

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

9 Months is Here Quickly

Liquidity Planning

- Pre-mortem topic
- And yet we are faced post mortem so many times with having to sort this out.
- Why? Not the standard of care to resolve this pre mortem.

Attention span of the client on this topic is limited

- Expensive
- Involves MY mortality
- No new \$\$ in my pocket

Let's put the problem in context

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

\$5 million in limited partnership interests, with a discounted value of \$4 million.

A residence worth \$1.5 million.

Marketable assets worth \$1 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 2.25m.

How do We Pay?

The marketable assets one million, can pay part of this tax, but if the residence is not sold shortly after death, the estate needs to find another 1.25m in liquidity to pay the estate taxes.

Options

1. Insurance
2. Loans from family members or capital infusion/advancements
3. Partnership loan, distribution or redemption?
4. 6161
5. 6166
6. Third party loans

Option 1: Insurance

- Irrevocable Insurance Trust: Benefits
 - Understandable
 - Quantitative
 - Certainly addresses this situation, but not the panacea because...
- Disadvantages
 - Cost: how will premiums be paid in excess of annual exclusion
 - Long term maintenance
 - Opportunity cost of premium amounts
 - Difficulty of infusing liquidity
 - Fixed amount problems: static

Option 2: Family Member Advancements

- Loan from family members
 - At what rate?
 - Interest problems
- Advancements
 - Problems (risk attitude/fmv/desire)
 - Have we ever done this?

Option 3: Partnership redemptions or borrowing: good/bad/uncertain?

- Rebecca set up partnership 2 years before she died
- SS and other retirement assets provided Rebecca with 50k a year; she was living on 150k a year.
- Investment return on marketable securities was 2 % a year.

Borrows or receives distribution or redeems from partnership to pay the \$1.25m extra

IRS now says what?

1. Pre mortem – expected to use cash
2. Post mortem – expected to use cash

And therefore,

2036

Transfer with retained interest.

Do they succeed?

Pre and Post Mirowski

Mirowski has an interesting use of post mortem proceeds to pay taxes that does not invoke section 2036.

Why?

Semi-Smell Test

The partnership had valid underpinnings and not just a sham/device to arrive at discounts?

Use the Government to do the Financing

Option 4: Extension of Time Under 6161

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.

What is Required?

- Any reason?
- “Reasonable cause” = 1 year extension;
+ “Undue hardship = up to 10 year extension.

“Reasonable Cause”

- Examples in the regulation are archaic, not likely to apply, and look like they are from the Titanic era
- Possibilities, not in the regs:
 - (1) pending Will or Trust contests
 - (2) construction actions,
 - (3) illiquidity and inability to generate cash from illiquid assets, and
 - (4) litigation or indecision between two or more executors in determining which assets to use or how to pay the estate tax.

“Undue Hardship”

- “[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.
- From the regs:
 - “*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.”

Considerations:

- Interest rate
- Interest effect as it relates to estate tax return? Income tax return?
- For how long?
- Applying for: timing and procedure

Option 5: Section 6166

You can describe it in a nutshell, but you can't keep it there: Deferral allowed...

For up to 15 years and 9 months:

- The first principal installment can be paid any time on or before five years and nine months after the date of the decedent's death.
- Each succeeding installment is to be paid annually.
- Interest is payable under Code section 6601 both during the first five years from the date that the estate tax should have been paid and during the installment period. Code §6166(f).

How Much Tax Can Be Deferred

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).

Numerically:

(Estate tax value of closely held business interests / Total Federal Estate Tax) * Adjusted Gross Estate

6166 Considerations Out of the Ordinary

- Qualification requirements
- Passive v. Active
- Buy Sell surprises?
- Interest rate surprises
- Investment Surprises
- Versus financing?

To qualify

1. a decedent must have an interest in a closely-held business
2. and be a citizen or resident of the United States,
3. and the business interest must exceed 35 percent of the decedent's adjusted gross estate. Code section 6166(a)(1).
4. 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

Passive v. Active

- the proprietorship, partnership, or corporation must be engaged in an active trade or business at the time of the decedent's death.

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

- 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.

Buy Sell Surprises

- An improperly coordinated buy sell agreement will have adverse consequences on the 6166 election
- Any one encounter this?

Mean Ole' 6166 (g): acceleration

- If > 50 % of the business is disposed of during the extension period
- If business is sold for down payment (insurance) + promissory note, then this is a “disposition” accelerating 6166
- How dealt with then?

- Installment sale of assets versus sale for an installment note
- Outline discusses provisions in the buy sell that could be used, drafting wise

Interest rate issues

- For the first \$562,500 [for a decedent dying in 2007] or \$576,000 [for a decedent dying in 2008], the interest rate is two percent. Code §6601(j).
- How much better is that than current rate?

Excess rate

- 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).
- Which, for the month of April, for example, was effectively...2.7 %.
- Hmm....what would happen if rate < 2 % under this standard?

Investment Analysis

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)

What if business goes down?

As a practical matter, as the advisor, do you want to assume that risk?

Graegin-type Loan

- What is it?
- Requirements
 - Prepayment – no
 - Terms – interest annually usually
 - Illiquidity – estate must have
- How long usually

Genesis

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). 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). *Estate of Todd v. Commissioner*, [57 T.C. 288 (1971)]

Extending this principle

The courts say:

If the amount of interest to be paid is ascertainable from the beginning, then the full amount of the interest to be paid is permitted as a deduction rather than either (1) the discounted present value of the interest payments (lower), or (2) on a current pay basis (hassle).

To qualify

- 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 estate must be illiquid.
- And the amount of the loan?

Extension 2: No prohibition necessarily...

- On business entities owned by family members providing the loan. The most cited case for this proposition is *Estate of Graegin v. C.I.R.*^[1]
^[1] T.C. Memo 1988-477.

How about with FLP?

- Generally, the IRS denies the deductions 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.

TAM 200513028

- 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. 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

6166 v. *Graegin*

- How do we compare to make apples v. apples
- Which to choose: non financial factors
- Who has done which one?

First, set time period =

- 5 year Graegin, = 5 year 6166 payoff

Then,

- Cash flow positive for a *Graegin* because estate tax is less
- Annually, more cash flow to pay interest on a *Graegin* versus 6166 because *Graegin* interest rate will be greater

Non tax

- Third party financing and overhang v. Government overhang
- No flexibility in lowering interest rate burden in *Graegin* v. prepayment allowed in 6166
- Audit exposure

Moral of the Story

- Pre-mortem: Clients should pay, focus, and plan for liquidity at a level > other elements of the estate plan.
- Treat as a separate project versus part of the basic estate plan documents
- And, if not done by clients pre mortem, offers fun and creative planning and analysis post mortem.