitute the decedent's interest in a closely held business identified by schedule and item number as they appear in the estate tax return.

(4) Facts which form the basis for the conclusion that the estate qualifies for the payment of estate tax in installment.

C. *Review By Service*

The District Director has the responsibility for processing a section 6166 election and will determine whether an election meets the requirements of section 6166.[42] If it appears that the election does not qualify, the executor will be given an opportunity for a hearing on the matter with an appropriate conferee in the District Audit Division before a final decision is reached on the election. After the hearing the District Director shall inform the executor if the election is rejected. A decision to reject an election will be regarded as the Service's decision on the matter and will not be subject to appeal to, or review by, the regional Appellate Division. If it is determined that the election meets the requirements of section 6166, *no* notice to that effect is sent to the executor and an executor is to assume that his election meets the requirements of section 6166, if he is not advised to the contrary. Thus, it is very important that the filing of the election is well documented and it is advisable to mail the election by registered mail with return receipt requested prior to the estate tax return due date.

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39. INT. REV. CODE OF 1954, § 6166(a).
40. *Id.* §§ 6166(a), 6081(a).
41. Treas. Reg. § 20.6166-1(e)(2) (1972).
42. Rev. Proc. 60-31, 1960-2 CUM. BULL. 1012.

D. *Protective Elections*

In the event that an interest in a closely held business fails to meet the requirements of section 6166(a), or if there is no tax due on the estate tax return, an executor can make a protective election.[43] This election will allow the executor to take advantage of section 6166 in the event that there are subsequent adjustments in the value of the closely held business or gross estate which would qualify the closely held business for section 6166 treatment or which would result in estate tax being due. The protective election must be filed on or before the due date of the return and should specifically state that it is a protective election. The protective election should also indicate the specific business interests included in the gross estate to which the protective election relates.[44]

E. *Bond*

While there is no specific provision in section 6166 authorizing the Service to require a bond for the estate tax to be paid in installments, section 6165 provides that in the event that the Secretary or his delegate grants an extension of time with which to pay any tax or deficiency, the taxpayer may be required to furnish a bond in an amount, not exceeding double the amount with respect to which the extension is granted, conditioned upon the payment of the amount extended. It does not appear to be the general practice of the Service to require a bond, at least in those estates with substantial amounts of business real estate.

V. Payment of Deferred Estate Tax

If an election is made to pay the estate tax in installments under section 6166, the first installment is due on or before the due date of the estate tax return.[45] This first installment should be paid together with the non-deferred portion of the estate tax. For the hypothetical estate, the amount of the first installment, assuming the tax would be paid in ten equal installments, would be $8,468 ($105,000 multiplied by $\frac{\$500,000}{\$620,000}$ multiplied by $\frac{1}{10}$). This installment would be paid together with the amount of the non-deferred tax so that the total payment required by the due date of the return would be $28,791, determined as follows:

Non-deferred portion of estate tax ($105,000 — $84,677)	$20,323
First Installment	8,468
Total Payment	$28,791

43. Treas. Reg. § 20.6166-1(e)(3) (1972).
44. *Id.*
45. Int. Rev. Code of 1954, § 6166(f); Treas. Reg. § 20.6166-1(c) (1972).

Thus, in the example, approximately $76,200 of tax could be deferred which substantially improves the possibility of preserving the family farming operation.

Each succeeding installment must be paid on or before the date which is one year after the date prescribed for the payment of the preceding installment.[46] Interest as provided under section 6601, is payable on the unpaid balance of the deferred tax and the interest must be paid annually as a part of each installment payment. Interest is also payable on the unpaid balance of any deferred deficiency. The interest rate presently charged is seven percent, but this rate will fluctuate with the prime interest rate determined under section 6621.[47]

It should be noted that section 6161, which provides for an extension of time for payment of estate tax in cases involving undue hardship, may apply to both the portion of the estate tax to be paid in installments under section 6166 and the portion of the tax not so deferred.[48] Thus an executor meeting the requirements of section 6161 may file an extension of time to pay not only the non-deferred portion of the estate tax but also any installments that are also due.

The discussion above has assumed that the deferred portion of the estate tax would be paid in ten equal installments. However, even though the executor elects to pay the deferred tax in ten installments, fewer than ten installments may be used.[49] The regulations specifically provide that "voluntary prepayments may be made at any time of all, or of any portion of the tax (including deficiencies) payable in installments."[50] It is worth noting that there is no requirement in the statute or regulations restricting the availability of section 6166 to estates that are suffering hardship; that is, the election is an absolute matter of right assuming all substantive and procedural requirements are met. If the executor has reason to believe that the estate will be open for a period of years, he should consider making the section 6166 election for the maximum ten installments even if it is expected that fewer would be needed or even if no deferral would be needed. This will permit the executor to pay a minimum of estate tax immediately and when he desires to close the estate, he may then voluntarily prepay the remaining installments. This may be particularly useful if the retention of funds or property within the closely held business is expected to generate large amounts of income or the assets are expected to appreciate greatly.

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46. INT. REV. CODE OF 1954, § 6166(e).
47. *Id.* § 6166(g). Prior to July 1, 1975, interest on the unpaid installments was four percent annually. This rate actually encouraged many estates to use the deferral provisions even if there was no hardship and the amount deferred was then invested at a much higher rate of return. The interest rate was changed by P. L. 93-625 which ties the interest rate to a fluctuating rate which is designed to be approximately ninety percent of the prime rate, as redetermined periodically. *See* INT. REV. CODE OF 1954, § 6621.
48. *Id.* § 6161(a)(2)(B); Treas. Reg. § 20.6166-1(g) (1972).
49. INT. REV. CODE OF 1954, § 6166(a).
50. Treas. Reg. § 20.6166-1(h) (1972).

VI. Acceleration of Payment of Deferred Estate Tax

Payment of the remaining installments can be accelerated for failure to pay an installment when due. Payment can also be accelerated for withdrawal of funds from the business or for disposition of the business interest if the withdrawal or disposition exceeds certain amounts. Partial acceleration will occur for the accumulation of income in the estate after the fourth taxable year of the estate's existence.

A. *Failure to Pay an Installment*

If an installment is not paid by the due date, section 6166(h)(3) provides that the "unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary or his delegate."[51] The regulations explain this provision in slightly differing language than that of the statute by providing that "the whole of the unpaid portion of the tax which is payable in installments becomes due and shall be paid upon notice and demand from the District Director."[52] However, if the estate can cure its delinquency before notice and demand there is authority for preserving the extension. The Seventh Circuit in *Lake Shore National Bank v. Coyle*[53] found the language of the regulations inconsistent with the "clear" intent of the statute and refused to rule that failure to pay an installment automatically made the whole tax due, but rather that the extension remained effective since the estate had paid the past due installments and interest before notice and demand was received.[54]

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51. Int. Rev. Code of 1954, § 6166(h)(3).
52. Treas. Reg. § 20.6166-3(c) (1960).
53. 419 F.2d 958 (7th Cir. 1969).
54. The authors feel that it is arguable that the *Lake Shore National Bank* case was wrongly decided. In rejecting the position of the Internal Revenue Service and the validity of *Treasury Regulation* section 20.6166-3(c) that the remaining balance becomes due automatically upon failure to pay an installment when due, the court interpreted section 6166(h)(3) in the light of the remainder of subsection (h). Subsection (h)(1), which does provide for automatic acceleration upon the withdrawal of fifty percent of the assets uses the language "extension of time for payment of tax provided in this section shall cease to apply." The court construed the omission of these words in (h)(3) together with the stated Congressional purpose to avoid immediate imposition of estate taxes on closely held businesses to permit the preservation of the extension. "Since estates which are late on installment payments are often those most in need of relief granted under Section 6166, Congress intended to give some flexibility to the District Director in handling late installments." *Id.* at 962. It appears that the court failed to consider that Congress had provided for any needed flexibility for the District Director in section 6161(a)(2) (B) which provides for an extension for section 6166 installments that would result in "undue hardship" to the estate. The I.R.S. apparently still adheres to its position of immediate and total acceleration if an installment is missed. This is evidenced in *Revenue Ruling* 76-23, 1976-3 *Internal Revenue Bulletin* 13, which although addressing itself to a different issue, gratuitously states that the election terminates if any installment is not paid on or before the due date.

Lake Shore National Bank is also interesting because of the apparent slowness with which the District Director served the notice and demand for acceleration. The estate was first in default on November 13, 1962, when it failed to pay the balance of an installment due on that date. The 1963 and 1964 installments were not paid at all and the next payment was made on July 16, 1965, over two and one-half years after the original default. Notice and demand was finally served two weeks after this payment.

It is recommended that if the executor believes he will be unable to meet an installment payment, he should apply for an extension under section 6161(a)(2)(B) rather than relying upon the delay or failure of the District Director to serve him with notice and demand of acceleration before he can cure the estate's delinquency.

B. *Withdrawals and Dispositions*

Because the primary purpose of estate tax deferral is the preservation and continuation of the closely held business interest, it is understandable that the deferred tax will be accelerated upon either substantial withdrawal of funds or property from the business or upon disposition of a substantial portion of the business or its assets. Section 6166(h)(1) covers such situations and together with the regulations promulgated thereunder represents one of the more complex areas concerning the extension. The following paragraphs will discuss the general statutory scheme and summarize the type and extent of withdrawals and dispositions that might concern a typical estate.

Aggregate withdrawals of money and other property from the closely held business interest equaling or exceeding 50 percent of the value of the business interest causes the extension to cease to apply and the unpaid portion of the tax must be paid upon notice and demand.[55] Value is defined to be the "value determined for Federal estate tax purposes."[56]

If the closely held business interest is a sole proprietorship, determining the withdrawal of 50 percent of the interest is fairly easy. The value of the business interest equals the value of the property and money used in the trade or business. Using the continuing hypothetical example with the $500,000 business interest, and assuming constant values, once $250,000 has been withdrawn acceleration of the unpaid tax would occur upon notice and demand. What would appear to be a fairly simple arithmetic computation can easily become confusing. For example, if all the business assets but the real estate are sold and the funds are withdrawn and used to pay administration costs and the early installments of the estate tax, this would constitute a 36 percent withdrawal ($180,000 divided by $500,000). There would be no acceleration until another 14 percent ($70,000 divided by $500,000) is withdrawn. However, if during administration of the estate the value of the real estate increased to $480,000 and 60 acres were sold for $90,000, which is used to retire a nonbusiness loan, then because of the sale and payment of the loan, $270,000 in total dollar amount has been withdrawn. However, this is not a 50 percent disqualifying withdrawal because value is to be determined for assets based on the federal estate tax valuation. Thus all computations

55. INT. REV. CODE OF 1954, § 6166(h)(1)(A)(i); Treas. Reg. § 20.6166-3(d)(1) (1960).
56. INT. REV. CODE OF 1954, § 6166(a).

must be adjusted for appreciation or depreciation during estate administration.[57]

The computation of the percentage of withdrawal is made in the following manner. First, a fraction is set up with the numerator as the present value to be withdrawn and the denominator as the present value of the entire remaining business interest. This fraction is multiplied by the percentage of the business interest not previously withdrawn.

$$\frac{\text{Value withdrawn}}{\text{Value of business at time of withdrawal}} \times \text{Percentage of business not previously withdrawn} = \text{Percentage of business withdrawn by last withdrawal}$$

The percentage of the business withdrawn by the last withdrawal is then added to the percentage or percentages of the business previously withdrawn. An acceleration occurs when the percentage or percentages equals or exceeds 50 percent.

In the hypothetical estate the percentage of withdrawal would be computed as follows for the example where the non-real estate assets were first sold and then the appreciated 60 acres was subsequently sold:

$$(1) \quad \frac{180{,}000}{500{,}000} \times 100\% = 36\%$$

$$(2) \quad \frac{90{,}000}{480{,}000} \times 64\% = 10.67\%$$

$$(3) \quad 36\% + 10.67\% = 46.67\%$$

Correspondingly, decreases in the value of property could result in an unexpected acceleration. If the real estate decreased in value to $240,000 and 80 acres were sold for $60,000, then total withdrawals would be $240,000 compared with an original value of $500,000, but the percentage of withdrawal is 52 percent with the second withdrawal computed as follows:

$$(2) \quad \frac{60{,}000}{240{,}000} \times 64\% = 16\%$$

$$(3) \quad 36\% + 16\% = 52\%$$

Thus, it is necessary to keep a continuing tabulation of the amount withdrawn and also to compute the value of the business at the time of each withdrawal.

There may also be problems in determining what constitutes a withdrawal, which is not a defined term. Presumably an exchange of assets for other assets or the reinvestment of proceeds of sale of assets in the business would not be a withdrawal.[58] Questions are raised, though, where the proceeds are not immediately reinvested in the business. Likewise, uncertainty could arise where

57. *Cf.* Treas. Reg. § 20.6166-3(d)(3) (1960) (Example 1). Even though this example refers to a partnership, its logic applies also to a sole proprietorship.
58. *Cf.* Rev. Rul. 75-401, 1975-37 INT. REV. BULL. 17.

additional assets of a capital nature, as contrasted with appreciation of existing assets, are added to the business and subsequently there are withdrawals composed in whole or in part of the additional assets. Based on the reasoning of *Revenue Ruling* 75-401,[59] assets added to the business after the date of death should not be included in computing withdrawals, but determining what assets were additional or existing at the time of death could present tracing problems. For a sole proprietorship, income would be added to the value of the business if retained in the estate and income earned after death should not give rise to a withdrawal based on the implicit reasoning of *Revenue Ruling* 75-401. Likewise, income received by a surviving joint tenant or other beneficiary who received title and possession in business assets directly probably would not be considered a withdrawal from the business when paid to that individual.

Presumably, the payment of the estate tax with funds from the business is a withdrawal,[60] but repayment of loans and payments of salaries and fiduciary income taxes present additional uncertainties although it seems likely that these repayments and payments are not withdrawals. Thus, where withdrawals may present a problem, it may be desirable to pay charges, debts and estate taxes from assets other than those being used in the trade or business. This avoids any question as to acceleration if there is any doubt that a payment may be considered a withdrawal.

There is still another potential problem concerning withdrawal for the sole proprietor. Suppose the estate in our example sells all the assets except the land and the land is subsequently leased for a cash rent. The regulations and statute both speak in terms of withdrawal from "the trade or business." It could be argued that the real estate has been withdrawn because the farming enterprise has been converted either to a non-qualifying trade or business or a different trade or business.[61]

With a partnership there is the possibility that withdrawals from the business by the other partners may affect the determination of the percentage of the withdrawals by the estate. The regulations make it clear that the 50 percent withdrawal must include solely withdrawals of the interest included in the estate and withdrawals by other partners are to be ignored.[62] Thus, if the decedent's interest in a partnership is less than 50 percent of the value of the partnership business, money or other property equaling or exceeding 50 percent of the value of the business can never be withdrawn and payment would never be accelerated.[63] If the decedent's partnership share is in excess of 50 percent of the value of the partnership business, the withdrawals still

59. *Id.*
60. This conclusion is inferred from the provisions of section 6166(h)(1)(B) which decrees that redemptions pursuant to section 303 are not withdrawals or dispositions if the distribution is used to pay federal estate tax when the tax, or the next installment, is due.
61. For a discussion of what constitutes a qualifying trade or business pursuant to section 6166, see text accompanying notes 17-26 *supra.*
62. Treas. Reg. § 20.6166-3(d)(3) (1960) (Example 2).
63. *Id.* § 20.6166-3(d)(3) (Examples 1 and 2).

must equal or exceed 50 percent of the total business interest which also must have been included in determining the gross estate. Withdrawals by other partners, while not counted in determining the 50 percent, can still affect the percentage of subsequent withdrawals by altering the relative value of the business interest included in the estate. An example of computations involving a series of withdrawals by the estate and other partners can be found in the regulations.[64]

Withdrawals from a corporation are treated very much like withdrawals from a partnership. If the decedent's shareholdings are less than 50 percent of the value of the business there can never be a disqualifying withdrawal since the withdrawal must be of interests included in the estate and must comprise over 50 percent of the total value of the business.[65] There is an exception exempting distribution in redemption of the decedent's stock which qualify under section 303. These distributions in redemption are not considered withdrawals if the proceeds are applied to the federal estate tax or to the next installment of the deferred estate tax.[66] By inference drawn from this exception, redemptions not qualifying under section 303 are withdrawals as would be dividends, liquidations and spin-offs. *Revenue Ruling* 75-401[67] attempts to clarify the status of dividends by ruling in a factual situation where all the corporation's earnings and profits were distributed that a dividend is a withdrawal only to the extent of earnings and profits accumulated before decedent's death. However, it is not clear from the ruling whether a dividend that does not carry out all earnings and profits would be considered to first carry out current (post-death) earnings and profits or accumulated (pre-death) earnings and profits. If the Service were to follow the concept found in section 316(a) the dividends would first carry out current earnings and profits.

Many of the same questions involving additions to the business, the effect of various payments and the possible change in the nature of the business which were discussed previously in connection with a sole proprietorship are equally applicable to partnerships and corporations. However, problems with salaries, loans and inventories should not arise in partnerships or corporations since presumably a salary or rent is deducted in determining income and there would be no withdrawal. The answers to these and similar questions are not to be found in the statute or regulations.

The estate and heirs are more likely to run afoul of the more restrictive disposition provisions than the more liberal withdrawal provisions. Whereas withdrawals are to be measured in terms of the entire value of the business, dispositions are to be measured in terms of the business interest included in the

64. *Id.* § 20.6166-3(d)(3) (Example 1).
65. *Id.* § 20.6166-3(d)(1).
66. INT. REV. CODE OF 1954, § 6166(h)(1)(B)(i); Treas. Reg. § 20.6166-3(d)(2) (1960).
67. Rev. Rul. 75-401, 1975-37 INT. REV. BULL. 17.

estate.[68] A disqualifying disposition occurs when property is "distributed, sold, exchanged or otherwise disposed of."[69] The terms of the statute make it clear that dispositions include every possible way by which property ceases to form a part of the estate, except transfers by the estate to distributees or transactions which are merely changes in form such as incorporations pursuant to section 351.[70]

However, a subsequent transfer by the beneficiaries, heirs, or trustees does constitute a disposition.[71] Likewise, a disposition by a joint tenant or by a donee of a gift in contemplation of death is a disposition which is counted in determining whether a 50 percent disposition has occurred.[72] There is an exception for distributions in redemption of corporate stock which qualify under section 303 when the proceeds are applied to the next payment of the federal estate tax.[73] Sales of assets to pay estate tax and the subsequent payment of estate tax would be a disposition. Similarly to the withdrawal provisions discussed earlier there are many questions concerning sales and reinvestments, various routine business payments, and conversion of the business into a different trade or business.[74] As with the withdrawal provisions, the statute and regulations are of little value and assistance.

The regulations require the executor to notify the District Director in writing within 30 days if he acquires knowledge of disqualifying withdrawals or dispositions.[75] Additionally, the executor with each installment payment must include a statement that to the best of his knowledge all withdrawals or dispositions have not resulted in a disqualification or he must include a statement completely disclosing all transactions involving withdrawals and dispositions.[76] There is a far better reason, though, than compliance with the reporting requirement for the executor to keep a close tabulation of withdrawals and dispositions. Because withdrawals and dispositions can be made by heirs, joint tenants, donees, trustees and others, the actions of such individuals could cause disqualification of the extension. If this disqualification occurs at an inopportune time, the executor's plans for preserving the business may be thwarted. Therefore, the best protection against inadvertent disqualification by others is to retain the assets or at least more than a substantial portion of the assets in excess of 50 percent of the closely held interest in the estate where the assets will be under the executor's control. This requires the planner to

68. INT. REV. CODE OF 1954, § 6166(h)(1)(A)(ii); Treas. Reg. § 20.6166-3(e) (1960).
69. INT. REV. CODE OF 1954, § 6166(h)(1)(A)(ii); Treas. Reg. § 20.6166-3(e) (1960).
70. INT. REV. CODE OF 1954, § 6166(h)(1)(D); Treas. Reg. § 20.6166-3(e)(2) (1960).
71. Treas. Reg. §§ 20.6166-3(e)(1), (4) (1960).
72. *Id.* § 20.6166-3(e)(4).
73. INT. REV. CODE OF 1954, § 6166(h)(1)(B)(ii); Treas. Reg. § 20.6166-3(e)(5) (1960).
74. *See* discussion of notes 58-64 *supra.*
75. Treas. Reg. § 20.6166-3(f) (1960).
76. *Id.*

provide that assets be subject to the executor's possession and the probate attorney to retain possession during administration of the estate.

Except for the simplest cases, the area of withdrawal and disposition is fraught with uncertainty. Fortunately, the 50 percent limitation for withdrawals and dispositions should give the executor a sufficient margin, at least in the early years of the extension to avoid disqualifying the extension, but careful planning and foresight are a necessity.

C. *Accumulation of Undistributed Net Income*

Partial acceleration can occur to the extent the estate has "Undistributed Net Income" for a taxable year of the estate after its fourth taxable year.[77] "Undistributed Net Income" is defined as the amount by which the distributable net income (as defined in section 643) exceeds the sum of (i) distribution deductions allowed under section 661(a)(1) and (2); (ii) the estate's federal income tax; and (iii) the amount of federal estate tax and interest paid during the taxable year.[78] Neither section 6166 nor the regulations exclude nonbusiness income from the determination of Undistributed Net Income. The payment of the Undistributed Net Income must be made to the District Director on or before the time for filing the fiduciary income tax return which is on or before the fifteenth day of the fourth month after the close of the taxable year.[79] An extension for filing the income tax return also extends the time for making the accelerated payment.[80] Accelerated payments due to Undistributed Net Income are applied equally to the remaining installments.[81]

The reason for this requirement is to require the estate during the period after which its administration would ordinarily be terminated, to use all of its annual income to satisfy the remaining federal estate tax. This partial acceleration does not have the effect of destroying the income tax advantages of maintaining the estate as a separate taxpayer; instead, its effect is merely to prevent accumulation of income in the estate.[82] As such, the provision has a relatively immaterial effect on the use of section 6166.

Of course, to the extent that the executor wants to avoid partial acceleration, he can make distributions during the taxable year which reduce the Undistributed Net Income and these distributions together with the reductions for federal estate and income tax paid during the year should avoid any application of the partial acceleration provisions. If the executor is satisfied that he can avoid liability personally, he could distribute the business interest and other estate assets to avoid having any estate income. However, distribu-

77. INT. REV. CODE OF 1954, § 6166(h)(2)(A).
78. *Id.* § 6166(h)(2)(B); Treas. Reg. § 20.6166-3(b)(2) (1960).
79. INT. REV. CODE OF 1954, § 6072(a); Treas. Reg. § 20.6166-3(b)(1) (1960).
80. Treas. Reg. § 20.6166-3(b)(1) (1960).
81. *Id.* § 20.6166-3(b)(3).
82. *See* discussion concerning income tax advantages at notes 97-100 *infra.*

tion of all the assets necessarily results in no income tax savings from prolonging the estate as a separate taxpayer and the income tax savings will often be one of the primary reasons for utilizing section 6166 for many estates. If the business interest is held in the estate in the form of corporate shares, the executor may through voting control of the corporation manipulate dividends and redemptions to provide just enough income to pay the installment, the interest, and the income tax, and thus avoid creating Undistributed Net Income.

VII. SECTION 303 REDEMPTIONS

Section 6166 may also be used to good advantage where the closely held business interest is in corporate form by combining the election with a section 303 stock redemption. The latter section provides for redemption of stock included in determining a deceased shareholder's federal taxable estate. The redemption may be made to the extent of the federal estate tax, state death taxes, and costs of administration.[83] The same basic considerations apply in determining if an estate is eligible for section 303 except that section 303 does not require either the value of the interest included in the determination of the decedent's estate to exceed 20 percent in value of the voting stock or require that there be ten or fewer shareholders.[84] Thus, some estates may qualify to use section 303 but not qualify under section 6166.

The basic advantage of qualifying under section 303 is that the redemption is then treated as a distribution in payment for the stock redeemed; that is, the redemption qualifies for capital gain treatment.[85] This avoids any possible dividend treatment because of the possible application of the attribution rules between estates and beneficiaries.[86] Another advantage is that the redemption can be made serially as several separate redemptions and these redemptions can be timed to coincide with the payment dates for the estate tax installments. However, care must be taken to complete the redemption within the time period prescribed by section 303.[87] Avoiding these time limitations may require the use of notes given by the corporation and fortunately the Internal Revenue Service has given valuable guidance in how to time these redemptions.[88] It is important to again note that a redemption pursuant to section 303 may cause acceleration under some circumstances where the amount paid in the redemption is not applied to the next payment of the federal estate tax.[89]

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83. INT. REV. CODE OF 1954, § 303(a).
84. *Id.* § 6166(c)(3).
85. *Id.* §§ 303(a), 301(c).
86. *Id.* §§ 302, 318(a)(3).
87. *Id.* § 303(b).
88. *Compare* Rev. Rul. 72-188, 1972-1 CUM. BULL. 383 (describing a situation in which several redemptions were held not to qualify under section 303 because of late timing) *with* Rev. Rul. 67-425, 1967-2 CUM. BULL. 134 *and* Rev. Rul. 65-289, 1965-2 CUM. BULL. 86 (permitting the completion of the redemption with corporate notes which are not equity interests).
89. INT. REV. CODE OF 1954, § 6166(h)(1)(B)(ii).

VIII. Probate Law, Income Taxation and Miscellaneous Considerations

The draftsmen of section 6166 showed little concern for coordinating the statute with local probate law to make the use of section 6166 more feasible. Practical problems are presented by the continuing administration of the estate, the continuing liability of the personal representative during the deferral period, and the delay of distribution of the assets. There may also be problems in determining the income tax liability of the estate and the various distributees and the calculation of the marital deduction if distribution to the spouse is delayed. While the following discussion is based on Iowa probate law, many jurisdictions will have similar problems.

A. *Probate and Fiduciary Income Tax Consideration*

Iowa probate law does not require distribution of assets within a specific time, except for specifically devised or bequeathed property which must be distributed within nine months of the appointment of the personal representative.[90] However, Iowa probate law does provide that final settlement of an estate shall be made within three years from the date of the second publication which would seem to place a maximum limit of approximately three years on the possibility of deferral.[91] Neither of these statutes presents an insurmountable obstacle because both allow the court to extend the time period. To delay distribution of a specific bequest or devise, the nine months may be extended "for good cause shown"[92] and to prolong administration beyond three years, the court may extend the time by order after notice to all interested parties.[93]

As a practical matter, the potential problem of a distributee entitled to a specific bequest objecting to a delay in distribution would generally only be present where the specific distributee would not himself benefit by the preservation of the business. This problem could be avoided by not making specific bequests of business assets or by avoiding specific bequests altogether.

A court order to prolong administration is required after notice, and the hearing gives any objecting party the opportunity to foil the extension.[94] But this provision allowing prolonged administration is probably of little value in most estates where there is the possibility of dissension, since the extension is probably feasible only if all parties agree. Even where all distributees agree, and even though a court order after notice should be sufficient protection, a prudent executor may want to secure consents from all parties to avoid the possibility of later objections. These problems may also be mitigated by proper planning and execution. If it is possible in advance to predict which heirs

90. Iowa Code § 633.355 (1975).
91. *Id.* § 633.473.
92. *Id.* § 633.355.
93. *Id.* § 633.473.
94. *Id.*

would probably object, they can be eliminated, except for the spouse, from involvement in the estate by satisfying their expectations with insurance proceeds or joint tenancy property. If the potential objectors to prolonging administration are entitled to only limited distributions which can be made from nonbusiness assets, it may be possible to complete their distributions and, in effect, terminate or limit their involvement in the estate thereafter. However, in most estates these alternatives may not be realistic because they will further deplete the estate's assets causing further and more extensive illiquidity. Naturally, broad powers concerning continuation of the business should be granted to the executor.

The form of the business interest represented in the estate may make the opportunity for deferral more feasible and easier to preserve. A sole proprietorship presents the greatest difficulties since usually a variety of different assets are involved, each of which may be sold or distributed. But if partnership interests or shares of a closely held corporation are involved, it may be possible to distribute a portion of the partnership interest or a specified number of shares to one or more of the beneficiaries. The prudent executor will want to maintain a sufficient percentage of the business interest in the estate to avoid acceleration caused by a disposition by the distributees and will also want to retain voting control of a corporation to avoid withdrawals from the business which could also cause acceleration.[95]

Another possibility for the executor who wants to terminate administration of the estate but preserve the extension is to "close" the estate, subject to a compliance report when the estate tax is finally paid, and make distribution of the business assets. Assuming the distributees are the ones engaged in the business, each such distributee could then agree to pay to the executor a prorated portion of the estate tax shortly before the time for each installment. However, this may be impractical if there are distributees who are not associated with the business and unless all questions concerning responsibility for the extended federal estate tax can be resolved in advance, especially giving full recognition of the problems caused by an unexpected acceleration. Except where the executor is the sole heir, full distribution is not recommended because the executor may later be held to be personally liable for the federal estate tax if it is not paid.[96]

This liability is often the chief deterrent to the election especially if the business is very risky or if there is the possibility the value of the business assets may decrease, because it is the executor and only the executor who can make the election. The executor would be well advised to secure indemnification agreements from the distributees, or to avoid the election, or to retain enough additional property in the estate in excess of the remaining estate tax to provide

95. For a discussion of disqualifying withdrawals and dispositions, see text accompanying notes *supra*.

96. INT. REV. CODE OF 1954, § 2002.

a cushion for business setbacks and decreases in asset value. This is especially advisable where the executor is not personally involved in the business. Standard procedure among attorneys who use section 6166 and make early distributions seems to be to have each distributee agree to indemnify the executor, but the bankruptcy or the death of one or more of the distributees could subject the executor to liability and make this procedure risky.

The prolonging of estate administration does have the rather substantial advantage of providing another taxpaying entity for several years. Until recently many attorneys were afraid to utilize section 6166 because of the uncertainty of the Internal Revenue Service's position on whether the estate could be prolonged beyond the period actually required to perform the ordinary duties of administration.[97] This presented the dangerous possibility of the income being retained in the estate or used to pay the federal estate tax, but the beneficiaries of the estate being taxable on the income which the Service felt should have been distributed. Recently though the Service, in *Revenue Ruling* 76-23,[98] has indicated that the estate may exist as a separate tax-paying entity during the deferral period. It is noteworthy that the ruling does not qualify this position by requiring a showing of hardship or necessity for the continued use of the election but the ruling really does not speak to the situation where the estate is using section 6166 even though it could pay the rest of the federal estate tax. This presents substantial income splitting possibilities where there is only one beneficiary or where there are only a few beneficiaries and the one beneficiary or the few beneficiaries are in high tax brackets. A primary example would be an only child, or a spouse, who is to receive the business, and who has substantial additional income from other sources. Furthermore, and very importantly, the income tax savings makes available additional funds to retire the still outstanding federal estate tax.

On the other hand, continuation of the business within the estate does deny the eventual distributees the income during the period of administration since income is to be used first to pay debts or charges which include the federal estate tax.[99] However, to the extent that the income is used to pay debts and charges, property which would otherwise abate to pay these debts and charges is available for eventual distribution to the distributee. Thus, the later distribution will include the income and it will not be subject to income tax earned in the estate's prior years. Whether the distributee's total final distributive share is reduced or increased will depend upon whether the increase in his share as eventually distributed due to the application of income to pay the federal estate tax and other costs and charges is more than or less than his

97. Treas. Reg. § 1.641(b)-3(a) (1960). *See also* Doino, *When Does an Estate Terminate for Income Tax Purposes*, PRENTICE-HALL—SUCCESSFUL ESTATE PLANNING IDEAS AND METHODS ¶¶ 16,010, 16,301.

98. Rev. Rul. 76-23, 1976-3 INT. REV. BULL. 13.

99. IOWA CODE §§ 633.351-52, 633.3(4) (1975).

share would have been if the share was subject to abatement plus the income which the distributee could have recieved during the deferral if he would have had possession of the property.[100] Where the distributee's share of the abated property is the same or a similar percentage when compared to his share of the income, the results of the election should result in a greatly increased eventual distribution. Of course, this advantage, which is primarily the savings generated by the existence of the estate as an additional taxpayer, is practical only if there is no great and pressing present need on the part of the distributee for the property and its income.

B. *Interrelation With the Marital Deduction*

In discussing prolonging administration of the estate where there will be a marital deduction, it should be remembered that to the extent income is diverted from the marital share the marital deduction may be subject to reduction.[101] There should be no total loss of the marital deduction unless the will directs the executor to delay distribution beyond the period reasonably required to administer the estate.[102] But to avoid any problems in this area, it is suggested that a marital trust qualifying under section 2056(b) be utilized and that the executor and trustee be identical and that distributions be made to the trust subject to an agreement by the trust to indemnify the estate. Finally, potential problems caused by the marital deduction may be avoided or reduced by judicious selection of assets for the marital share or limited use of the marital deduction.

C. *Fiduciary Fees*

Other practical considerations involve the size and timing of the fees for the attorney and executor. Presumably extraordinary fees could be awarded since there would be services in connection with tax matters and operating the estate's business.[103] Customarily in many estates all or a portion of the fees are paid at or near the closing of the estate, but there appears to be no prohibition against advance payment of fees especially with the likelihood that the estate's administration will be prolonged.

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100. The provisions relating to abatement can be found in *Iowa Code* sections 633.436-37. Section 6166 of the *Internal Revenue Code of 1954* also presents an interesting opportunity to mitigate the sometimes harsh results of the abatement provisions in cases with facts similar to *In re Estate of Noe*, 195 N.W.2d 361 (Iowa 1972), which held that the remainder interest of children who received no other property was subject to abatement. By keeping the estate open and earning sizeable amounts of income the remaindermen have less of the burden and this may prevent the sale or termination of the remainder interest to satisfy the debts and charges.

101. Treas. Reg. § 20.2056(b)-4(a) (1958).

102. Treas. Reg. § 20.2056(b)-5(f)(1) (1958). *See also* Rev. Rul. 76-23, 1976-3 INT. REV. BULL. 13. The ruling would by implication support the position that prolonging estate administration would not cause loss of the marital deduction.

103. IOWA CODE § 633.199 (1975).

IX. Proposed Legislation

This article would be woefully incomplete if some mention were not made of the possible effect of estate tax reform on section 6166. As this article is being written, there are approximately twenty estate tax reform proposals pending in Congress and many of these proposals have as their avowed purpose the preservation of the "small" family farm or business. At least one of these proposals, that advanced by President Ford, appears to use section 6166 as a departure point. His proposal, as reported in one source,[104] would place a five year moratorium on the payment of federal estate tax attributable to a closely held qualifying business, allow payment over the next 20 years at a four percent interest rate beginning after the moratorium, and relieve the executor of personal liability for the nonpayment of the deferred tax. However, the deferral would be available for a business interest worth only $300,000 and the deferral would phase out gradually until there would be no deferral when the closely held interest reached $600,000 in value. Although the cited source had no further details, it can be expected that other restrictions will be placed on the availability of this provision.

The provision relieving the executor of personal liability is an important step and may be the most noteworthy concept of the proposed legislation and should remove much of the current hesitancy about using the existing section 6166. Presumably, there will be some form of transferee liability to take its place. Still, many questions remain. Will the basic provisions of the existing section 6166 be retained, and, assuming the existing statute is retained, how will it be coordinated with new legislation? Will the generosity of a five year moratorium on both the tax and the interest and the twenty years of installments at only four percent be a matter of right? If so, as a practical matter, what qualifying estate would not make the election simply to avail itself of a 25 year loan at an effective interest rate of less than four percent? Will the current withdrawal and disposition provisions be carried over or, possibly, will they be tightened? Will there be a requirement for qualification which will restrict devolution of the business property to family members, and, if so, how narrow will these restrictions be? At the very least, it is safe to say that the results will be interesting if the proposal is adopted in its current form.

X. Conclusion

Section 6166 should not be viewed as presenting only long-term advantages where the prime consideration is preserving the business although this is certainly important. Deferral also has definite short term uses especially where additional time is needed to consummate a sale or secure a loan or provide for an orderly business liquidation. By making the election to pay the federal estate tax over ten years, the executor is gaining additional time to negotiate

104. 7 Prentice-Hall—Successful Estate Planning Ideas and Methods 3 (1976).

and consummate the sale or loan. Once the alternative plan is completed, the estate tax can be paid with the proceeds of the loan, sale or liquidation and the extension can be terminated with no penalty.

The pre-mortem estate planner should be cognizant of the requirements for qualification and the steps that he may take to increase the amount eligible for deferral so that he may properly plan for the use of section 6166. The probate attorney needs to realize the opportunities for use so he may use the deferral in those estates which would profit by its use.

In certain favorable situations where there are very few heirs, all or most of whom stand to profit directly by continuation of the business, consideration should be given not only to using the extension when hardship is present, but also where the business is in need of capital because section 6166 presents the opportunity for a "loan" which must be granted if there is a compliance with the statutory requirements. With the estate as another taxpayer, the income tax savings could exceed the interest on the extension and the heirs as a group would benefit.

But, as this article has sought to explain, section 6166 is not as straightforward as if first appears and should be used only after understanding and appreciating the additional requirements of time and labor and the possibilities of liability for losses. While section 6166 may have a limited applicability, ignoring its existence is overlooking potentially great savings.