

## Some Useful Farm, Ranch, and Small Business Estate Tax Payment Provisions

There are a number of tax law provisions that a small business owner, the owner of real property used in a trade or business, or a farm or ranch owner (“small business owner”) will find useful to ease the pain of paying estate tax.

A. **Stock Redemption to Pay Estate Tax.** A small business owner where the business is incorporated may want to plan to be able to qualify for the special provisions under IRC § 303 that allow a corporate redemption of stock in order to pay estate taxes and administrative expenses. This can help with liquidity by enabling the release of funds from the corporation without dividend (*i.e.*, double tax) treatment, and is particularly useful where the stock is not all being sold pursuant to a buy-sell agreement. The basis for the stock being redeemed will be the stepped-up basis at death under IRC § 1014, so generally there will not be gain or loss realized on the stock itself at the stockholder level. (Sales or distributions of corporate assets will trigger taxation at the corporate level.) In order to meet the qualifications for the special redemption the business owner may desire to give away other assets in order to meet the percentage requirements, combine corporations that alone do not meet the percentage requirements, contribute other assets to the corporation, or value the corporation at the higher end of the fair market value range on the estate tax return. Also, a recapitalization with a redemption of preferred stock should be considered since the IRC § 303 redemption can eliminate the IRC § 306 preferred stock bailout taint. The major requirements for qualification include:

(1) **Amount.** The redemption is limited to the amount of death taxes (including generation skipping) and the funeral and administrative expenses deductible by the estate. IRC § 303(a)(2). Stock used for a marital deduction gift may not qualify for an IRC § 303 redemption; also, the IRC § 303 redemption is not available for stock used to satisfy a pecuniary bequest because this is treated as a sale of the stock. Treas. Regs. § 1.303-2(f).

(2) **Percentage Test.** The value of the stock of the closely held business must be more than 35% of the adjusted gross estate. IRC § 303(b)(2)(A). The stock value of two or more corporations can be combined if 20% or more of the value of each corporation is owned by decedent and included in the gross estate or is held by the surviving spouse with decedent as joint tenant, tenants in common, or community property. IRC § 303(b)(2)(B).

(3) **Time.** The redemption must occur after death, and must occur (i) three years plus 90 days from the later of the due date of the return (without extension) or the actual filing, (ii) 60 days after a final Tax Court decision, or (iii) before the last installment is due on a payment deferral election under IRC § 6166. IRC § 303(b)(1). If this stretches more than four

years after death, redemptions qualify only for the lesser of taxes and expenses unpaid immediately before the distribution or the amount of these items paid within one year after the redemption distribution. IRC § 303(a)(4).

B. **Elective Deferral of Payments.** Under IRC § 6166 the estate of a closely held business owner who is a US citizen or resident may elect to stretch estate tax payments over a period of up to 10 years in annual installments with the first installment due within five years of the due date (without extensions) of the estate tax return, subject to the payment of interest during this five year period in four annual installments. IRC § 6166(a)(1) and (3) and (f)(1). Planning for this deferral is similar to planning for the other special closely held business provisions discussed above. The five year deferral and the installment election also apply to generation skipping tax direct skips made at death, but not to taxable terminations or taxable distributions. IRC § 6166(i).

(1) **Low Interest.** The interest on the first \$1 million of taxable value (indexed for inflation; \$1,520,000 in 2018) is 2%, and the balance bears interest at only 45% of the rate of IRC § 6601(a). However, no estate tax or income tax deduction will be available for any such interest paid. IRC §§ 163(k) and 2053(c)(1)(D).

(a) **Taxable Value.** The special 2% rate applies to the portion of the deferred estate tax that is attributable in 2018 to the first \$1,520,000 in taxable value of the closely held business. The first \$1,520,000 in “taxable value” of the business is the first \$1,520,000 above the applicable exclusion amount (under the unified credit). IRC § 6601(j)(1)(A). Thus, for example, in 2018, when there is an effective estate tax exclusion of \$11.018 million, the amount of estate tax attributable to the value of the closely held business between \$11.018 million and \$12.538 million is eligible for the 2% interest rate. This will change after 2025 when the effective estate tax exclusion sunsets back to lower prior levels (indexed for inflation).

(b) **Other Rate.** Where tax is deferred but the 2% rate does not apply, a different reduction applies. The interest rate on deferred estate tax attributable to (1) the taxable value of the closely held business in excess of the \$1,520,000 amount (in 2018) (as adjusted), (2) holding companies, and (3) nonreadily tradable business interests where the decedent qualified for the 20% interest test (described below) using family attribution, is an amount equal to 45% of the rate applicable to underpayments of tax. IRC § 6601(j)(1)(B).

(c) **Application of Payments.** Tax payments on the deferred amounts will be applied to each portion of the liability proportionately. IRC § 6601(j)(1). (For example, assume one-third of the deferred amount qualifies for the 2% rate, and the remaining two-thirds is subject to the regular rates. A tax payment of \$90,000 reduces the 2% portion by \$30,000 (1/3) and the regular portion by \$60,000.)

(2) **Qualification.** The major qualification requirements include:

(a) **Amount of Deferral.** The portion of the estate tax that can be deferred is the portion that is in the same proportion as the value of the closely held business is to the value of the adjusted gross estate. IRC § 6166(a)(2).

(b) Percentage Test. The business must be more than 35% of the adjusted gross estate less deductions for administrative expenses, losses, etc. under IRC §§ 2053 and 2054 (*i.e.*, no marital or charitable deduction is taken into account here). The value of more than one business may be combined if 20% of the value of the business is included in the gross estate or is held by the surviving spouse in joint tenancy, tenancy in common, or community property. IRC § 6166(c). Special use value of real estate will be used where this has been elected because the values used are estate tax values. IRC § 6166(b)(4). Passive assets are excluded from value. IRC § 6166(b)(9).

(c) Closely Held Business. The business must be closely held but may be in the form of a sole proprietorship, or a partnership or corporation of which 20% or more of the total capital interest or voting stock value is included in the gross estate or which have 45 (15 prior to 2002) or fewer partners or shareholders. IRC § 6166(b)(1).

(i) Attribution of Ownership. Attribution rules apply to deem the ownership of related parties to belong to decedent (interests or shares owned by the decedent's spouse, siblings, ancestors, and descendants are treated as owned by the decedent, and there is attribution for certain indirect ownership through entities), and gifts within three years of death are included for this purpose as well. IRC §§ 6166(b)(2), 2035(d)(3)(C). In applying the 45 partner or shareholder test, above, interests or shares owned by the decedent's spouse, siblings, ancestors, and descendants are treated as owned by the decedent. Any interest owned jointly by a married couple is counted as one partner or shareholder.

(ii) Attribution Election for Qualification. In applying the 20%-interest test, the executor may elect to have the interests of these family members counted as the decedent's. However, if this is the way the decedent's interest qualifies for the deferral, then (1) the five-year deferral period is lost (*i.e.*, the ten-year payment period starts right away), and (2) the favorable 2% interest rate is not available on deferred amounts. IRC § 6166(b)(7).

(d) Active Trade or Business. The business must actually be engaged in an active trade or business at the time of death where active management has been provided by decedent or decedent's agent. IRC § 6166(b)(1); Rev. Rul. 75-365, 1975-2 C.B. 471. Farms can include residential property occupied on a regular basis by the owner or lessee for operating the farm. IRC § 6166(b)(3). Stock cannot be readily tradeable on an exchange or over the counter market. IRC § 6166(b)(7). Passive real estate holding is unlikely to qualify. Rev. Rul. 2006-34, 2006-1 C.B. 1171, Rev. Rul. 75-366, 1975-2 C.B. 472, PLR 8244003, PLR 8432007, and PLR 8448006.

(e) Active Business of Farming. For a farm to meet the active trade or business requirement, the decedent must be engaged in the business by cultivating, operating, or managing the farm for profit, either as an owner or tenant, and receive any rental based on farm production rather than a fixed amount. Ltr. Ruls. 8020143 and 8136022; Rev. Rul. 75-366, 1975-2 C.B. 472. Management may be through an agent. Ltr. Rul. 8133015. It is helpful to show management and participation to have participation in important decisions (*e.g.*, crops to

plant, use of subsidies, marketing plans), to visit the operation regularly, to make crop-sharing arrangements, and to bear certain costs (*e.g.*, maintenance, property taxes, fertilizer).

(f) Election. The election must be made on a timely filed return or, in some cases, on the deficiency assessed during audit if values increase to a point that qualification becomes possible. IRC § 6166(d) and (h). See Treas. Regs. § 20.6166-1. It may be best to file a protective election if qualification is possible. Reg § 20.6166-1(d). The protective election would need to be finalized by filing a final Notice of Election within 60 days after the values are finally determined. The Service does not believe any reasonable cause exception applies for a failure to timely make the election, and does not believe Reg. § 301.9100-3 relief applies either to this “statutory” rather than “regulatory” election. Chief Counsel Advice 200628042; PLR 200721006.

(3) Termination. Deferred tax will be accelerated if:

(a) Sale. A sale or other disposition (other than certain reorganizations (see IRC § 6166(g)(1)(C)) or transfers by reason of death under the will, trust, or intestacy (see IRC § 6166(g)(1)(D)) of 50% or more in the aggregate of the value of the decedent's interest occurs (IRC § 6166(g)(1)(A));

(b) Redemption. Where redemptions under IRC § 303 occur, to the extent not used to pay the next installment of taxes (IRC § 6166(g)(1)(B));

(c) Distribution. The estate has undistributed income for any year ending on or before the first installment becomes due (*i.e.*, after four taxable years) (IRC § 6166(g)(2));

(d) Nonpayment. The required installments are not paid when due (IRC § 6166(g)(3)(A)).

(4) Bonds, Liens, Liability. A bond of up to double the tax deferred may be required by the Service. IRC § 6165. The personal representative is personally liable unless discharged by the posting of the bond, the payment of the tax, or following of the special lien procedure. IRC § 2204A. A special lien in lieu of the regular tax lien may be elected by all persons with an interest in the property filing an agreement consenting to the lien and naming an agent to make payments, receive notices, and otherwise deal with the Service. The lien applies to all real property and assets expected to survive the deferral period. IRC § 6324A. The lien is on an amount not to exceed the principal of the deferred taxes and four years of interest. IRC § 6324A(b)(2) and (e)(2). The value is estate tax value after reduction for encumbrances such as mortgages and any liens under the special valuation provisions. IRC § 6324(b). If the lien is insufficient, a bond may be accepted for the remaining amount. IRC § 6324A(b)(3). Additional security may be required on 90 days notice if the value of the lien property becomes less than the required amount, and if not provided, the tax will be accelerated. IRC § 6324A(d)(5).

(5) Review. Where installment payment relief is denied under IRC § 6166 either initially or as to continued eligibility, under IRC § 7479, if administrative review has been exhausted or the Service fails to make a determination after 180 days from request, a declaratory

judgment may be sought from the Tax Court without having to pay the tax prior to the judicial review. This is different from other federal courts where the tax must first be paid and a refund sought. To seek a refund in a federal court relating to the IRC § 6166 election, all installments must be current when the case is filed. *Hansen v. U.S.*, 248 F3d 761, (8th Cir. 2001). Also, generally an overpayment of an installment is not refunded but is a credit against future installments, at least where the payment results from an error is on the part of the taxpayer and not under threat from the Service to which the taxpayer protests. *Bell v. Com'r*, 928 F2d 901 (9<sup>th</sup> Cir. 1991); see *Est. of Shapiro v. Com'r.*, 111 F3d 1010 (2d Cir. 1997).

C. **Discretionary Deferral of Payments and Deferrals for Remainders and Reversions.** A discretionary deferral of payments may be available for a reasonable period not to exceed twelve months from the original due date of the return (*i.e.*, up to 21 months from the date of death). IRC § 6161(a)(1). An additional extension for up to ten years may be available if reasonable cause, such as undue hardship, lack of liquidity, etc., is demonstrated. IRC § 6161(a)(2); Regs. § 20.6161-1. Up to a 4 year extension for reasonable cause after an audit deficiency assessment may be available under IRC § 6161(b). IRC § 6161 discretionary deferrals may also apply to installments due under IRC § 6166. Security may be required under IRC § 6165, and the statute of limitations will be extended under IRC § 6503 for any extension under IRC § 6161. The Code also provides a separate deferral mechanism under IRC § 6163 which provides for a deferral until six months after the end of the prior interest for tax attributable to a reversion or remainder interest. An additional three years deferral may be possible under this provision if reasonable cause is demonstrated. Security may be required under IRC § 6165.