

Business Rich, Cash Poor:

Strategies for Dealing with the Estate Tax Before and After Death

Brandon K. Jones
Carruthers & Roth, P.A.
Phone: (336) 478-1160
E-mail: bkj@crlaw.com



1

2

Introduction

- The federal gift and estate tax exclusion amounts for 2022 will (may?) be \$12,060,000 per person, or \$24,120,000 for a married couple
- The owner of even a successful closely held business may face liquidity issues during life - and after death, his or her estate may as well
- Low liquidity can make paying estate tax difficult if sale of the decedent's small business is inadvisable – poor market timing, expectation for the business to remain owned and operated by the family, etc.



2

Pre-Death Planning Strategies for Small Business Owners

- Life Insurance
- Lifetime gifts of business interests
 - Recapitalizations
- Sales to IDGTs (intentionally defective grantor trusts)
- Cash out



3

Section 6166 – Overview

- Important tool for taxable estates that contain significant closely held business interests and are therefore illiquid
- If the estate qualifies, the Section 6166 Election allows the estate to pay a portion of the estate tax in installments over many years
- The amount of the estate tax that can be deferred and paid in installments is only that portion of the tax that is attributable to the decedent's closely held business interest
 - The rest is due and payable as usual



4

Section 6166 – Repayment Period

- Executor can pay the estate tax attributable to the decedent's closely held business interests in up to 10 annual installments
- First installment can be deferred for up to 5 years
 - But interest still due during the deferral period
 - Section 6166(f)(1)



5

Section 6166 – Interest Rates

- “2% Portion”
 - 2% rate for interest payable on the first \$1,000,000 (indexed for inflation - \$1,640,000 in 2022) of taxable value of a closely held business
- Amounts exceeding the “2% portion” bear interest at a rate equal to 45% of the annual underpayment rate under Section 6621(a)(2)
 - *i.e.*, (Federal short-term rate + 3%) x 45%



6

Section 6166 – Eligibility

- Decedent must be a US Citizen or resident alien
- An “interest in a closely held business” exceeds 35% of the decedent’s “adjusted gross estate”
 - Adjusted gross estate = gross estate reduced by Sections 2053 and 2054 deductions
 - Section 2035 applies to prevent deathbed transfers in an attempt to qualify for Section 6166



7

Section 6166 – “Interest in a closely held business”

- **“Interest in a closely held business” – Section 6166(b)(1):**
 - Interest in a sole proprietorship
 - Interest as a partner in a partnership if:
 - Decedent owned 20% or more of the total capital interests; and
 - Partnership has 45 or fewer partners
 - Stock in a corporation if:
 - Decedent owned 20% or more of the value of the voting stock; and
 - Corporation has 45 or fewer shareholders



8

Section 6166 – “Interest in a closely held business”

- To qualify under Section 6166, the business must be an active trade or business
 - Generally determined at the entity level
 - Fact specific analysis
 - Value of passive assets owned by an otherwise active business are disregarded pursuant to Section 6166(b)(9)(B)



9

Section 6166 – “Interest in a closely held business”

- Real estate interests can present close calls
- Revenue Ruling 2006-34 specifically addresses a decedent’s real estate interests under Section 6166
 - Heavy use of independent contractors, such as property management companies, suggests no active trade or business



10

Section 6166 – “Interest in a closely held business”

- Rev. Rul. 2006-34 - Additional factors:
 - The amount of time the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) devoted to the trade or business
 - Whether an office was maintained from which the activities of the decedent, partnership, LLC, or corporation were conducted or coordinated, and whether the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) maintained regular business hours for that purpose
 - The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) was actively involved in finding new tenants and negotiating and executing leases



11

Section 6166 – “Interest in a closely held business”

- Rev. Rul. 2006-34 - Additional factors (continued)
 - The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises
 - The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and
 - The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) handled tenant repair requests and complaints.



12

Section 6166 – “Interest in a closely held business”

- Real Estate Interests
 - Common scenario: Decedent owned both the operating business entity and the business premises



13

Section 6166 – Aggregation of Multiple Businesses

- Interests in two or more closely held businesses are treated as a single closely held business if 20% or more of the value of each business is included in determining the value of the decedent's gross estate – Section 6166(c)
 - *i.e.*, the executor can aggregate multiple small businesses to reach the “35% of adjusted gross estate” threshold, so long as the decedent owned more than 20% of each business



14

Section 6166 – Holding Company Election

- Holding Company Rules – Section 6166(b)(8)
- “Holding company” is any corporation holding stock in another corporation
 - If holding company owns stock in a company that carries on a trade or business, then stock in the holding company is deemed to be stock in the company carrying on the trade or business for Section 6166 purposes



15

Section 6166 – Holding Company Election

- Executor must make an affirmative election to take advantage of holding company rules
- Benefit: Stock owned by the holding company would otherwise be considered a passive asset under Section 6166(b)(9)(B) and ineligible for Section 6166 installment treatment
- Downsides: 1) 2% interest rate not available; and 2) payments cannot be deferred for 5 years
 - Holding Company Election applies to all Section 6166 property



16

Section 6166 – Making the Election

- Section 6166 election must be made no later than due date of the estate tax return
- Among other things, election must include:
 - Amount of tax to be paid in installments
 - Date selected for first payment
 - Number of annual installments
 - Identity of closely held business property
 - Facts that formed the basis for the executor's conclusion that the estate qualified for Section 6166



17

Section 6166 – Making the Election

- Declaratory judgment can be filed in US Tax Court to determine initial and continuing eligibility for Section 6166 treatment (Section 7479)
 - Must first exhaust administrative remedies
 - Exhaustion requirement satisfied if IRS fails to act within 180 days of request for a determination



18

Section 6166 – Bonds and Liens

- General, automatic 10-year lien on estate assets – Section 6324
- If Section 6166 Election is made, IRS may also require the estate to provide a bond under Section 6165
 - Must be determined on a case-by-case basis
 - Bond can up to twice the amount of the deferred tax
- In lieu of bond, the executor can agree to a special lien under Section 6324A



19

Section 6166 – Acceleration

- Full amount of deferred tax can be accelerated and become due and payable under a variety of circumstances, including:
 - Disposition of the closely held business interest
 - Failure to timely pay installments
 - Failure to apply undistributed net income of the estate to deferred tax liability



20

Section 6166 – Acceleration: Disposition of Interests

- Section 6166(g)(1) - Acceleration of tax is triggered if:
 - any portion of an interest in a closely held business is distributed, sold, exchanged, or otherwise disposed of, or
 - money and other property attributable to such an interest is withdrawn from such trade or business, and
 - the aggregate of such distributions, sales, exchanges, or other dispositions and withdrawals equals or exceeds 50 percent of the value of such interest
- If decedent owned multiple small businesses, their values are aggregated for the purposes of this rule. 26 CFR 20.6166A-3(e)(6), Example 1



21

Section 6166 – Acceleration: Disposition of Interests

- Exceptions to acceleration under Section 6166(g)(1)
 - Distributions of post-death income earned by the company do not trigger acceleration. 26 CFR 20.6166A-3(d)(1) and 26 CFR 20.2032-2(d); PLR 200043031



22

Section 6166 – Acceleration: Disposition of Interests

- Exceptions to acceleration under Section 6166(g)(1)
 - Transfers to beneficiaries pursuant to the estate plan - 6166(g)(1)(D)
 - Acceleration rule “does not apply to a 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, the applicable law of descent and distribution, or a trust created by the decedent.”
 - If a beneficiary subsequently dies, acceleration will not be triggered if the business interest is transferred pursuant to that person’s estate plan (provided the subsequent beneficiary is a family member)



23

Section 6166 – Acceleration: Disposition of Interests

- Exceptions to acceleration under Section 6166(g)(1)
 - Prohibited “distribution, sale, exchange, or disposition” of interests generally does not include reorganizations or transactions that “are mere changes in form” - 26 CFR § 20.6166A-3(e)(2)
 - Regulations specifically exclude:
 - Section 351 tax-free exchanges
 - Types D, E, and F reorganizations under Section 368
 - Section 355 spinoffs



24

Section 6166 – Acceleration: Failure to Pay Installments

- Failure to timely pay an installment also triggers acceleration
- 6-month grace period under Section 6166(g)(3)(B) – but 5% penalty per month on unpaid payment



25

Section 6166 – Acceleration: Failure to Pay Undistributed Income

- Estate must also apply all of its undistributed net income each year to the deferred tax – failure to do so triggers acceleration



26

Section 6166 – Planning Considerations

- Section 6166 rules are complex, so work closely with advisors to ensure businesses are structured in a way to take advantage of the Section 6166 deferral opportunity
- When making lifetime gifting decisions:
 - Ensure that the aggregate value of closely held business interests will continue to make up more than 35% of adjusted gross estate
 - Consider making gifts of interests that are unlikely or less likely to qualify for Section 6166 deferral – *i.e.*, passive or investment activities – rather than those interests that are more certain to qualify
 - Retain ownership of at least 20% of the value of each individual business so they each qualify and can be aggregated



27

Graegin Loans

- Estate of Graegin v. Commissioner, T.C. Memo 1988-477
- Estate borrows cash to pay the estate tax from the decedent's closely held business, a related entity, or a third-party



28

Graegin Loans

- Two primary benefits if done properly:
 - Liquidity to finance the estate tax and defer cash payments
 - Interest over the term of the loan can be deducted under Section 2053, thereby reducing the overall estate tax liability



29

Graegin Loans

- To qualify for interest deduction, must comply with Section 2053, regulations, and case law:
 - Loan must be “actually and necessarily” incurred in the administration of the estate
 - This requirement is satisfied if the estate is illiquid and borrowing money is necessary to avoid a forced sale
 - Loan must be bona fide
 - Estimated interest is 1) ascertainable with reasonable certainty; and 2) certain to be paid



30

Graegin Loans

- To ensure eligibility for deduction, the promissory note should:
 - Have a fixed interest rate
 - Prohibit prepayment
 - Accelerate the total amount of interest that would have been paid upon default
- Section 2053 deduction is allowed only for the portion of the interest attributable to the illiquid asset(s)



31

Section 6161 Extension

- Section 6161(a)(2) gives the IRS the authority to extend the due date of the estate tax by up to 10 years
- Taxpayer bears the burden of proof to show “reasonable cause”



32

Section 6161 Extension – Reasonable Cause

- Regulations provide four examples of “reasonable cause” justifying a Section 6161 extension:
 1. An estate includes sufficient liquid assets to pay the estate tax when otherwise due. The liquid assets, however, are located in several jurisdictions and are not immediately subject to the control of the executor. Consequently, such assets cannot readily be marshaled by the executor, even with the exercise of due diligence.



33

Section 6161 Extension – Reasonable Cause

- Regulations provide examples of “reasonable cause” justifying a Section 6161 extension:
 2. An estate is comprised in substantial part of assets consisting of rights to receive payments in the future (i.e., annuities, copyright royalties, contingent fees, or accounts receivable). These assets provide insufficient present cash with which to pay the estate tax when otherwise due and the estate cannot borrow against these assets except upon terms which would inflict loss upon the estate.



34

Section 6161 Extension – Reasonable Cause

- Regulations provide examples of “reasonable cause” justifying a Section 6161 extension:
 3. An estate includes a claim to substantial assets which cannot be collected without litigation. Consequently, the size of the gross estate is unascertainable as of the time the tax is otherwise due.



35

Section 6161 Extension – Reasonable Cause

- Regulations provide examples of “reasonable cause” justifying a Section 6161 extension:
 4. An estate does not have sufficient funds (without borrowing at a rate of interest higher than that generally available) with which to pay the entire estate tax when otherwise due, to provide a reasonable allowance during the remaining period of administration of the estate for the decedent's widow and dependent children, and to satisfy claims against the estate that are due and payable. Furthermore, the executor has made a reasonable effort to convert assets in his possession (other than an interest in a closely held business to which section 6166 applies) into cash.



36

Section 6161 Extension

- IRS has discretion to grant or deny a Section 6161 extension, but denial can be reversed by a court if the IRS's decision was "arbitrary and capricious"



37

Section 6161 Extension - Application

- Application for extension must be made before the estate tax due date.
- Application must:
 - Be in writing
 - Stat the period for which the extension is requested
 - Include a declaration that it is made under penalty of perjury; and
 - Be supported by evidence showing the reasonable cause



38

Section 6161 Extension

- If the extension is granted, the IRS may require a bond
- Interest rate at the federal short-term rate plus 3% must be paid throughout the term of the extension
 - But interest is deductible under Section 2053



39

Section 303 Redemption

- If estate qualifies, in general, distributions in redemption of a deceased shareholder's stock are treated as a capital transaction, not a dividend
 - Due to basis step-up, result is often little no tax



40

Section 303 Redemption - Eligibility

- Estate Eligibility – Similar to Section 6166
 - The value of the decedent's stock included in his or her gross estate must exceed 35% of the value of the decedent's adjusted gross estate – Section 303(b)(2)
 - Stock in two or more corporations can be aggregated if decedent owned more than 20% of each



41

Section 303 Redemption – Limitation on Amount

- Distribution amount that qualifies for favorable tax treatment under Section 303 limited to the sum of:
 - estate, inheritance, legacy, and succession taxes; and
 - the amount of funeral and administration expenses allowable as deductions to the estate under section 2053



42

Section 303 Redemption – Timing

- Redemption must occur:
 - Three years and 90 days from the due date of the federal estate tax return; or
 - 60 days after a tax court decision in an estate tax liability contest has become final; or
 - If a Section 6166 election has been made, the time permitted for the payment of estate tax installments.



43

Section 303 Redemption

- Even if estate otherwise has liquidity to pay the estate tax, a Section 303 redemption can be a great, tax-efficient opportunity to get cash out of the business



44