

BORROWING TO PAY ESTATE TAX

What to Do When There's Not Enough Bucks to Take Care of the Financial Damage

presented
at the

**34TH ANNUAL
NOTRE DAME TAX &
ESTATE PLANNING INSTITUTE**

September 25, 2008

Louis S. Harrison
312-332-5440
lharrison@harrisonheld.com

1. Why the Issue?

First, insurance is not the panacea to "replace estate taxes" or to "provide liquidity" when an estate has fully marketable assets. An estate that has readily marketable assets does not need liquidity to pay estate taxes.¹

However, estates with closely held businesses, family limited partnership, or commercial real estate (and occasionally, very expensive residential real estate), often run into issues of how to pay the estate tax within 9 months of passing.² And in those instances, insurance is not always available or purchased to provide the liquidity.

Example: Rebecca, aged 75, a surviving spouse, passes away with the following assets:

1. *\$4 million in limited partnership interests, with a discounted value of \$3 million.*
2. *A residence worth \$1.5 million.*
3. *Marketable assets worth \$2 million.*

The total assets are worth, for gross estate tax purposes, \$6.5 million. Rebecca dies in a State that taxes assets at a marginal rate of 9.09%, so that the overall estate tax rate is 50% (e.g., federal rate of 45% + marginal state death rate of 9.09%, less value of the deduction for state taxes, $9.09\% \times .45$). After taking out the credit equivalent amount, the estate taxes are approximately 2.75m.

The marketable assets \$2 million, can pay part of this tax, but if the residence is not sold shortly after death, the estate needs to find another .75m in liquidity to pay the estate taxes. Should the family limited partnership be tapped? If not, a third party loan, from either an individual like a beneficiary, or a financial institution, could be considered. Or perhaps a request to defer estate taxes under 6161 should be made?

The primary decisions are which of four methods-- internal financing, third party financing, discretionarily allowed extension under Code section 6161, or mandatory extension under Code section 6166 -- the estate could or should use to pay estate taxes when there is insufficient readily available liquidity within 9 months of passing.

This is further made difficult by illiquidity caused by the family partnership, which could create section 2036 concerns for the estate, as discussed below.

The outline discusses principles and decisions as to which source to look for in the payment of estate taxes; and after this discussion, proposes heuristics as to whether third party financing or section 6166 (if available) should be used and under which circumstances.³

¹ And insurance companies are not eleemosynary institutions, meaning that there really is no replacement of the estate tax without incurring substantial financial cost.

² As we know, the estate tax is due 9 months after date of passing, with possible extensions of time to pay the estate tax pass this date, as discussed in this outline.

³ Heuristics, or rules of thumb, are interesting parts of an estate planning practice: as decisions become more complex, and in many matters, almost beyond the comprehension and attention by clients, planners often approach clients with the "desired" decision, for clients to consider. Importantly, the planner has to have this desired decision prior to discussion. Hence, heuristics in our field play an important part in any complicated decision-making process that confronts clients in the estate administration front.

2. Amounts Necessary to Require Filing

With all new estate administration matters, the practitioner needs to make an initial determination as to whether an estate tax return will be required to be filed. The heuristic on this determination, under current law, is that if the “gross estate” is less than \$2 million, an estate tax return is not required. However, this heuristic is over-simplified. The practitioner should focus on three variables that complicate this rule of thumb:

1. Congress is constantly fiddling with this threshold amount, and it is scheduled to increase to \$3.5 million in year 2009.

2. The term “gross estate” is a tax term defined by the Internal Revenue Code that is not tied directly to probate matters and is much more expansive than one would think. Many assets that one unfamiliar with the estate tax return may think are not subject to estate tax may, in fact, be subject (*e.g.*, insurance, retained fiduciary appointments under Code section 2036, joint interests). Therefore, a careful review of a client’s financial portfolio is necessary.

3. Lifetime taxable gifts, those using unified credit (also known as the “applicable credit amount”), reduce the threshold amount noted in the first paragraph. For example, a gross estate of \$10,000 may still require the filing of the estate tax return if the client has made lifetime taxable gifts of \$2 million or more.

The specific rule is that for estates of decedents dying during or after 2008, an estate tax return is required only if the gross estate plus adjusted taxable gifts exceeds the “applicable exclusion amount” since a credit of the “applicable credit amount” is allowed to the estate of every decedent against the tax imposed by Code section 2001. Code §2010. The applicable exclusion amounts and applicable credit amounts for 2008 and subsequent years are as follows:

2008	\$2,000,000
2009	\$3,500,000
2010	N/A
2011 and thereafter	\$1,000,000

3. Due Dates for the Return

A crucial date for the practitioner is the estate tax return filing date. Ticklers should be placed in the file from the onset, and the practitioner should always remember that the estate tax return must be filed and the tax paid within nine months after the date of the decedent’s death. Code §6075(a). The exact due date is the day of the ninth calendar month after death numerically corresponding to the day of the calendar month on which death occurred, modified by the following two exceptions:

1. If there is no numerically corresponding day in the ninth month, the due date is the last day of the month. For example, say the decedent dies on May 31. The ninth calendar month thereafter is February, which typically has only 28 days. The due date would be, therefore, the last day of February. Treas.Reg. §20.6075-1.

2. If the due date falls on a Saturday, Sunday, or legal holiday, the next day that is not a Saturday, Sunday, or legal holiday is the due date. *Id.* For example, if the decedent died May 7, 2008, the return would be due February 9, 2009.

Either the filing date, the payment date, or both may be extended, in which case the due date is the last day covered by the extension. Granting an extension for filing is now mandatory if it is applied for before the return due date. The request must be filed before the expiration of nine months after the date of death. The automatic extension now allowed to file the return may not be more than six months. Treas.Reg. §20.6081-1(b). The regulations do not allow the district director to grant an additional extension of time for filing the return beyond the six months (except in the case of taxpayers who are abroad).

However, an extension of the date for filing does not extend the due date for tax payment. Code §6151(a). From a practical standpoint, this means that in most circumstances both filing and payment will occur on the required date. Unlike an income tax return, for which extension is quite common, an extension on the filing of an estate tax return should be treated as an unusual circumstance and is to be avoided. The practical effect of extending the filing and not the payment is that penalties for late filing will not occur. However, there are still penalties, .005 percent of the tax due per month, for the underpayment of the estate tax due as of the required payment date.

4. Due Dates for Payment

The estate tax is due within nine months from death, except if an extension of time to pay is received (discretionarily under Code section 6161 or pursuant to an election to pay the estate tax in installments under Code section 6166, discussed below).

Payment, as a practical matter, should not occur much before the required payment date. No discount is granted for an advance payment. Hence, payment early is in effect an interest-free loan to the government. At a six-percent earnings rate, the payment one month early of \$1,000,000 costs the estate \$5,000 in lost interest. It is advisable, however, to be ready for payment and perhaps even file and pay one day early, in case there are mishaps with the filing or payment, thereby allowing the executor another day to correct them and still allow for a timely filing.

5. Where To File and What Is Considered Timely

As of January 1, 2002, a new procedure was implemented for filing estate tax returns. Before that date, the filing location was based on where a decedent was domiciled at date of death. Now, all returns are filed in Cincinnati, in an effort by the Service to consolidate the filing and review process. The actual filing address for U.S. citizens is Internal Revenue Service Center, Cincinnati, OH 45999 or by private delivery to Internal Revenue Service Center, 201 W. Rivercenter Blvd., Covington, KY 41011 (see Instructions for IRS Form 706 p. 2, Section E). The practitioner should use certified mail or private couriers approved by the IRS, *e.g.*, Airborne Express, DHL, FedEx, and UPS.

The nonresident U.S. citizen filing address is Philadelphia, PA 19255.

The general rule is that as long as the return is sent on the due date, it is considered a timely filed return. However, unlike income tax returns, there is not yet a matching computer program to record the date of mailing with the timely receipt, meaning that a late filing penalty notice can inadvertently, and erroneously, be caused by mailing the check on the date the return is due.

The check should be made payable to the United States Treasury for the full amount of tax shown due on the return. The decedent's name and social security number and the comment, "Form 706," as well as, for pragmatic reasons primarily, the date of death should all be written on the check. Other forms of payment are possible, though unusual. As for the old practice of, occasionally paying the estate tax with

Treasury bonds at par, no such “flower” bonds exist any longer (they should have “flowered” by, at the latest, 2001) and therefore this practice is no longer relevant to the practitioner.

6. How To File

Typical practice is to make complete copy sets with receipts for the executor post-filing and at least two file copy sets (useful for a variety of reasons to the practitioner post-filing, including funding and distribution and investment issues). If the return is filed in person or by messenger (now unusual), the Service should be asked to stamp a copy of the check for the payment and the copy of the return with the Service receipt. If the return is filed by mail, written proof of the mailing date and receipt of the return and payment should be obtained.

7. Discretionary Extension of Time to Pay Estate Tax Extension of Payment Due Date for Reasonable Cause

The estate tax is due within nine months from the date of the filing of the return unless an extension of time to pay is received (discretionarily under Code section 6161 or pursuant to an election to pay the estate tax in installments under Code section 6166 discussed below).

Code section 6161(a)(2) authorizes the Secretary to extend “for reasonable cause” the time for payment of the federal estate tax (or any installment under Code section 6166) for a reasonable period not exceeding ten years from the date the tax was due.

Specifically, the regulations provide that if there is “reasonable cause” the time period for filing may be extended up to 12 months. Treas. Reg. §20.6161-1(a)(1). If, in addition to “reasonable cause” there is a showing of “undue hardship” the time period for filing may be extended up to 10 years. Treas. Reg. §20.6161-1(a)(2). The instructions to the 706 provide, importantly, that even with a showing of “undue hardship” the extensions may be granted “for 1 year at a time.”⁴

Under Treasury Regulation section 20.6161-1, reasonable cause is illustrated by the following cases: the pertinence of and comments to these reasons by the author are noted in caps and brackets:

Example (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. [EDITORIAL COMMENT: NOT LIKELY TO ARISE EXCEPT IN RARE CIRCUMSTANCES.]

Example (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. [EDITORIAL COMMENT: NOT LIKELY TO ARISE EXCEPT IN RARE CIRCUMSTANCES.]

Example (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. [EDITORIAL COMMENT: NOT LIKELY TO ARISE EXCEPT IN RARE CIRCUMSTANCES.]

⁴ Extensions for deficiency payments can also be extended for up to 4 years with a showing of undue hardship. Treas. Reg. §20.6161-2.

Example (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. [EDITORIAL COMMENT: THE PHRASE "WITHOUT BORROWING AT A RATE OF INTEREST HIGHER THAN THAT GENERALLY AVAILABLE" SEEMS TO TAKE MOST CASES OUT OF THIS EXAMPLE.]

As none of the above examples are pertinent to modern economic situations facing an estate, the executor should develop another rationale as to why "it is impossible or impractical for the executor to pay the full amount of the estate by the estate tax return due date" (language from the 706 Instructions). Strategies that should satisfy this standard include (1) pending Will or Trust contests, (2) construction actions, (3) illiquidity and inability to generate cash from illiquid assets, and (4) among the more novel theories, litigation or indecision between two or more executors in determining which assets to use or how to pay the estate tax.

To extend the period beyond 1 year, the estate must show "undue hardship." The term "undue hardship" means more than an inconvenience to the estate.

According to the regulations, "[a] sale of property at a price equal to its current fair market value, where a market exists, is not ordinarily considered as resulting in an undue hardship to the estate." The negative implication is that a sale at less than fair market value should show undue hardship.

The regulations contain the following examples:

Example (1). A farm (or other closely held business) comprises a significant portion of an estate, but the percentage requirements of section 6166(a) (relating to an extension where the estate includes a closely held business) are not satisfied and, therefore, that section does not apply. Sufficient funds for the payment of the estate tax when otherwise due are not readily available. The farm (or closely held business) could be sold to unrelated persons at a price equal to its fair market value, but the executor seeks an extension of time to facilitate the raising of funds from other sources for the payment of the estate tax.

Example (2). The assets in the gross estate which must be liquidated to pay the estate tax can only be sold at a sacrifice price or in a depressed market if the tax is to be paid when otherwise due."

Example 2, relating to illiquidity, is in the current economic environment the one that will most likely be used.

If the request is granted, the estate tax due carries with it interest. See Tech.Adv.Mem. 9241002 (July 23, 1992); Rev.Proc. 81-27, 1981-2 Cum.Bull. 548; Rev.Rul. 80-250, 1980-2 Cum.Bull. 278). This rate, after the application of the deduction, is often still at a rate greater than that on T-bills. Therefore, there is a risk to the executor that the estate assets have to earn or increase in value greater than the interest charge or the estate will be financially harmed by the extension. Further, unlike section 6166, the interest should be a deduction against the estate tax, whereas the 6166 interest rate is reduced to .45 of the required rate. The current highest marginal estate tax rate is 45 %. As a result, a deduction reduces the 6161 rate to 55% of the required 6621 rate [unless a share of the residue qualifies for the charitable or marital deduction, in which case the 55% figure will be impacted by an interrelated computation]. The 6166 rate is at 45% of the required 6621 rate [on amounts above the "2% rate" threshold].

An application under Code section 6161 should be made on Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes. The form must be filed on or before the due date for payment of tax. Treas.Reg. §20.6161-1(b). The executor may be required to furnish a bond not exceeding double the amount of the tax due for the payment of the amount covered by the extension. Code §6165.

As a practical matter, because the extension is discretionary, the request should be made early in the return preparation process, before the 6 month mark, so that the estate receives acceptance of the decision. Most practitioners do, however, for a variety of reasons unrelated necessarily to tax planning, wait until the last minute and file the form right before the 9 month mark (and hold their breath as to acceptance).

8. Mandatory Extension of Time to Pay Estate Taxes

a. Qualification

The most important election to defer the payment of estate tax is pursuant to Code section 6166. Section 6166 allows the deferral and payment in installments of federal estate taxes relating to an interest in a closely held business. To qualify for section 6166, a decedent must have an interest in a closely-held business and be a citizen or resident of the United States, and the business interest must exceed 35 percent of the decedent's adjusted gross estate. Code §6166(a)(1).

The term "closely held business" includes an interest as a proprietor in a trade or business, an interest in a partnership carrying on a trade or business if 20 percent or more of the total capital interest is included in determining the gross estate of the decedent or the partnership has 15 or fewer partners, or stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock is included in determining the gross estate of the decedent or the corporation has 15 or fewer shareholders. Code §6166(b)(1).

The representative may request that the Code section 6166 election be treated as a timely filed application for an extension under Code section 6161. This will rarely be a concern as in most instances the representative will know whether the estate qualifies under section 6166, with one exception being valuation disputes (as to assets other than the closely held business, no doubt), or active versus passive concerns, with the Service. Multiple operating partnerships are aggregated for purposes of determining the 35% qualification (and also the deferral amount that is available).

At least 20% of the capital interest in a partnership (or the partnership had no more than 45 partners) or 20% of the voting interest in a corporation (or the corporation had no more than 45 shareholders) must be includable in the gross estate.

If the decedent owned a business interest through a holding company, the holding company interests cannot count toward the deferral amount unless the Executor makes an election under Code §6166(b)(8). The election causes the 2% portion to be deemed to be zero (i.e., the first \$562,500 of tax will be charged the higher quarterly interest rate instead of 2%), and causes the first installment of tax to be due on the filing date (i.e., the five-year deferral of principal is not available).

b. Payout Period and Deferral Amount

If deferral is allowed under Code section 6166, then a certain amount of the estate tax can be paid in installments. That amount is the fraction of the estate tax equivalent to the ratio of the closely held business amount to the value of the gross estate, with certain adjustments. Code §6166(a)(2).

The first installment can be paid any time on or before five years and nine months after the date of the decedent's death. Code §§6166(a)(3), 6151(a). Each succeeding installment is to be paid annually. Code §6166(a)(3).

Interest is payable under Code section 6601 both during the first five years from the date the estate tax should have been paid and during the installment period. Code §6166(f).

Specifically, only interest on the unpaid balance is due on the first four anniversary dates after the due date. No payment is required on the filing date. The first tax payment (along with the interest payment) is due on the 5th anniversary of the due date of the return. Each year the estate must file an information return with the Service coordinating with the payment that year. (This requirement may be substantially less onerous than those requirements that would be associated with a third party loan.)

Principal payments (i.e., those made in year 5 and thereafter) are applied pro rata to the 2% and non-2% portions. I.e., the Estate cannot pay down the higher-interest-rate portion more quickly than it pays down the 2% portion of principal. Code § 6601(j)(4).

How Much Tax Can Be Deferred

Estate tax value of closely held business interests	X	Total Federal Estate Tax
Adjusted Gross Estate*		

* *Adjusted Gross Estate = (Gross Estate) - (Debts and Expenses under Code §§ 2053, 2054)*

c. Passive Assets

For purposes of determining whether the closely held business amount exceeds 35 percent of the adjusted gross estate, the value of any interest in a closely held business does not include the value of the interest that is attributable to passive assets held by the business. Code §6166(b)(9).⁵

The term "passive assets" means assets other than those used in carrying on a trade or business. Further, in order for a decedent's interest to qualify for the election, the proprietorship, partnership, or corporation must be engaged in an active trade or business at the time of the decedent's death. If all of the decedent's real estate were owned through limited partnerships, the Service may examine the partnership's level of activity to determine whether the decedent's partnership interest qualifies under 6166. *See* Rev. Rul. 2006-34. The activities of any partner, employee, or agent of the partnership will be considered the partnership's activities. *See Id.*

A family limited partnership with marketable investment assets is passive and will not qualify for section 6166 deferral.

A family limited partnership with active rental real estate operations could be active. Most rulings on active versus passive focus on rental real estate. For rental real estate operations, the minimum activity level is a facts-and-circumstances test. New Revenue Ruling 2006-34 (June 26, 2006) (attached) provides a "nonexclusive" list of factors that the IRS will examine to determine whether the entity's level of activity was sufficient for Code section 6166.

⁵ Ponder whether capital reserves in a business can be justified as necessary for "net working capital" or future "capital expenditures."

Activities of agents and employees will be considered. Modest activity by independent contractors will not automatically disqualify the business, especially if their services are of the type which the business itself could not provide, and if the work is carefully reviewed. The use of a third party management firm (in which the Company had no ownership interest) weighs heavily against an active trade or business.

Many Private Letter Rulings that were issued before Rev. Rul. 2006-34 also provide examples of what qualifies. The IRM specifically cites Priv. Ltr. Rul. 200518047 (May 6, 2005) and Priv. Ltr. Rul. 200521014 (May 27, 2005) as representing the current IRS view (and presumably these two PLR's are still consistent with Rev. Rul. 2006-34 despite being issued earlier in time).

d. Reasons for Electing Code section 6166 Treatment

There are two primary reasons for an estate to elect deferral under Code section 6166.

First, the estate may not have the liquidity to pay the estate taxes nine months after date of death. Liquid assets outside of the business may be unavailable or insufficient. Further, the business may not have the capital and may not be capable of sustaining additional debt.

Second, even if there are sufficient liquid assets to pay the tax at one time, economic considerations may militate in favor of deferral. From an economic perspective, a quantification of the benefits expected from the deferral must be carefully compared with the costs of the deferral, such as the interest paid during the installment payment period. Accordingly, an estate may desire to use section 6166 for economic reasons if it can earn at a greater growth rate than the effective interest rate on the unpaid installment.

Economically, if the business itself appreciates on an after-tax rate greater than the effective interest rate, then there is an economic benefit in electing section 6166 deferral. In that situation, even taking into account the interest paid, the family is better off economically by deferring the payment of estate tax as opposed to paying the estate tax in a lump sum nine months after the date of death.

For example, assume a company worth \$1.7 million is owned by an estate that owes \$500,000 in estate taxes. The company, an S corporation, has available \$500,000 in liquid assets from previously earned and taxed receipts. It reinvests the assets of the business in such a way that the overall value of the company, after consideration of any inherent capital gains tax, is growing at a ten-percent rate. The estate elects section 6166 deferral. Assume that the estate's first principal payment on the tax due is \$50,000, with an additional \$20,000 in interest (\$500,000 multiplied by an average interest rate of four percent). As an S corporation, the company makes a dividend distribution, which can be done free of income tax to the estate, of \$70,000 to cover the payment. Even if the business were a C corporation, Code section 303 could be used to allow after-tax distributions to the estate to pay the tax.

Should the company have distributed the \$500,000 in a lump sum to the estate to avoid this \$20,000 (and each future) interest charge? If so, the company would have lost the ability to realize the projected ten-percent per annum growth on that \$500,000. Ignoring cumulative return on earnings, the cost to the company would have been the loss of \$50,000 per annum. By electing the deferral, the company is benefiting by \$50,000 minus the \$20,000 effective interest cost, or \$30,000 per year.

e. Interest

Interest is charged on the unpaid principal balance during the deferral period. For the first \$562,500 [for a decedent dying in 2007] or \$576,000 [for a decedent dying in 2008] of deferred estate

taxes (the deferred tax attributable to the first \$1,250,000 [for a decedent dying in 2007] or \$1,280,000 [for a decedent dying in 2008]) in value in excess of the useable applicable exclusion amount at death, the interest rate is two percent. Code §6601(j).

The *lesser* of the following amounts is qualified for a 2% interest rate under Code § 6601(j):

- ▶ (Hypothetical tax on \$1,250,000 [for a decedent dying in 2007] or \$1,280,000 [for a decedent dying in 2008]) + (Hypothetical tax on current applicable exclusion amount of \$2,000,000 [figure changes each year under Code]) - (\$780,800 current applicable credit amount)

= \$562,500 [for a decedent dying in 2007]

= \$576,000 [for a decedent dying in 2008]

OR

- ▶ The amount of the tax which is extended under Code § 6166.

On the excess amount of estate tax, the interest charge is 45 percent multiplied by the federal short term rate plus three percent. Code §6621(a)(2). This rate was recently at 6% for the calendar quarter beginning on April 1, 2008. Therefore, for the first quarter of the extension, the interest rate would be 2.7%. The rate is subject to change each quarter thereafter.

f. Avoiding Acceleration

If the estate has chosen the installment payment method, then Code section 6166(g) provides a boundary that needs to be considered. Section 6166(g) provides in part that if any portion of an interest in a closely held business that qualifies under section 6166 is distributed, sold, exchanged, or otherwise disposed of and the aggregate of these dispositions and withdrawals equals or exceeds 50 percent of the estate tax value of the business interest, then the extension of time for the payment of tax provided for under section 6166 ceases to apply. Code §6166(g)(1).⁶

The executor must file a report of all withdrawal and liquidation activity with each installment payment.

⁶ The due dates for installments are accelerated if:

- ▶ The Estate has undistributed net income (i.e., DNI reduced by deductions, income taxes, and estate tax installments) for a taxable year ending on or after the first installment due date. Code § 6166(g)(2).
- ▶ 50% or more of the value of the entire entity is withdrawn (on a cumulative basis). In the partnership setting, at a minimum, this means that 50% of the commercial activities are sold and the proceeds distributed. If the underlying real estate in the partnership is sold, but the net proceeds are retained in the partnership, the acceleration provisions will not be triggered. Acceleration is triggered by the distribution/withdrawal of funds from the partnership (amounting to 50% of the estate tax value, on a cumulative basis). See, e.g., Rev. Rul. 89-4 (Jan. 9, 1989).
- ▶ 50% or more of the decedent's interest in the entity is distributed (unless the distribution is to the decedent's beneficiaries pursuant to his trust or Will), sold, exchanged, or disposed of (on a cumulative basis).

The application of section 6166(g) to a buy-out agreement that requires the mandatory purchase of stock at a deceased shareholder's death can have drastic and unexpected results. For example, the typical buy-out agreement provides that the purchase can be satisfied by a promissory note that can be paid in one or more installments. At the time the stock is exchanged for the promissory note, which is usually at the closing, there is a disposition of more than 50 percent of the value of the stock. The exceptions to section 6166(g), such as a distribution of the stock from the deceased shareholder to a beneficiary under the estate plan documents, do not apply. Code §6166(g)(1)(D). See Tech. Adv. Mem. 8506004 (Nov. 5, 1984). The acceleration clause is then initiated and section 6166 ceases to apply. Because the deceased shareholder's estate has received only a promissory note and no cash, there may be insufficient cash to pay the estate tax. The buy-out agreement has then created a liquidity crisis.

For example, assume the two shareholders of a company enter into a cross-purchase agreement for the sale of each of their 50-percent interests in the company. The agreement provides that at death a deceased shareholder's estate must sell all of his or her interest to the surviving shareholder within six months of passing. The price is determined pursuant to a formula. Also, the amount to be paid in cash at closing is equal to the amount of available insurance proceeds on the deceased shareholder's life passing to the surviving shareholder or, if greater, 30 percent of the purchase price. The remaining amount can be represented by a promissory note payable in ten equal installments. Each owns an insurance policy with a face value of \$500,000 on the life of the other shareholder. At the first shareholder's passing, his or her stock interest is determined to be worth \$2 million, but only \$500,000 is available in insurance. Under the agreement, \$600,000 is paid at closing (30 percent) and \$1.4 million is paid by a promissory note. If the shareholder's taxable estate, other than the \$2 million in stock, exceeds \$2 million, the \$2 million in stock is taxed at a marginal (federal and estate) rate of 50 percent and results in about \$1,000,000 of additional tax. However, only \$600,000 in cash is received; although, the shareholder had intended that his or her estate be able to pay the remaining \$404,000 in installments under section 6166, section 6166(g), results in deferral being unavailable. Absent a discretionary extension of time to pay granted by the Service under Code section 6161, the estate needs to find an additional \$400,000 of liquidity within nine months of the shareholder's passing.

g. Completion of the Form

Form 706 provides that the election to defer tax under Code section 6166 be made by checking the appropriate box in response to question 3 of part 3 and submitting with the return "the additional information described on page 9 of the instructions." Form 706, part 3, question 3. This is not the model of clarity as the necessary information is not very clear within the instructions and generally disorganized. Further, there is no additional form prescribed by the IRS. However, a notice of election should contain the following information:

- a. the decedent's name and Social Security number;
- b. calculation of the maximum amount that can be paid in installments;
- c. the amount of tax that is to be paid in installments;
- d. the date selected for payment of the first installment;
- e. the number of annual installments, including the first installment, in which the tax is to be paid;
- f. the properties shown on the estate tax return that constitute the closely held business interest (identified by schedule and item number); and

g. the basis for the executor's conclusion that the estate qualifies for payment of the estate tax in installments (spreadsheets are recommended). Treas.Reg. §20.6166-1(b).

The practitioner should also indicate whether the notice is a protective or final election. Treas.Reg. §20.6166-1(d).

h. Lien

The Service has an estate tax lien on all assets in the gross estate, including the partnership interests. Code § 6324. Further, the Service may decide to require that the Estate provide a bond or special lien on the partnership interests, as a condition of granting the 6166 extension. Code § 6324A; Notice 2007-90 (Nov. 13, 2007). The reason: the general estate tax lien under Code § 6324 expires after ten years, while the estate tax may be extended beyond ten years under 6166.

When the closely held business consists of a partnership or business asset, the lien applies to the stock or partnership interests and not to the underlying assets of the Company or partnership. See In re Roth, No. 03-385, 2004 WL 716743 (W.D. Pa. Apr. 1, 2004) (mem. op.) (refusing to enforce an estate tax lien as against the proceeds of the assets of the decedent's closely held corporation, sitting in the hands of the estate's beneficiary, even though the sale of the corporate assets and withdrawal of proceeds had reduced the stock value to zero); CCM 20070801F (Feb. 23, 2007).

For example, if the election is made with regard to a partnership, the partnership may still distribute funds to the Estate (or revocable trust), and the executor (or trustee) may still distribute those funds to the beneficiaries. In that case, the lien does not follow/impact the distribution amounts. The lien stays only with the partnership interest, even if the value is reduced by the distributions. However, once the total of these distributions reaches 50% or more of the partnership interest value, then the entire estate tax is accelerated and immediately due upon demand. The cumulative value should therefore be monitored carefully.

9. Third Party Financing

An estate may deduct administration expenses allowable under the probate law of the jurisdiction where the estate is being administered,⁷ and which are actually and necessarily incurred in administering a decedent's estate.⁸

Interest on funds borrowed to pay taxes or other debts of the estate while the estate is illiquid (for example, if the estate assets cannot be immediately liquidated) may be deductible as an administration expense under section 2053(a)(2).⁹ Specifically, in *Estate of Todd v. Commissioner*,¹⁰ the Tax Court held

⁷ Code sec.2053(a)(2).

⁸ *Estate of Grant v. Commissioner*, 294 F.3d 352, 353 (2d Cir.2002), affg. T.C. Memo.1999-396; Treas. Reg. sec. 20.2053-3(a).

⁹ See, e.g., *Estate of Todd v. Commissioner*, 57 T.C. 288, 1971 WL 2614 (1971) (9-month loan); *Estate of Thompson v. Commissioner*, T.C. Memo.1998-325 (series of five 1-year notes); *McKee v. Commissioner*, T.C. Memo.1996-362 (note with term of 85 days); *Estate of Graegin v. Commissioner*, T.C. Memo.1988-477 (loan with balloon payment in 15 years).

¹⁰ 57 T.C. 288 (1971)

that interest incurred for a loan to pay Federal estate taxes and State inheritance taxes was an allowable administration expense.

More interestingly, even projected interest payments may be deductible for estate tax purposes as administration expenses.¹¹ If the amount of interest to be paid is ascertainable from the beginning, then the full amount of the interest to be paid may be permitted as a deduction rather than the discounted present value of the interest payments, thereby eliminating the need to file periodic claims for refund or encountering statute of limitations issues.

In order for the interest to be ascertainable, the loan must provide for a fixed rate as opposed to an adjustable rate of interest, and the loan must prohibit the prepayment of the amount borrowed unless all the interest that otherwise would have been due is also paid upon prepayment. The most cited case for this proposition is *Estate of Graegin v. C.I.R.*¹² There, the lender was the decedent's closely held operating company – the actual cause of the estate's liquidity problem. The decedent's son was both a co-executor of the decedent's estate and the president of the closely held company involved. The court analyzed the long term loan from the decedent's closely held corporation -- 15 years-- to determine if the interest was really going to be paid for the full 15 years and whether this was really a loan.

The Court noted:

"While we agree with respondent that loans between a debtor and creditor having an identity of interest require close scrutiny, such identity of interest per se is not fatal in characterizing the transaction as a loan....We are mindful of the potential for abuse presented by the facts in this case; however, we found Paul Graegin's testimony regarding his intention with respect to the repayment of the note credible."

With regard to the identity of the lender being the closely held corporation, the Court indicated that there were enough checks and balances on repayment to make the loan credible:

"In addition, presumably the outside shareholder (Stephen Curtis) would complain if the loan is not timely paid. We believe the interest rate was reasonable, even though it was based on the prime rate of interest (a short term obligation interest rate) whereas the loan in question was for a 15-year period. While we are disturbed by the fact that the note requires only a single payment of principal and interest, such a repayment term is not unreasonable given the decedent's post-mortem asset arrangement. Finally, we note that both the Bank and the guardian ad litem for the minor heirs, even though they were not adverse parties, concurred in the decision to borrow from Graegin Corporation and that the local court having jurisdiction over the decedent's estate approved the borrowing. Thus, all matters considered, we believe the loan from Graegin Corporation was a genuine indebtedness."

The court concluded that the interest rate was ascertainable because it was a fixed rate loan. Treasury Regulation Section 20.2053-1(b)(3) requires both that the amount of the estimated expense be ascertainable with reasonable certainty and that it be paid:

"Here, the amount of interest on the note is not vague or uncertain but instead is capable of calculation ($\$204,218 \times 15\% \times 15 \text{ years} = \$459,491$). The promissory note could not be prepaid,

¹¹ *Estate of Bahr v. Commissioner*, 68 T.C. 74 (1977).

¹² T.C. Memo 1988-477.

either as to principal or interest. As stated, we found credible Paul Graegin's testimony as to his intent to cause the loan to be timely repaid. Accordingly, we conclude that the amount of interest on the note is ascertainable with reasonable certainty, and that it will be paid. "

In a somewhat similar case, Klein v. Hughes,¹³ the IRS allowed a deduction for interest on a loan to pay estate taxes in the amount of \$50 million. The lender was an LLC created by the decedent's tax attorney. The lender was to borrow the funds from the decedent's company (a holding company for fractional interests in a number of LLCs from which the decedent could not compel distributions) and loan those funds at a higher rate to the decedent's trust. The lending LLC received a closing fee and was to earn fees based on the spread on the loan.

The note called for a balloon payment of interest and principal payable 25 years in the future with prepayments prohibited. It was estimated that the estate would incur \$309mm of substantial interest expense by the time the loan was due. The IRS and the appropriate court allowed the deduction of the entire interest expense without requiring a present value calculation.

In another case, Estate of Gilman,¹⁴ the estate's representatives, in a post-death restructuring of the decedent's \$611 million estate, managed to disqualify the estate for 6166 installment payments and create a degree of illiquidity in the form of promissory notes payable from several of the decedent's businesses. The court's reasoning in allowing the deduction of \$38 million in interest to pay estate taxes was similar to that in *Graegin* and *Klein*, that a deduction is permitted if the loan is bona fide and necessary to pay legitimately incurred obligations of the estate.

The General Principles of *Graegin* and Its Progeny

Graegin and related cases require the following guidelines to be met in order to deduct interest incurred in borrowing funds to pay estate taxes:

- The loan must be actually and necessarily incurred in the administration of the decedent's estate, *i.e.*, the estate must be illiquid.
- The interest expense must be ascertainable with reasonable certainty and there must be assurances that it will be paid.
- The loan must be bona fide (related parties will be closely scrutinized).
- The lender must report the interest income.
- The authority to borrow to pay taxes must be allowable under local law.

All of these guidelines are necessarily met if the estate is illiquid and the funds to pay estate taxes are borrowed from a commercial lender. All of these variables can be met even with a family limited partnership. But the IRS will not necessarily allow the accelerated interest deduction for estate tax purposes in the flp setting.

Example: Assume that John, a widower, has a house worth \$1 million, limited partnership interests in a family limited partnership worth \$3 million, and retirement plan assets worth \$2m. The retirement plan assets go directly to his three children, without any obligation to pay estate taxes (to maximize the extension of time in which to defer income taxes and to take funds out of the IRA.) His projected estate tax, after

¹³ 2004 WL 838198 (Cal. App. 1 Dist. 2004) – (Unreported case).

¹⁴ TCM 2004-286

including state inheritance taxes, is approximately \$2 million. If the house is sold, his estate will acquire \$1 million in liquidity to pay the taxes. His estate is still \$1 million short to pay taxes. Assets from the partnership must be used, but how?

How then would the estate tax be paid if the partnership assets are needed for this purpose? One possibility is a partial distribution to the partners, with the partners contributing assets to the estate (either as loans or “reverse” advancements) to pay the estate tax. Or, if the estate is a partner, a pro rata distribution to all the partners, including the estate, to allow the estate liquidity to pay the estate taxes, would be an alternative. Both of these options increase the ability of the Service to assert 2036 (a) (1); e.g., the Service would argue that the partnership was intended from inception to be available to pay estate taxes, and therefore evidenced an implied retention.

Another solution: the partnership could loan money to the estate for this purpose. This has less of a section 2036 taint. In addition, if this is done, the question is whether the estate gets to deduct all future interest payments on the loan because of the *Graegin* decision.

IRS Rulings in Family Limited Partnership Cases

How close to the edge, including on the section 2036 argument, is this approach? It does require a tough countenance and a clear understanding of how this could increase audit scrutiny.

The interest deduction and FLP valuation discount issues have a lot of common elements and the IRS approach to each is very similar. Generally, the IRS denies the *Graegin-like* deduction in cases where the liquidity is the result of an asset or assets held by the estate which have no valid business purpose or economic reality and are nothing more than wrappers to enable the estate to qualify for various valuation discounts. Given the number of cases in the last five years that apply section 2036 to invalidate discounts in family partnerships which have no economic substance, the IRS scrutiny on this element will be substantial.

If the partnership consists of readily marketable assets, then for the loan to be sustainable, it must at a minimum have a justifiable and sustainable business purpose. In addition, the ability of the family to control the partnership will be a devastating fact -- the Service's strongest argument is that the loan arrangement with a family partnership does not change the economic interests of the partners -- and therefore must be disregarded.

In this regard, a negative ruling, TAM 200513028, addresses the bad fact partnership cases the IRS will look for in terms of liquidity and economic reality:

- Family members owned 99% of a FLP holding liquid assets.
- The executor had the ability to liquidate the internal assets of the FLP.
- Over half of the internal assets of the FLP consisted of readily marketable securities.
- There was no demonstrable economic purpose to the partnership.
- The family (but not the estate) could control the distribution from the partnership.

The Service refused to allow the deduction for interest despite citing all the relevant authorities allowing such a deduction.¹⁵ The court was persuaded that the payment of interest did not change the economic consequences to the beneficiaries because the partners and the beneficiaries of the estate were the same:

¹⁵ "In general, the courts and the IRS have concluded that interest expense incurred by an estate on funds borrowed by the estate can be a deductible administration expense provided the loan was reasonably and necessarily incurred

"Further, we do not believe that the interest expense is deductible under section 2053 because: (1) it is questionable whether the Estate will actually make the payments in accordance with the terms of the arrangement; and (2) even if the Estate makes the payments in accordance with the terms of the arrangement, the payments (whether characterized as interest or principal) will have no economic impact on the parties involved."

Analysis

Whether to incur a loan and attempt to deduct all future interest payments requires a financial analysis, and needs to be decided on a case by case basis. But in those estates that are illiquid and in which third party financing is desired, interest payments can be structured to be deductible ala the *Graegin* and related decisions.

If the loan is a commercial loan, at a fixed and reasonable rate of interest, the IRS can only attempt to establish that the alleged illiquidity is illusory i.e. that the loan was unnecessary.

If the loan is a noncommercial one, from a family limited partnership, this could bolster the Service's attempt to disregard the partnership under section 2036, though the author believes this argument to be fallacious. More concerning, if the underlying partnership is demonstrated not to have economic substance, or if the estate can force liquidation of the assets in the partnership, the Service could argue that the loan was unnecessary -- that distributions to the partners could have been made instead -- and disallow the interest payments.

10. Which One Should be Chosen: A Graegin Type Loan or Section 6166

The variables are complex in this analysis and make the comparison difficult from a practical perspective. Economically, as discussed below, the analysis can focus on cash flow and determine which approach will generate more cash flow for the estate (or lose less, as the case may be).

But pragmatically, it is hard to determine which route to select. For example, with section 6166, the estate can pay off the estate tax obligation earlier, if the liquidity emerges or for other investment reasons. However, with the *Graegin* loan, there is in essence no prepayment possibility and the interest must be paid through the term.

Conversely, with *Graegin*, the interest rate is fixed, whereas under section 6166, the interest rate is variable and could increase or decrease based on economic conditions. For example, in a hyper

in the administration of the estate," citing Rev. Rul. 84-75, 1984-1 C. B. 193 ("... because the loan was obtained to avoid a forced sale of assets, the loan was reasonably and necessarily incurred in administering D's estate."); Estate of Todd v. Commissioner, 57 T.C. 288 (1971) ("the estate did not own any liquid assets at the time; and that if the estate liquidated some of its nonliquid assets, these would have had to have been sold at reduced prices."); Estate of Thompson v. Commissioner, T.C. Memo. 1998-325, 35-36 ("We are convinced that the financial position of the estate at the time of the borrowing was insufficient to make the required tax payments and provide for the maintenance of Cane Mill [business property owned by the estate]"); McKee v. Commissioner, T.C. Memo. 1996-362 ("the executors determined that it was preferable to preserve all of decedent's [closely-held] stock and to borrow funds... in order to better ensure the estate's ability to pay its obligations."); Estate of Graegin v. Commissioner, T.C. Memo. 1988-477 ("[t]o avoid a forced sale of its assets, the estate had to borrow money to satisfy its Federal estate tax liability."); Estate of Huntington v. Commissioner, 36 B.T.A. 698, 726 (1937) ("[t]he issuance of the notes avoided the necessity of sacrificing the assets of the estate by immediate or forced sale"). See also, *Hibernia Bank v. United States*, 581 F.2d 741 (9th Cir. 1978)."

inflation environment, the election of section 6166 would prove horrible, versus having done a *Graegin* loan instead.¹⁶

With a *Graegin* loan, there is a third party overseer, with loan covenants and guarantees that are more onerous than the conditions imposed by the Government with section 6166.

Section 6166 requires annual filings; *Graegin* requires annual compliance with the financing requirements of the third party.

Section 6166 is subject to the government arguing that it does not apply, and certainly could be a trigger for an audit. *Graegin* is subject to the IRS disallowing the up front interest deduction under the argument that the estate did not need to incur the loan for liquidity purposes.

And the above are just a few of the practical nuances of selecting one of the techniques versus the other.

From a cash flow standpoint, the way to compare *Graegin* versus 6166, as demonstrated below, is to compare the cash flow requirement of each strategy. In this regard, if the *Graegin* loan is determined to be 5 years, then the 6166 payments should be run out 5 years, and a side by side comparison made.

In the example below, the *Graegin* loan is for 5 years, at a 6 % interest rate. The 6166 rate is first at 2.7 %, and thereafter assumed to be 3.15 % for the remainder of the loan. On the surface, the 6166 immediately shows less cash flow is required to pay the Juice -- 3.15 % for example, versus 6 %. On the other hand, the *Graegin* loan interest is immediately deducted for federal estate tax purposes, meaning less federal (and state) estate tax paid up front.¹⁷

So, which is better? *Graegin* saves federal estate taxes of \$989,224, the difference between the federal tax due of \$15,660,142 in the 6166 scenario, versus \$14,670,918 in the *Graegin* scenario. There is an additional state tax differential of \$300,000 for a total differential as \$1,300,000. With *Graegin*, 5 years of interest at about \$510,000 per year, were deducted from the gross estate.

However, the *Graegin* analysis requires interest to be paid equal to about \$2,500,000, whereas the 6166 requires interest to be about \$308,000 per year, or \$1,500,000 total, for a difference of \$1,000,000.

Graegin probably incurs an additional \$50,000 of expense, after taking into account the estate tax deduction.

So, in the above analysis, *Graegin* saves about \$300,000 in total taxes.

¹⁶ Ponder, however, that the *Graegin* loan, with third party financing, will be at an interest rate that is supposed to take into account forward rates, and interest rate increases (or decreases during the term). Therefore, in most situations, the *Graegin* loan and the 6166 interest rate should be essentially equivalent in terms of economic risk.

¹⁷ Note that for income tax purposes, the interest payments are not deductible under either scenario.

Attachment One: Mathematical Analysis of *Graegin* v. 6166

Estate of Smith

IRC §6166 v Public Bank Note
Cash Flow Analysis

Scenario A: 5 Yr Deferral for Federal Tax Only: \$8.5mm Public Bank Note, 6.0% Interest Only

	<u>IRC §6166</u>		<u>Public Bank Note</u>		<u>Difference</u>	<u>Comments</u>
Beginning Balance	11,100,000		11,100,000			
Graegin Loan	<u>0</u>		<u>8,500,000</u>			
Adjusted Beginning Balance	11,100,000		19,600,000			
Federal Tax Due	(15,660,142)		(14,670,918)			Federal Tax Savings
Reduced by 6166 Deferral	<u>9,839,440</u>					989,224
Federal Tax Paid 4/2/2008	(5,820,702)	15,000,000				
Illinois Tax Due 4/2/2008	<u>(5,202,567)</u>	5,800,000	<u>(4,850,842)</u>	19,400,000		Illinois Tax Savings
Total Amount Paid 4/2/2008	(11,023,269)	20,800,000	(19,521,760)			Total Tax Savings
						<u>1,340,949</u>
Balance 4/2/2008	<u>76,731</u>		<u>78,240</u>			
Distribution to Beneficiaries		76,731		78,240		Per Joan, assumes all year end balances are distributed to Estate Beneficiaries
Partnership Distribution*	1,700,000		1,700,000			
Interest Payment^	<u>(278,013)</u>		<u>(510,000)</u>			
Distribution to Beneficiaries		1,421,987		1,190,000		
Partnership Distribution*	1,700,000		1,700,000			
Interest Payment^^	<u>(309,071)</u>		<u>(510,000)</u>			
Distribution to Beneficiaries		1,390,929		1,190,000		
Partnership Distribution*	1,700,000		1,700,000			
Interest Payment^^	<u>(309,071)</u>		<u>(510,000)</u>			

Borrowing to Pay Estate Tax

Distribution to Beneficiaries		1,390,929		1,190,000	
Partnership Distribution*	1,700,000		1,700,000		
Interest Payment^^	(309,823)		(510,000)		
Distribution to Beneficiaries		1,390,177		1,190,000	
Partnership Distribution*	1,700,000		1,700,000		
Interest Payment^^	(308,318)		(510,000)		
Federal Tax Payment	(9,839,440)				
Public Bank Loan Payment			(8,500,000)		
Funds Needed to Payoff Tax/Loan	(8,447,758)		(7,310,000)		1,137,758
Total Funds Distributed to Beneficiaries		5,670,753		4,838,240	832,513
Public Bank Graegin Note Total Savings***					305,245

Comments

^ Assumes 6% interest rate X 45% = 2.7% until 12/31/08 of the Federal §6166 deferral & 6.00% fixed interest rate on Public Bank Loan.

^^ Assumes 7% interest rate X 45% = 3.15% after 01/01/09 of the Federal §6166 deferral & 6.00% fixed interest rate on Public Bank Loan.

*** Doesn't include Public Bank \$25,000 origination fee and out of pocket expenses or their related estate tax deduction.

Attachment Two: Passive v. Active under Section 6166

Internal Revenue Service (I.R.S.)

Revenue Ruling

REAL PROPERTY INTERESTS; CLOSELY HELD BUSINESS

Published: June 26, 2006

Section 6166.--Extension of Time for Payment of Estate Tax Where Estate Consists Largely of Interest in Closely Held Business, 26 CFR 20.6166-2: Definition of an interest in a closely held business.

Real property interests; closely held business. This ruling updates the guidance provided by [Rev. Ruls. 75-365, 75-366, and 75-367](#), and provides certain safe harbors and a non-exclusive list of factors that are likely to be relevant in determining whether a deceased owner's activities with regard to certain real property were sufficiently active to support a finding that the real property interest constitutes a closely held business interest for purposes of section 6166 of the Code. [Rev. Rul. 75-365](#) revoked and [Rev. Rul. 75-367](#) revoked in part.

Real property interests; closely held business. This ruling updates the guidance provided by [Rev. Ruls. 75-365, 75-366, and 75-367](#), and provides certain safe harbors and a non-exclusive list of factors that are likely to be relevant in determining whether a deceased owner's **activities** with regard to certain **real** property were sufficiently active to support a finding that the **real** property interest constitutes a closely held business interest for purposes of section **6166** of the Code. [Rev. Rul. 75-365](#) revoked and [Rev. Rul. 75-367](#) revoked in part.

ISSUE

Whether the **real** property interests described in the situations below constitute interests in a closely held business for purposes of [section 6166 of the Internal Revenue Code](#).

FACTS

In each situation, the **real** property interests are included in the decedent's gross **estate** and aggregate in value more than 35 percent of the decedent's adjusted gross **estate** within the meaning of [section 6166\(b\)\(6\)](#). Further, in each situation the only assets that might be part of a closely held business are the interests described. In each situation, the eligibility requirements of [section 6166\(b\)](#) regarding the number of partners, members, or shareholders or the percentage of capital interest in the partnership or LLC or voting stock in the corporation are satisfied.

Situation 1. A died on January 1, 2005. At the time of death, A owned a ten store strip mall titled in A's name. A personally handled the day-to-day operation, management and maintenance of the strip mall. A also personally handled most repairs. When A was unable to personally perform a repair, A hired a third party independent contractor. A selected the contractor and reviewed and approved the work performed.

Situation 2. B died on February 1, 2005. At the time of death, B owned a small office park titled in B's name. The office park consisted of five separate two-story buildings, each of which had multiple tenants. B hired DEF Management Corporation (DEF), a property management company in which B had no ownership interest, to lease, manage, and maintain the office park, and B relied entirely on DEF to

provide all necessary services. The primary duties of DEF's employees consisted of advertising to attract new tenants, showing the property to prospective tenants, negotiating and administering leases, collecting the monthly rent, and arranging for independent contractors to provide all necessary services to maintain the buildings and grounds of the office park, including snow removal, security, and janitorial services. DEF provided a monthly accounting statement to B, along with a check for the rental income, net of expenses and fees.

Situation 3. Same as Situation 2 except that B owned 20 percent in value of the stock of DEF.

Situation 4. C died on April 1, 2005. At the time of death, C's assets included the one percent general partner interest and a 20 percent limited partnership interest in a limited partnership. The limited partnership owned three strip malls that, collectively, constituted 85 percent of the value of the limited partnership's assets. The partnership agreement required C, as the general partner, to provide the limited partnership with all services necessary to operate the limited partnership's business, including daily maintenance to and repairs of the strip malls. From 1992 until death, C received an annual salary from the limited partnership for C's services as general partner. In performance of C's obligations under the limited partnership agreement, C (either personally or with the assistance of employees or agents) performed substantial management functions, including collecting rental payments and negotiating leases, performing daily maintenance and repairs (or hiring, reviewing and approving the work of third party independent contractors for such work), and making decisions regarding periodic renovations of the three strip malls.

Situation 5. D died on May 1, 2005. At the time of death, D owned 100 percent of the stock in MNO Corporation (MNO), a dealership in the business of selling automobiles, automotive parts and related supplies, and repair services. D made all decisions regarding MNO, including the approval of all advertising and marketing promotions, management and acquisition of inventory, and matters relating to dealership personnel. D also supervised all employees of MNO. In addition to the stock of MNO, D directly owned Real Property P. Real Property P was constructed for MNO and contained unique features tailored to an automobile dealership, including a showroom and office space and areas for servicing automobiles and storing inventory. D leased Real Property P to MNO under a net lease, and MNO's employees performed all maintenance of and repairs to Real Property P.

LAW

[Section 6166\(a\)\(1\)](#) of the Code permits an executor to elect to pay part or all of the estate tax imposed by section 2001 in two or more (but not exceeding ten) equal installments if a decedent was a citizen or resident of the United States on the date of death, and if the value of an interest in a closely held business (the "closely held business amount" as defined in [section 6166\(b\)\(5\)](#)) which is included in the decedent's gross estate exceeds 35 percent of the adjusted gross estate.

[Section 6166\(b\)\(1\)](#) defines the term "interest in a closely held business" to mean:

- A. an interest as a proprietor in a trade or business carried on as a proprietorship;
- B. an interest as a partner in a partnership carrying on a trade or business, if--(i) 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or (ii) such partnership had 45 or fewer partners; or
- C. stock in a corporation carrying on a trade or business if-- (i) 20 percent or more in value of the voting stock of such corporation is included in determining the gross **estate** of the decedent, or (ii) such corporation had 45 or fewer shareholders.

[I.R.C. § 6166\(b\)\(1\)](#). The determination as to whether an interest qualifies as an interest in a closely held business under [section 6166\(b\)\(1\)](#) shall be made as of the time immediately before the

decedent's death. [I.R.C. § 6166\(b\)\(2\)\(A\)](#). Thus, a decedent must own an interest in a closely held business immediately before death to be eligible for an extension of time for payment under [section 6166](#).

Under [section 6166\(b\)\(9\)\(A\)](#), for purposes of [section 6166\(a\)\(1\)](#) and determining the closely held business amount, the value of an interest in a business does not include the value of that portion of the interest that is attributable to **passive** assets held by the business. The term "**passive** asset" is defined in [section 6166\(b\)\(9\)\(B\)\(i\)](#) as any asset other than an asset used in carrying on a trade or business.

[Revenue Ruling 75-366, 1975-2 C.B. 472](#), involved a decedent whose gross **estate** included farm **real estate** operated by tenant farmers. The decedent paid 40 percent of the expenses, received 40 percent of the crops, and actively participated in important management decisions of the tenant farms. The decedent made almost daily visits to inspect and discuss farm operations, and occasionally delivered supplies to the tenants. The ruling held that farming under these circumstances was a productive enterprise like a manufacturing enterprise and was distinguishable from the mere management of investment assets. Therefore, the decedent's farm assets constituted an interest in a closely held business for purposes of [section 6166](#).

[Revenue Ruling 75-365, 1975-2 C.B. 471](#), also involved a decedent's interest in **real estate**. In that ruling, the Service considered a situation in which the decedent individually maintained a fully equipped business office to collect **rental** payments on **commercial** and farm **rental** properties, receive payments on notes receivable, negotiate leases, make occasional loans, and direct by contract the maintenance of the properties. The ruling held that the decedent was merely an owner managing investment assets to obtain the income ordinarily expected from them, and was not conducting a trade or business. Therefore, the **commercial** and farm **rental** properties and notes receivable included in the decedent's gross **estate** did not constitute an interest in a closely held business for purposes of [section 6166](#).

[Revenue Ruling 75-367, 1975-2 C.B. 472](#), held that a decedent's ownership of 100 percent of the stock of an electing small business corporation that built homes on land owned and developed by the decedent, together with a business office and warehouse used both by the corporation and by the decedent in the land development activities constituted an interest in a closely held business. The ruling held, however, that the eight homes that were owned by the decedent and rented to tenants and for which the decedent collected rents, made the mortgage payments, and performed necessary repairs and maintenance, did not constitute an interest in a closely held business because the decedent's interest in those homes merely represented an investment.

ANALYSIS

In order for an interest in a business to qualify as an interest in a closely held business under [section 6166](#), a decedent must conduct an active trade or business, or must hold an interest in a partnership, LLC, or corporation that itself carries on an active trade or business. Based on the definition of a passive asset in [section 6166\(b\)\(9\)\(B\)\(i\)](#), [section 6166](#) applies only with regard to an active trade or business, as distinguished from the mere management of investment assets.

In determining whether the activities of the decedent, partnership, LLC or corporation constitute an active trade or business, the activities of agents and employees of the decedent, the partnership, LLC or corporation are also taken into consideration. The fact that some of the activities are conducted by third parties such as independent contractors who are neither agents nor employees of the decedent, partnership, LLC or corporation, will not prevent the business from qualifying as an active trade or business so long as these third-party activities are not of such a nature that the activities of the decedent,

partnership, LLC or corporation (and their respective agents and employees) are reduced to the level of merely holding investment property.

Often, day-to-day real estate operations and activities are performed by independent contractors, such as property management companies. If a decedent, partnership, LLC, or corporation uses an unrelated property management company to perform most of the activities associated with the real estate interests, that fact suggests that an active trade or business does not exist.

To determine whether a decedent's interest in real property is an interest in an asset used in an active trade or business, the Service will consider all the facts and circumstances, including the activities of agents and employees, the activities of management companies or other third parties, and the decedent's ownership interest in any management company or other third party. The Service will consider the following nonexclusive list of factors:

- The amount of time the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) devoted to the trade or business;
- Whether an office was maintained from which the activities of the decedent, partnership, LLC, or corporation were conducted or coordinated, and whether the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) maintained regular business hours for that purpose;
- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) was actively involved in finding new tenants and negotiating and executing leases;
- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;
- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and
- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) handled tenant repair requests and complaints.

No single factor is dispositive of whether a decedent's **activities** with respect to the **real** property (or the **activities** of a partnership, LLC, or corporation through which decedent owns the **real** property) constitute an interest in a closely held business for purposes of [section 6166](#).

HOLDINGS

(1) In Situation 1, A provided significant services to the strip mall tenants. A personally handled the day-to-day operation, management and maintenance of the strip mall. A's **activities** went beyond those of a mere investor collecting profits from a **passive** asset. Moreover, even in situations in which A hired independent contractors to perform repairs that A could not perform personally, A was involved in the selection of the contractors and reviewed and approved the work performed. Under these circumstances, the use of independent contractors on occasions when A could not personally perform the work does not prevent A's activities from rising to the level of the conduct of an active trade or business. Thus, A's ownership of the strip mall qualifies as an interest in a closely held business for purposes of [section 6166](#). (The result would be the same if the strip mall had instead been held in a single-member LLC owned by A, and the LLC were disregarded as an entity that is separate from its owner under § 301.7701-1 through 3 of the Procedure and Administration Regulations.)

(2) In Situation 2, in determining whether B was a proprietor carrying on an active trade or business with respect to B's interest in the office park, the activities of DEF Management Corporation (DEF) and its relationship with B are taken into account. DEF and its employees provided all necessary services for B's office park. B had no ownership interest in DEF. B's reliance on DEF to perform all necessary services, B's lack of any significant participation in the management or oversight of the property, and B's lack of any ownership interest in DEF are all factors that weigh heavily against a finding that the office park was used by B in an active trade or business. Thus, B was not a proprietor in an active trade or business and B's interest in the office park does not qualify as an interest in a closely held business for purposes of [section 6166](#).

(3) In Situation 3, DEF provided all necessary services with regard to the management and maintenance of the office park, including advertising to attract new tenants, showing the property to prospective tenants, negotiating and administering leases, collecting the monthly rent, and arranging for third party independent contractors to provide all necessary services to maintain the buildings and grounds of the office park, including snow removal, security, and janitorial services. These activities are sufficient to conclude that DEF was actively managing the office park. Because B owned a significant interest in DEF, the activities of DEF with regard to the office park allow B's interest in the office park to qualify as an interest in a closely held business for purposes of [section 6166](#).

(4) In Situation 4, the determination of whether the limited partnership was carrying on a trade or business for purposes of [section 6166](#) is made with reference to the partnership's activities. Because the limited partnership, rather than C, owned the interest in the strip malls, the nature and level of the activities of the limited partnership must be evaluated. The limited partnership, acting through its general partner C, handled the day-to-day operations and management of the strip malls. The activities of C on behalf of the limited partnership included (either personally or with the assistance of employees or agents) performing daily maintenance of and repairs to the strip malls (or hiring, reviewing and approving the work of third party independent contractors for such work), collecting rental payments, negotiating leases, and making decisions regarding periodic renovations of the strip malls. Thus, the limited partnership carried on an active trade or business. Because the strip malls were used in carrying on the partnership's active trade or business, they are not passive assets under [section 6166\(b\)\(9\)](#) and their value is not excluded from the value of C's interest in the partnership for purposes of [section 6166](#). C's interest in the limited partnership qualifies as an interest in a closely held business for purposes of [section 6166](#). (Because C owned at least 20 percent of the partnership, the conclusion would be the same even if C's activities were instead performed by another employee, partner or agent of the partnership).

(5) In Situation 5, MNO was engaged in an automobile dealership business. Thus, MNO was conducting an active trade or business at the time of D's death. Consequently, D's 100 percent stock interest in MNO qualifies as an interest in a closely held business. In addition, Real Property P was used exclusively in the business of MNO under a net lease from D. As in Situation 3, because D owned a significant interest in MNO, whose activities with regard to Real Property P constituted active management, D's interest in Real Property P also qualifies as an interest in a closely held business.

EFFECT ON OTHER REVENUE RULINGS

[Rev. Rul. 75-365, 1975-2 C.B. 471](#), is revoked, and the portion of [Rev. Rul. 75-367, 1975-2 C.B. 472](#), relating to the eight rental homes is revoked.

DRAFTING INFORMATION

The principal author of this revenue ruling is Tracey B. Leibowitz of the Office of the Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division). For

further information regarding this revenue ruling, contact Laura R. Urich at (202) 622- 4940 (not a toll-free call).

Rev. Rul. 2006-34, 2006-26 I.R.B. 1171, 2006 WL 1723550 (IRS RRU)
END OF DOCUMENT

Attachment Three: The Darwinian Approach to Partnership Sustainability: *Mirowski*

by
Louis S. Harrison

The partnership “discount” cases over the last 5 years (since what has become known as *Strangi II*, T.C. Memo. 2003-145) have provided the tax planner with a reasonable roadmap as to how to structure sustainable partnerships for estate tax planning purposes. The cases established that the Tax Court is more than willing to apply a broad reading and liberal application of Code Sec. 2036, meaning that it will apply 2036 to partnership cases to ignore the partnership for purposes of valuing partnership assets. The net result is that no discount would be allowed in these instances.

In order to be conservative and to avoid this liberal application of Code Sec. 2036, in a recent column we summarized the steps necessary to have a sustainable partnership, as follows:

1. There must be demonstrated “substantial business and other non-tax reasons.” Without this, any partnership stands a difficult time being taken seriously, that is, being respected for tax purposes.
2. There must be actual consideration received in terms of the partnership interests: equity interests, cash flow and tax implications should be proportional to the level of contribution.
3. Outside of the partnership, partners should retain other assets for his or her support. [Reason: to avoid the argument that there is an implied retention sufficient to invoke Code Sec. 2036 (a)(1)];
4. There must be actual transfers: the assets have to be re-titled in the partnership name; the i’s must be dotted and t’s crossed. [Reason: create credibility that the establishment of the partnership was really intended for economic purposes; ignoring formalities creates the impression that the partners do not really intend to operate as a partnership. Further, ignoring partnership formalities makes it easier to argue Code Sec. 2036 (a)(2) should apply.]
5. The partnership must be maintained as a separate entity; there can be no commingling.
6. Investments within the partnership should maintain some integrity: who is monitoring them, are they being re-invested, actively managed, consistent with some end game in the investment world? [Reason: need to establish an economic justification for the partnership; contributing assets to a partnership with no activities within the partnership that change the make-up of partnership assets indicates there is no reason for the partnership, even though this would not be true in all circumstances (e.g., divesting control in order to prevent third parties from exercising undue influence); still, changing the investments within the partnership after contribution provides a good indicia that the partnership was established for a real business reason].
7. The requisite returns should be filed.
8. The partnership should actually be managed pursuant to the purposes set forth for its establishment. [Reason: consistency demonstrates the economic substance of the partnership.]

Prior to a recent Tax Court case, *Mirowski v. Comm’r*, T.C. Memo. 2008-74, the question was whether the above steps would be sufficient, or whether the planners could expect an even broader reading by the court of Code Sec. 2036. In what can be described as a taxpayer victory, the Tax Court in *Mirowski* established by its holding the following principle: if the taxpayer can legitimately establish that the

partnership was set up for reasons in addition to tax planning, the Court will work hard to avoid a liberal application of Code Sec. 2036 to the partnership. The smell test, or better yet, the stink test, continues to be alive and well to the partnership estate planning arena.

Specifically, if the partnership is a sham, set up for only tax reduction purposes, the practitioner should expect the Service and Tax Court to aggressively apply Code Sec. 2036 to ignore the partnership for planning purposes. If, on the other hand, the partnership was establishing for a valid economic purpose, e.g., consolidating a family's assets, the Tax Court will take a more restricted view on whether Code Sec. 2036 applies.

Mirowski certainly cannot be viewed as a "good facts" case, other than evidence that it was set up for (barely sustainable) reasons in addition to tax planning. The decedent transferred marketable securities of \$62,000,000 into the partnership. The decedent retained (only) \$3.3 million of cash and cash equivalents outside of the partnership. The decedent retained control as general partner in the partnership. The decedent died within a month of establishing the partnership and funding it. In this short window between partnership creation and death, the decedent transferred about 48 % of the partnership (with a gift tax liability of about \$11, 750, 623 and insufficient liquidity outside of the partnership in which to pay that liability).

Based on prior cases, specifically *Bongard*, 124 T.C. 95 (2005), *Erickson* [insert cite], and *Strangi II*, these would be bad facts and the decedent would have expected the Tax Court to include the assets in the decedent's estate without discounts, especially true because of the lack of assets retained to pay gift and estate taxes (Code Sec. 2036 (a)(1) inclusion), control as a general partner (Code Sec. 2036 (a)(2) inclusion), and death within 1 month of creation (showing that it was a sham and not eligible for the bona fide full and adequate consideration exception to Code Sec. 2036 application).

However, two of the three daughters, partners in the partnership, testified as to the investment and family control purposes for the partnership, and evidence supported that the decedent did not die of an illness expected at the time of the partnership inception. Despite the lack of a contemporaneous writing substantiating these reasons, the court found the daughters' "testimonies to be reasonable....[and] relied on those testimonies in making our findings of fact, including our findings that Ms. Mirowski had the following legitimate and significant nontax reasons for forming, and transferring certain assets" to the partnership:

- (1) Joint management of the family's assets by her daughters and eventually her grandchildren;
- (2) maintenance of the bulk of the family's assets in a single pool of assets in order to allow for investment opportunities that would not be available if Ms. Mirowski were to make a separate gift of a portion of her assets to each of her daughters or to each of her daughters' trusts; and (3)
- providing for each of her daughters and eventually each of her grandchildren on an equal basis.

Because of *Mirowski*, the following are two concerns as to the potential applicability of Code Sec. 2036 that could be interpreted in the taxpayer's favor, provided the partnership is set up with a degree of economic substance and purpose independent of mere tax savings:

1. Did the decedent retain sufficient assets to maintain the decedent's lifestyle without relying on distributions from the partnership, necessary to avoid Code Sec. 2036 (a) (1)? Even though assets outside of the partnership retained by the decedent may be insufficient to pay gift or estate taxes, the *Mirowski* court did not conclude that this invoked 2036 (a)(1). The court took every step to conclude that the decedent could reasonably expect cash flow from the retained assets sufficient to cover these liabilities, even when it was certain that the decedent would not.

2. Retention of control of the partnership by the decedent does not necessarily invoke Code Sec. 2036 (a) (2). Contrary to Judge Mary Ann Cohen's scary extension and application of Code Sec. 2036 (a) (2) in *Strangi II, infra*, any time the decedent is acting as a general partner in the partnership, the *Mirowski* court was not willing to accept that conclusion. The *Mirowski* court held, correctly, that a general partner's adherence to fiduciary obligations takes control as general partner out of Code Sec. 2036 (a) (2). This is true even with regard to a certain amount of discretion in the general partner as to the distribution of cash flow.

The *Mirowski* case does not mean that practitioners can be cavalier about partnership planning. It does mean that families should establish partnerships to achieve non-tax goals, should work hard on establishing viable and correct reasons in this regard, should manage the partnership consistent with those reasons, both pre-mortem and post-mortem, and should have evidence, written (if possible) and oral, that substantiate these reasons. Further, letters in the file that are inconsistent with those reasons, or that demonstrate that the partnership was set up merely to achieve tax purposes, will go counter to the substance that the *Mirowski* court relied on to sustain the partnership.

With *Mirowski*, the planner now has available the tools to sustain partnership discount planning in the vast majority of cases outside of the deathbed arena. Importantly, the decedent has "to want" the partnership. As practitioners recognize on numerous occasions, the potential for saving estate taxes is not a sufficient reason for many clients to enter into partnerships; these same clients will often say "no" to partnership planning for a variety of reasons, including short term expense, confusion, sharing control, reducing flexibility, and lack of desirability of having a business arrangement with family members. Therefore, "yes" partnership planning could work; but "no," it will not be used by clients in all cases in which it could be so used effectively.

TABLE OF CONTENTS

1.	Why the Issue?.....	2
2.	Amounts Necessary to Require Filing	3
3.	Due Dates for the Return	3
4.	Due Dates for Payment	4
5.	Where To File and What Is Considered Timely	4
6.	How To File	5
7.	Discretionary Extension of Time to Pay Estate Tax Extension of Payment Due Date for Reasonable Cause	5
8.	Mandatory Extension of Time to Pay Estate Taxes	7
	a. Qualification	7
	b. Payout Period and Deferral Amount	7
	c. Passive Assets.....	8
	d. Reasons for Electing Code section 6166 Treatment.....	9
	e. Interest.....	9
	f. Avoiding Acceleration	10
	g. Completion of the Form	11
	h. Lien	12
9.	Third Party Financing	12
	The General Principles of <i>Graegin</i> and Its Progeny	14
	IRS Rulings in Family Limited Partnership Cases	15
	Analysis	16
10.	Which One Should be Chosen: A Graegin Type Loan or Section 6166.....	16
	Attachment One: Mathematical Analysis of <i>Graegin v.</i> 6166.....	18
	Attachment Two: Passive v. Active under Section 6166.....	20
	Attachment Three: The Darwinian Approach to Partnership Sustainability: <i>Mirowski</i>	26

Paying the Estate Tax When the Estate's a Little Short on Funds

9 Months is Here Quickly