



# WRMarketplace

An AALU Washington Report

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**TOPIC: The §6166 Estate Tax Deferral for Closely Held Business: Q&As.**

**MARKET TREND:** For many business owners, their business interests are their biggest asset, which necessitates careful planning to preserve the business while managing the potential estate exposure.

**SYNOPSIS:** Internal Revenue Code (“Code”) §6166 is an estate tax deferral provision for estates of decedents holding concentrated positions in qualifying closely held business interests. The Code §6166 permits payment of the estate taxes attributable to those business interests over a maximum 14 year-period, with interest potentially lower than commercially available rates. Yet attaining the benefits of this deferral requires the satisfaction of strict eligibility standards and significant post-election administration. Failure to comply can result in termination of the election and acceleration of the entire deferred liability. In addition, the election does not minimize the estate’s overall tax liability nor defer the taxes associated with non-business assets.

**TAKE AWAYS:** In business succession planning, a §6166 deferral election may provide a powerful post-mortem planning tool to help minimize the initial strain on the estate and prevent a forced sale of the estate’s business interest. However, the election’s complex administrative and compliance requirements and the potential for payment acceleration make it an insufficient substitute for lifetime succession planning. Other planning options, such as life insurance, which can be used instead of, or in conjunction with, a contemplated §6166 election, may offer a

simpler and more certain approach to the funding of both business and non-business estate tax liabilities.

Many closely-held business owners have their net worth concentrated in their business, but they may fail to plan for the transition of that business at death, potentially leaving their estates and families unprepared and scrambling to find resources to pay expenses and potential estate tax liabilities. Identifying methods to manage the estate tax payment without jeopardizing the business or forcing the liquidation of estate assets becomes critical in these cases. Under the right circumstances, a Code §6166 deferral election may provide a solution.

### **WHAT IS A §6166 ELECTION?**

Code §6166 is an estate tax deferral provision for estates of decedents holding concentrated positions in qualifying closely held business interests (i.e., over 35% of the estate). Making an election under Code §6166 (“**§6166 election**”) permits payment of the estate tax liability attributable to those business interests over a maximum 14-year period.<sup>1</sup>

### **WHY MAKE THE ELECTION?**

In the absence of lifetime planning to address the succession and estate tax liability of a closely held business, the §6166 election can help minimize the initial strain on the estate and offer time to generate liquidity for the estate tax payment. Contemplating the proposed deferral of estate taxes also may make sense when crafting the lifetime business succession plan, as there is a time value to money, particularly if the deferral comes at interest rates that are lower than those commercially-available (as discussed below). The estate may have the opportunity to earn more on its assets than the interest accrued on the deferred tax.

### **WHO CAN MAKE THE ELECTION?**

The election is available to an estate of a decedent who was a U.S. citizen or resident<sup>2</sup> and held interests in a closely-held business, the value of which exceeds 35% of the decedent’s adjusted gross estate (“**35% threshold**”). The estate executor must make the election on a timely-filed federal estate tax return.

- **Qualifying Business Interests.** An interest in a “closely held business” (“**CHB**”) is an interest in: (1) a sole proprietorship; (2) a partnership if at least 20% of the total capital interest of the partnership is included in the decedent’s gross estate or there are no more than 45 partners; or (3) a corporation if at least 20% of the value of the corporation’s voting stock is included in the decedent’s gross estate or there are no more than 45 shareholders. Various attribution rules and elections apply in meeting these ownership tests.<sup>3</sup> The CHB also must carry on an “active” trade or business.<sup>4</sup> The IRS has interpreted this requirement as intended to apply to businesses such as manufacturing, mercantile, or service enterprises, which conduct an active business, rather than being a passive owner of investment assets. Certain qualified lending and financial businesses also qualify as “active businesses.”

- **35% Threshold.** The value of the decedent’s qualifying CHB interests must exceed 35% of the adjusted gross estate (“**AGE**”).<sup>5</sup> The AGE is the gross estate reduced by deductions for administration and funeral expenses, claims, mortgages, and casualty losses (“**administrative deductions**”).<sup>6</sup>

*Example 1:* Zac is a founder of Z Co., an operating CHB. He is a widower who passed away in July 2019 with a gross estate valued at \$30 million and an interest in Z Co. valued at \$10 million. If the estate’s administrative deductions are \$800,000, the AGE is \$29.2 million. Zac’s estate cannot make the §6166 election because his Z Co. interest represents only 34.2% of the AGE. If the administrative deductions are \$1.45 million, however, the Z Co. interest makes up 35% of the AGE, permitting the estate to make the §6166 election.

Valuation of the CHB interest, however, must exclude a proportionate value of any “passive assets” owned by the business, meaning any asset not used in carrying on the trade or business.<sup>7</sup>

### **HOW MUCH TAX CAN BE DEFERRED?**

The maximum amount of estate tax eligible for deferral (the “**§6166 liability**”) depends on the ratio that the value of the CHB interest bears to the value of the AGE.

*Example 2:* Assume similar facts from Example 1, except that Zac’s Z Co. interest is worth \$20 million, the AGE is \$28.55 million, and the federal estate tax due on Zac’s estate is \$6.86 million. The maximum §6166 liability that Zac’s estate can defer under a §6166 election is \$4,805,604 ( $\$6.86 \text{ million estate tax} \times (\$20 \text{ million CHB} / \$28.55 \text{ million AGE})$ ).

### **HOW LONG IS THE DEFERRAL?**

The maximum deferral period is 14 years, although interest is payable annually during that time. Generally, principal payments on the §6166 liability may be initially deferred for up to five years and then paid in equal annual installments for two to ten years. The first principal installment must be paid no later than the fifth anniversary of the original estate tax due date.

*Example 3:* Using facts from Example 2 and assuming Zac’s estate elects the maximum §6166 deferral, it would only pay interest on the §6166 liability in years 1-4. It would make the first of 10 annual principal installments of \$480,560 ( $\$6166 \text{ liability of } \$4,805,604 / 10 \text{ years}$ ), plus interest, in year 5, with the final installment due in year 14.

## WHAT IS THE INTEREST ON DEFERRAL?

Two separate interest rates may apply to the §6166 liability:

- **2% portion.** A 2% interest rate applies to the “2% portion” of the §6166 liability, which equals the lesser of: (1) the full amount of the estate tax attributable to the CHB; or (2) the product of the inflation-adjusted taxable value set by Code §6166 for the year of the decedent’s death multiplied by the estate tax rate. For 2019, the maximum 2% portion is **\$620,000**.<sup>8</sup>
- **Remaining §6166 Liability.** Interest equal to 45% of the regular federal underpayment rate accrues on the §6166 liability in excess of the 2% portion (“**§6166 balance**”).<sup>9</sup> This rate varies with the quarterly adjustment of the federal underpayments rate. For the third quarter of 2019, the rate applicable to the §6166 balance is 2.25%.<sup>10</sup>

When the deferred §6166 liability exceeds the 2% portion, principal installments are prorated between the 2% portion and the §6166 balance for purposes of the interest computation.<sup>11</sup>

*Example 4:* Assume the same facts as Example 3 and that, for the entire §6166 deferral period for Zac’s estate, a 2.25% interest rate applies to the §6166 balance. The initial 2% portion of the §6166 liability is \$620,000, and the §6166 balance is \$4,185,604 (§6166 liability of \$4,805,604 - \$620,000). In years 1 through 5, Zac’s estate makes annual interest payments of \$107,765 (\$12,524 on the 2% portion and \$95,241 on the §6166 balance).

Beginning in year 5, when the estate pays its first principal installment of \$480,560, and with each principal payment thereafter, the 2% portion is reduced by \$62,000 and the §6166 balance by \$418,560, with the applicable interest determined accordingly. Upon full payment in year 14, Zac’s estate will have paid \$1,023,766 in interest on the deferred §6166 liability of \$4,805,604.

## IS SECURITY REQUIRED?

The IRS may require security for a §6166 deferral through the estate’s provision of a surety bond or the grant to the IRS of a special lien on the affected business property. Notice 2007-90 sets out a list of non-exclusive factors that the IRS will consider, which include the duration and stability of business, the ability to timely pay installments of the tax and interest, and the business’s compliance history.

## WHAT ARE SOME OF THE CHALLENGES?

**Complexity.** Even a basic overview of the Code §6166 rules illustrates the complexity associated with making the election. For example, what type and level of activity is required to qualify as an active CHB? What is considered a “passive asset?” CHBs invested in real estate or rental properties in particular face these issues.<sup>12</sup> Also, as noted, additional requirements and limitations apply when determining whether holding companies will qualify as CHBs under §6166.

Apart from the eligibility requirements, successful §6166 deferrals require significant post-election administration, including calculating the interest payments; ensuring proper proration, as needed, of the principal installments between the 2% portion and the §6166 balance; tracking and ensuring timely payment of the interest and installment payments, etc. There are costs associated with this administration, and failure to comply can result in termination of the election and acceleration of the full §6166 liability, as discussed below.

Added complications can arise based on the IRS security requirements for the deferral. Surety bonds may not be feasible due to cost; however, the provision of a special IRS lien may limit the ability to obtain commercial loans and/or violate existing business or lending agreements.

**Potential Acceleration.** The §6166 deferral terminates if any portion of the CHB interest is distributed, sold, exchanged, or otherwise disposed of, or assets attributable to the interest are withdrawn from the business, and the aggregate of such dispositions and withdrawals equals or exceeds 50% of the interest's value.<sup>13</sup> Any unpaid portion of the §6166 liability becomes payable in full upon IRS notice and demand.

Late or non-payment of any interest or installment payment (subject to a six-month grace period)<sup>14</sup> also can terminate the deferral, again triggering full payment of the outstanding §6166 liability upon IRS notice and demand.

If the estate has undistributed net income for any taxable year on or after the first installment payment is due (e.g., after the fourth year), the executor must make a payment of that undistributed net income towards the §6166 liability.<sup>15</sup>

**Exit Plan Required.** The §6166 election does not minimize the estate tax liability. Any potential savings associated with the election arise only from the deferral of payments and the application of comparatively low interest rates on the deferred liability. Accordingly, the estate must still ensure it will have funding to make the payments on the liability as they come due.

**No Interest Deduction.** The interest paid on the §6166 liability is not deductible for either income tax or estate tax purposes. This factor should be considered when comparing a §6166 election versus financing the liability through a commercial loan, which may require a higher rate but may produce an interest deduction.

**Other Liquidity Needs.** The §6166 deferral only applies to the estate tax liability associated with the CHB. Liquidity may still be needed to address the estate's remaining estate tax liability and administrative expenses.

### **WHAT ABOUT SIMPLER OPTIONS?**

The §6166 election can offer a powerful post-mortem planning option for estates holding qualifying CHB interests, particularly if the business owner is uninsurable, but rarely will it be a sufficient substitute for lifetime business succession planning given its compliance and administrative complexities and other limitations. Advanced planning that proactively prepares

for transition of the business and addresses the potential estate tax liability will generally be the best solution for minimizing confusion, conflict, and the possible loss of a business after a key owner's death. Implementing buy-sell arrangements or using lifetime gift or sale strategies to transfer business interest out of the estate to intended successor family members can help manage the estate tax concerns.

In terms of simplicity, however, acquiring life insurance is one of the most straightforward ways to address estate liquidity needs. It can provide readily-available cash for estate taxes and other expenses promptly after the insured's death, without the qualification and administrative complexities associated with a §6166 deferral. The policy death benefits should be paid without income tax, and if held in an irrevocable trust, should not be includible in the decedent's estate. Depending on the product and premium costs, life insurance may be more cost-effective than a §6166 election, or coverage could be acquired in conjunction with a contemplated §6166 election to support payment of the non-deferred estate tax liability and/or as a future funding source for the deferred taxes.

### **TAKE AWAYS**

In business succession planning, a §6166 election may provide a powerful post-mortem planning tool to help minimize the initial strain on the estate and prevent a forced sale of the estate's business interest. However, the election's complex administrative and compliance requirements and the potential for payment acceleration make it an insufficient substitute for lifetime succession planning. Other planning options, such as life insurance, which can be used instead of, or in conjunction with, a contemplated §6166 election, may offer a simpler and more certain approach to the funding of both business and non-business estate tax liabilities.

### **NOTES**

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<sup>1</sup> To the extent that an interest in a closely held business is the subject of a direct skip for generation-skipping transfer ("GST") tax purposes, which occurs at the same time as and as a result of the decedent's death, then any GST tax imposed on the transfer of such interest is deferred as part of the estate tax under Code §6166.

<sup>2</sup> Citizenship or residency status is determined for U.S. estate tax purposes as of the date of death.

<sup>3</sup> For example, for purposes of determining the number of partners or shareholders in a CHB, stock or partnership interests held by a husband and wife as community property, joint tenants, tenants by the entirety, or tenants in common are treated as owned by a single person, and interests held by the decedent or by any member of the decedent's family (within the meaning of Code §267(c)(4)) are treated as owned by the decedent (Code §6166(b)(2)). For purposes of meeting the 20% ownership tests, the executor can elect to include as part of the decedent's gross estate any CHB interests held indirectly by the decedent or held by members of the decedent's family as if they were part of the decedent's gross estate; provided that, if the executor makes that election, the estate waives the benefit of the initial 5-year deferral period for principal payments and application of the 2% interest rate on the "2% portion" of the deferred tax amount (discussed later herein) (Code §6166(b)(7)).

<sup>4</sup> An exception applies for certain personal holding companies meeting specified requirements, although if elected, certain deferral benefits will not apply. See Code §6166(b)(8).

<sup>5</sup> For purposes of the 35% threshold, interests in two or more CHBs, if there is included in determining the value of the decedent's gross estate 20% or more of the total value of each such CHB, shall be treated as an interest in a single CHB. In calculating the 20% inclusion requirement, an interest in a CHB which represents the surviving spouse's

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interest in property held by the decedent and the surviving spouse as community property, joint tenants, tenants by the entirety, or tenants in common shall be treated as having been included in determining the value of the decedent's gross estate. See Code §6166(c).

<sup>6</sup> Generally, the deductions permitted under Code §§2053 and 2054. See Code §6166(b)(6).

<sup>7</sup> Code §6166(b)(9). These are some exceptions for stock held in "active" corporations. Note also, that, in connection with meeting the 35% threshold, Code §6166(k)(5) and §2035(c)(2) provide that the estate exceeds the 35% threshold test only if it meets the threshold by determining the AGE both with and without regard to property included in the gross estate under Code §2035 (e.g., gifts made within three years of death that would have been included in the decedent's estate under Code §§2036, 2037, 2038, or 2042 ("string provisions") if the transferred property (or a relinquished power therein) had been retained by the decedent at death).

<sup>8</sup> See Code §6601(j); Rev. Proc. 2018-57. For 2019, the indexed amount is \$1.55 million (x 40% = \$620,000).

<sup>9</sup> Code §6601(j)(1)(B) and §6621(b).

<sup>10</sup> Based on a federal underpayment rate of 5%.

<sup>11</sup> Code §6601(j)(4). Such payments are treated as reducing the 2% portion by an amount which bears the same ratio to the amount of such payment as the amount of the 2% portion (determined without regard to proration) bears to the total §6166 liability. Interest compounds daily for both rates.

<sup>12</sup> See e.g., Rev. Rul. 2006-34. For such businesses, the IRS looks at all the facts and circumstances, including the non-exclusive list of factors provided in Rev. Rul. 2006-34 (e.g., time devoted to management, whether a separate office was maintained, etc.).

<sup>13</sup> Code §6166(g)(1). The 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. A similar rule applies in the case of a series of subsequent transfers of the property by reason of death so long as each transfer is to a member of the family of the transferor (within the meaning of Code §267(c)(4)). Special rules also apply for a distribution in redemption of stock qualifying under Code §303, which provides for treatment of qualifying redemptions of corporate stock from a decedent's estate as a sale or exchange of the stock redeemed, rather than as a dividend distribution. A full discussion of the interaction of Code §6166 and §303 is beyond the scope of this report.

<sup>14</sup> Code §6166(g)(3). For payments within the grace period, the 2% interest rate will no longer apply to that payment, and it will be subject to penalties.

<sup>15</sup> The payment will apply to reduce each remaining installment payment equally.