Chapter 14.

Deferral and Extension of Estate Tax Payments

OVERVIEW OF THE ESTATE TAX

The estate tax is due and payable at the same time the tax return is due, that is 9 months after the date of death. It must be paid within the time prescribed to avoid assessment of various penalties. Extensions of time for payment may be granted, but such extensions, although preventing the application of certain penalties, do not entirely negate the assessment of interest.

Due Date

The payment due date is the same numbered day of the ninth month after the date of death as that date was of the month in which death occurred. If there is no similarly numbered day in the ninth month, the tax is deemed to be due on the last day of that month. For example, if the date of death were July 31, the due date would be April 30 of the following year.

Place of Payment

The law requires that the tax be paid, without any assessment or notice by the Internal Revenue Service (IRS), to the IRS office where the estate tax return is filed. Unless the return is hand carried to the office of the IRS District Director, it should be mailed to the IRS Service Center for the State in which the decedent was domiciled on the date of death.

Method of Payment

The tax may be paid by check or money order payable to the IRS. If the amount of tax paid with the return is different from the amount of the net estate tax payable as computed on the return, the executor should explain the difference in an attached statement.

Flower Bonds

Treasury bonds of certain issues (known as "flower" bonds) are redeemable at par (plus the accrued interest from the last preceding date to the date of redemption) upon the death of the owner, at the option of the estate representative. No treasury obligations issued after March 3, 1971, will be redeemable at par value for this purpose.

ESTATE TAX OPTION FOR CLOSELY HELD BUSINESS INTERESTS

The estate of an individual who dies owning a closely held business interest--including an interest in timberland--may, by meeting certain requirements, qualify for a special elective method of paying the estate tax attributable to that interest. Under IRC Section 6166, payment of the tax may be totally deferred for the first 5 years, with the estate making 4 annual payments of interest only, followed by payment of the balance in up to 10 annual installments of principal and interest. The maximum payment period, however, is 14 rather than 15 years because the due date of the last payment of interest coincides with the due date for the first installment of tax. Election of special use valuation as discussed in chapter 13 does not prevent an election under Section 6166.

Percentage Test

The closely held business interest must comprise more than 35 percent of the decedent's adjusted gross estate. It can be composed entirely of timber property, or partially include timberland, but must be an active business. If special use valuation has been elected by the estate (see chapter 13), that value is used for purposes of determining whether the 35-percent test has been met.

Mortgage Effects.--Insofar as the eligibility of an ownership interest as a percentage of the decedent's gross estate is concerned, mortgages secured by real property used in the business must be deducted. Eligibility is measured in terms of the net value of the property in question and whether that value meets the 35-percent threshold requirement. See IRS Letter Ruling 8515010, which discusses the effect of a mortgage that encumbers both property used in the closely held business and other property. The IRS here ruled that the gross value of the decedent's closely held timber-growing business had to be

reduced by that portion of the outstanding mortgage attributable to it for purposes of valuation under the Section 6166 installment provisions. The mortgage in question encumbered both timberland and pasture. The rental of the pasture by the dece-dent was determined to be a passive activity, not the conduct of an active business. The timberland was held to be an active business, however, and an alloca-tion of the mortgage between it and the pasture on the basis of acreage was therefore necessary.

Combining Interests.--Interests in two or more closely held businesses may be combined for purposes of meeting the 35-percent test if more than 20 percent of the value of each is included in the gross estate. The value of a surviving spouse's interest in property held as tenancy in common, tenancy by the entirety, joint tenancy, or community property will be counted in determining whether more than 20 percent of the business was owned by the decedent.

Interest Payable on Deferred Tax

Interest on deferred tax is payable at a special, low, 4-percent rate, compounded daily, on the por-tion attributable to the first $1 million in value of the closely held business. After accounting for the unified credit, this means that a maximum of $153,000 in tax is covered by the 4-percent rate--a significant advantage for a qualifying estate. Amounts of deferred tax beyond that level are subject to interest based on the Federal short-term rate, also compounded daily. Interest payments are deductible for income tax purposes or as an estate administration expense if also deductible for that purpose under State law.

Making the Election

The election must be made on a timely filed estate tax return containing the following information: (1) the decedent's name and taxpayer identification number; (2) the amount of the tax to be paid in installments; (3) the date elected for payment of the first installment; (4) the number of annual installments, including the first installment, in which the tax is to be paid; (5) the properties shown on the estate tax return that constitute the closely held business interest; and (6) the facts supporting the conclusion that the estate qualifies for the deferral and installment election.

Subsequent Deficiencies.--If the election is made at the time the estate tax return is filed, it will also cover subsequent estate tax deficiencies determined by the IRS that are attributable to the closely held business. This is in addition to the estate tax origin-ally due with the return as filed.

Protective Election.--If it is not certain at the time of filing the return that the estate qualifies for the election, a protective election can be made. It will allow subsequent deferral of any portion of the tax attributable to the closely held business that is shown on the return, or deferral of deficiencies remaining unpaid at the time values are finally determined. The protective election must be made on a timely filed return. A final election notice must then be filed within 60 days after it has been determined that the estate qualifies for the election.

Acceleration of Unpaid Taxes

Deferred tax payments are accelerated if more than one-half of the value of the qualified business interest is withdrawn or disposed of during the deferral period. The same rule applies if funds or assets are withdrawn that represent 50 percent or more of such value. For this purpose, values are measured as of the date of the withdrawal(s), not the date of death.

Death of Original Heir.--The transfer of the decedent's interest upon the death of the original heir, or upon the death of any subsequent transferee who has received the interest as a result of the prior transferor's death, will not cause acceleration of taxes if each subsequent transferee is a member of the transferor's family.

Delinquent Payments.--A delinquent payment of either interest or tax will accelerate the due date of the unpaid tax balance if the full delinquent amount is not paid within 6 months of its original due date. The late payment, however, will not be eligible for the special 4-percent interest rate. Additionally, a penalty of 5 percent per month of the amount of the payment will be imposed.

Liability for Payment of the Tax

With a Section 6166 election, the estate representative is basically liable for payment of the tax. However, an executor or administrator seeking discharge of liability may file an agreement that gives

rise to a special estate tax lien. The lien is against "real and other property" expected to survive the deferral period. The maximum amount subject to the lien is the amount of deferred tax plus the first 4 years of interest. All parties having an interest in the property to which the lien is to attach must sign an agreement to its creation.

Once filed, the lien is a priority claim against the property, with some exceptions. These exceptions are as follows: (1) real property tax and special assessment liens; (2) mechanics' liens for repair or improvement of real property; (3) real estate construction or improvement financing agreements; and (4) financing for the raising or harvesting of a farm crop, or the raising of livestock or other animals.

What Constitutes a Closely Held Business Interest?

Sole Proprietorships.--Sole proprietorships may qualify as closely held businesses. Assets, including cash, must actually be involved in the trade or business of the sole proprietorship before their value can be included. Passive assets held by a sole proprietorship are not considered in determining value.

Partnerships.--If certain rules are met, partnership interests may qualify. Either 20 percent or more of the partnership's total capital interest (see page 98 for a discussion of partnership capital interests) at the time of the decedent's death must be included in the decedent's gross estate, or the total number of partners must not exceed 15. The inclusion of the value of passive assets held by a partnership is disallowed for purposes of the 35-percent test. Partnership interests held by a decedent's family are treated as if owned by the decedent. Internal Revenue Code Section 267(c)(4) defines the family of an individual as including brothers and sisters (whole- or halfblood), spouses, ancestors, and lineal descendants. A husband and wife are considered as one partner if the property is held as community property, tenancy in common, joint tenancy, or ten-ancy by the entirety.

Corporations.--Corporate interests may also qualify as interests in closely held businesses. In order for a corporate interest to qualify, however, 20 percent or more of the corporate voting stock must be included in the decedent's gross estate, or the total number of shareholders must not exceed 15. Only stock constitutes an interest in a corporate closely held business. Corporate debt securities are not interests. It is not necessary that the shareholder decedent have been personally involved in the busi-ness in order for his (her) stock ownership to qualify under Section 6166. As with partnerships, corporate interests held by a decedent's family are treated as if owned by the decedent. The definition of family is as noted above. A husband and wife are treated as one shareholder if the stock is held as community property, tenancy in common, joint tenancy, or tenancy by the entirety.

Trusts.--The installment payment IRC provisions and IRS regulations do not refer specifically to trust ownership of an interest in a closely held business. The IRS, however, does recognize business interests in trust as qualifying under Section 6166.

When is a Closely Held Business an Active Business?

The line between what is and what is not an active business is often a fine one. The required involvement for installment payment purposes can be contrasted with the material participation requirements for special use valuation as discussed earlier. There are two key differences between material participation for purposes of special use valuation and the necessary activity for purposes of Section 6166. For purposes of Section 6166, the question of whether the operation amounts to an active business is determined as of immediately prior to the decedent's death. For special use valuation purposes, material participation by the decedent or a family member is required for 5 or more of the last 8 years before death, retirement, or disability, whichever occurs earliest. It cannot be gained through the services of an agent, such as a property manager. On the other hand, even an unrelated agent, as well as a family member, can assure the necessary degree of involvement for purposes of Section 6166 (IRS Letter Ruling 8020101). Section 6166 eligibility can also be established through power of attorney (Letter Ruling 8134010).

Disqualification Not Appealable.--An IRS determination that an estate does not qualify for a Section 6166 election because the decedent's activities did not constitute an interest in a closely held business is not appealable to the Tax Court. See *Estate of Sherrod* [82 TC 523, 85-2 USTC 13,644 (CA-11)] in which the decedent's activities with respect to his timberland were held by the IRS not to constitute an active trade or business for Section 6166 purposes. The court noted that its jurisdiction was strictly limited by statute and that it did not have the authority

to enlarge upon the sole statutory grant of jurisdiction given to the IRS with respect to Section 6166 eligibility.

Technical Advice Memorandum 8437001 (May 9, 1984).--Here the IRS held that 5,126 acres of timberland owned by the decedent (comprising 87.7 percent of the adjusted gross estate) did not qualify as an interest in a closely held business within the meaning of Section 6166(b)(1)(A) of the IRC. The decedent's activities with respect to the property included visiting the property routinely to observe timber growth and development, and to study the land and its potential for raising timber; making management decisions, such as whether to plant seedlings, when to sell timber, whether to clear and replant after cutting, and in general what forestry techniques were best suited to his particular situation; negotiating contracts for the sale and harvesting of timber; observing cutting operations to insure compliance with contract terms; and overseeing the maintenance of roads and firebreaks, and the prevention of trespass. During a 6-year cutting con-tract, however, the decedent had granted the con-tractor almost complete control over the cutting operation and the property. The IRS found that during this period the decedent's prerogatives with respect to the property were limited to policing the cutting for the purpose of enforcing the contract terms, and that the cutting arrangement was thus similar to a "net\net" lease arrangement wherein the lessor merely receives a net income based on ownership of the leased property. This fact was the overriding factor in the IRS conclusion that the decedent's relationship to his timber assets was not that of a proprietor carrying on a trade or business.

IRS Atlanta District Memorandum.--In an unnumbered and undated memorandum issued by the IRS Atlanta District Office, the IRS held that the nature and level of the decedent's activities with respect to his nearly 500 acres of timber property was insufficient to constitute an active trade or business for Section 6166 purposes. The estate representative's statements that the decedent had actively managed the property in accordance with good forestry practices was countermanded by an IRS appraiser who stated that the timber was all natural; that none had been planted; that there was no evidence of cutting in recent years or of thinning; that the only fire-breaks were roads; and that here had been no prescribed burning within the past 5 years. He con-cluded that the decedent had just let the timber take its natural course and that there was no evidence of forestry practices.

Letter Ruling 9015003 (December 22, 1989).--In supplementing Letter Ruling 9001062, the IRS concluded that a decedent's one-third interest in a timber business held in trust qualified as an interest in an active, closely held business for Section 6166 purposes. The property was under active forest management; daily operations and timber sales were carried out by an independent forest management company. The decedent, individually and through her agents, participated in the decision-making pro-cess in running the business. She and other grantors met annually with the trustee and a representative of the forest management company to review the prior year's forest management activities, to discuss plans for the coming year, and to make long-term plans. The decedent also shared equally with the other grantors the income from and the expenses of the business, and thus also shared in the risks involved. For purposes of Section 6166(a), activities of an agent may be attributed to a decedent. In this case, the trustee was the decedent's agent.

What Constitutes Withdrawal or Disposition?

Changes in organizational form do not terminate the installment payment right if they do not materially affect the business. Thus, incorporation of a sole proprietorship, a shift from sole proprietorship status to partnership, liquidation of a corporation, and transfer of a sole proprietorship to a limited partnership have all been held not to accelerate payment. Installment sale of property, however, will terminate Section 6166 status if the 50-percent limit is reached.

Converting cropland, for which a Section 6166 election is in force, to grass or tree cover under the Conservation Reserve Program is not a withdrawal or disposition (IRS Letter Ruling 9212001). The tax attributable to the property will continue to be eligible for deferral and payment in installments.

Like-kind Exchange.--The transfer of assets in a tax-free exchange does not accelerate payment of tax that has been deferred. In Letter Ruling 8722075, an estate's partition of an undivided interest in woodlands, followed by a like-kind exchange, did not affect the 6166 election that was in force. Although more than 50 percent of the property may have been transferred, depending on whose values were accepted, the exchange did not materially alter the

timber business or the estate's interest in the timber business. The partition and exchange was, therefore, not a disposition for acceleration purposes.

Letter Ruling 8437043 (June 8, 1984).--The IRS here held that a proposed sale of timber, comprising 51 percent of the closely held business interests and a proposed 29-year lease of the land (comprising 35 percent of the closely held business interests) to a forest products company would constitute a disposition under Section 6166 (g)(1)(A). The estate, according to the ruling, would be liquidating its active business enterprise of timber production in exchange for an arrangement in which it would merely hold the land as an investment asset from which income would be derived solely on the basis of ownership.

Planning Opportunities

Because the value of the closely held business must exceed 35 percent of the adjusted gross estate, woodland owners seeking to qualify under Section 6166 should be familiar with the various elements that constitute the adjusted gross estate. If the value of the tree farm is very close to 35 percent, consideration should be given to increasing its value or decreasing the adjusted gross estate during the decedent's life-time. In order to reduce the adjusted gross estate, the types of expenses which may be deducted to arrive at it should be reviewed for possible changes (see chapter 3 for a discussion of adjusted gross estate).

Great care should be taken in deciding whether to make gifts of assets in order to qualify for Section 6166 treatment. Gifts made within 3 years of death that would not normally be included in the gross estate will be considered to determine if the 35-percent test is met. This provision was specifically designed to prevent deathbed transfers intended to qualify the estate for Section 6166 treatment.

Special use valuation should also be carefully evaluated. While its election will decrease estate tax liability, its use may preclude qualifying for installment treatment. The value of deferring the estate tax payments should be compared to the value of the estate tax reduction.