



FEATURE: ESTATE PLANNING & TAXATION

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How to Administer a Section 6166 Estate

Help preserve the family business

Internal Revenue Code Section 6166 can provide significant federal estate tax deferral for estates of closely held business owners. Judicious application of IRC Section 6166 during the administration of a business owner's estate can help to preserve the family business. Here are some of the many intricate steps required to administer a Section 6166 estate.

This article is the second of a two-part series on Section 6166. The first article, published in the April issue of *Trusts & Estates*, focused on lifetime planning for business owners using Section 6166.¹ We'll use the same defined terms as we did in that article.

The 6166 Notice of Election

Section 6166 allows the executors of a qualifying estate to make one or more 6166 elections. To make a 6166 election, executors must attach a 6166 Notice of Election to a timely filed federal estate tax return (Form 706).² The Section 6166 filing deadline is statutory. Therefore, estates that fail to timely file Form 706, including extensions, and make a 6166 election can't receive regulatory relief.³ Without 6166 deferral or a discretionary IRC Section 6161 extension of time to pay, the federal estate tax on all estate assets, including any closely held business interests, will be due nine months following the decedent's date of death (the payment date).⁴

Protective elections. Protective elections are critical components of any Section 6166 estate administration. Executors of estates with closely held business interests should consider filing a Notice of Election

listing each such interest, even if certain interests don't initially appear to qualify for 6166 deferral. In addition, executors should make a protective request under Section 6161 to extend the time to pay the federal estate tax attributable to the estate's closely held business interests. A protective Notice of Election, combined with a Section 6161 extension (and corresponding state extension, if applicable), will maintain maximum flexibility. If the value of one or more business interests is adjusted on audit, then including a catchall provision in the Notice of Election for assets later determined to qualify for 6166 deferral allows an estate to defer the estate tax on such assets.

Critical elements. The Notice of Election must provide the decedent's name, Social Security number, amount of deferred estate tax, date for payment of the first installment and number of annual installments.⁵ The Notice of Election must also identify each of the estate's closely held business interests and detail why such interests qualify for a 6166 election.⁶ If the Notice of Election fails to include certain elements, then the estate won't qualify for 6166 deferral.⁷

Interest Rates and 6166 Ratio

Executors can determine the amount of estate tax deferred under Section 6166 by first computing the ratio (the 6166 ratio) of the value of the qualifying business interests to the adjusted gross estate (AGE)⁸ and then multiplying the total federal estate tax due by the 6166 ratio.⁹ The federal estate tax on the Section 6166 portion can be deferred, while the balance on the non-deferred portion must be paid by the payment date. A 6166 election entitles an estate to pay federal estate tax on qualified business assets in up to 10 equal annual installments. In certain instances, an estate can also defer the initial tax payment for five years from the payment date and pay only interest during this period.¹⁰

Estates that qualify for a 6166(a)(1) election or a

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6166(b)(10) election will pay interest on the deferred federal estate tax at two separate rates. The first interest rate (the 2 percent portion) is fixed at 2 percent and accrues on the lesser of the estate tax due on the total deferred assets and the estate tax due on \$1 million, adjusted for inflation.¹¹ In 2017, the 2 percent portion applies to the first \$596,000 of federal estate tax.¹² Interest on any deferred estate tax in excess of the 2 percent portion, and on all of the tax deferred due to a 6166(b)(7) election or a 6166(b)(8) election, will accrue at 45 percent of the annual federal underpayment rate determined under IRC Section 6621(a)(2).¹³ The federal underpayment rate is equal to the sum of 3 percent and the federal short-term interest rate (rounded to the nearest percent) and is adjusted quarterly.¹⁴

Example 1. In January 2017, the Internal Revenue Service increased the federal short-term interest rate to 0.96 percent. The excess Section 6166 underpayment rate for the first quarter of 2017 was therefore 1.8 percent.¹⁵ Given the current, historically low interest rates, the interest rate on the 2 percent portion is actually higher at the moment than the interest rate on the balance of the deferred estate taxes.

Notably, the interest paid on the federal estate taxes deferred under Section 6166 isn't deductible for income tax¹⁶ or estate tax purposes.¹⁷

Computing Section 6166 Payments

Audit adjustments. When estimating the initial non-deferred estate tax due on the payment date, executors should be conservative. Adjustments on audit may change the value of both deferred and non-deferred assets, affecting the 6166 ratio. Each audit change will necessarily affect the amount of deferred estate tax the estate will owe over the deferral period. During audit, business assets included in the protective Notice of Election may be added or subtracted from the deferral pool. Executors should also re-evaluate the use of Section 6166(b)(7) family attribution for smaller business interests when aggregating business interests under Section 6166(c). Aggregation requires 20 percent or more of the total value of each business interest to be included in the gross estate. In certain audit situations, it may be better to forego deferring the estate tax on business interests that require family attribution. Executors

can then aggregate only those interests held by the decedent that meet the 20 percent threshold, thereby gaining a valuable 5-year interest-only deferral period under Section 6166(a)(1).

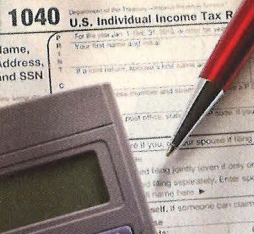
Deductions. Any IRC Section 2053 and IRC Section 2054 deductions taken on Form 706 reduce the value of the AGE and therefore increase the 6166 ratio. As noted above, the 6166 ratio determines the amount of the non-deferred tax that will be due on the payment date, as well as the amount of the deferred estate tax to be paid over time.

State estate tax. As of Jan. 1, 2017, 14 states and the District of Columbia have a state estate tax.¹⁸ Many of these states don't allow deferral of state estate tax on closely held business interests. Such states require the

When a U.S. citizen or resident dies, an immediate inchoate federal estate tax lien arises under IRC Section 6324(a) against all of such individual's assets.

entire state estate tax to be paid initially and deducted on Form 706.¹⁹ Some states allow deferral of state estate taxes similar to Section 6166, but have their own underpayment interest rates and methods for computation. In such states, executors may be able to deduct state estate tax and interest as paid.²⁰

As installments of deferred state estate taxes and interest thereon are paid, executors of a Section 6166 estate must file a supplemental federal estate tax return (a Supplemental 706) to claim deductions for such payments. If an estate defers both federal and state estate taxes, the IRS and the state separately recompute the estate tax annually. States often compute the deferred state estate tax and interest without incorporating the most recent Supplemental 706. For this reason, executors should compute the deferred federal and state estate tax payments and interest and not rely on the annual invoices received from the IRS and the relevant state. Any discrepancies must be resolved quickly before the next annual payment is due.



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Administration expenses. Generally under IRC Section 2053, administration expenses must be paid in full before being deducted on Form 706. However, an estate can take certain estimated deductions on Form 706 that are reasonably ascertainable and will be paid.²¹ Such deductions include the executor's commissions and legal and accounting fees. In a Section 6166 estate, executors should consider the anticipated length of the administration period when estimating these expenses on Form 706. Larger deductions taken on Form 706 will decrease the AGE and increase the 6166 ratio. An estate can deduct additional administration expenses not included on Form 706 as they're paid by filing a Supplemental 706.

Supplemental 706s. Most deductions taken on a

Example 2. An estate has \$900 of closely held business assets and \$200 of non-business assets. The estate qualifies for deferral under Section 6166(a)(1). Initial paid and estimated administration expenses deducted on Form 706 total \$100. The AGE is \$1,000, and the initial 6166 ratio is 0.90. The federal estate tax is \$400. Forty dollars is due by the payment date, and \$360 is deferred. Later, the estate pays additional interest on the deferred state estate tax and administration expenses of \$40 and files a Supplemental 706. The AGE is re-computed as \$960. The new 6166 ratio is 0.9375. The overall federal estate tax is reduced to \$384. Because the new deductions relate back to the payment date, only \$24 was technically due by the payment date, although \$40 was previously paid. Therefore, \$16 is now treated as an overpayment.

Once an estate begins making deferred estate tax payments, an estate must also pay any UNI of the estate to the IRS before the end of the estate's fiscal year or risk estate tax acceleration.

Supplemental 706 relate back to the original payment date. New deductions taken on a Supplemental 706 reduce the total federal estate tax due, and most such deductions are included in the computation of the 6166 ratio. Exceptions under Section 6166(b)(6) include deductions for expenses that are incurred or accrue after the payment date.

When the 6166 ratio increases, the amount of the deferred estate tax also increases. Additional deductions that relate back to the payment date therefore decrease the total federal estate tax (and interest) due as of the payment date.²² However, at the time the Supplemental 706 is filed, the federal estate tax on the non-deferred portion of the estate has already been paid based on the original AGE and 6166 ratio. For this reason, each time a Supplemental 706 is filed, some of the paid estate tax will be an overpayment that will be applied to the remaining federal estate tax due.

Allocation of Overpayments

Without a protective election or a maximum deferral election on the Notice of Election, the IRS will reduce the amount of tax eligible for deferral by the total amount of the overpayment. This method will reduce each installment of deferred tax. If the executors prefer to have the maximum amount of tax eligible for deferral extended under Section 6166, then they should request maximum deferral on the Notice of Election. With maximum deferral, the IRS will apply the overpayment entirely against the next upcoming installment of deferred tax. The overall interest charged by the IRS will be higher with maximum deferral, but the next installment payment will be reduced by the full amount of the overpayment, thereby providing the estate with immediate financial relief. When preparing the Notice of Election, executors should determine whether maximum deferral will be better for the estate. Note that even when states allow the equivalent of 6166 deferral, they don't always honor requests for maximum deferral. Therefore, the state Section 6166 allocation of overpayments can differ from the federal allocation.

Estate Tax Liens

Inchoate estate tax lien. When a U.S. citizen or resident dies, an immediate inchoate federal estate tax lien arises under IRC Section 6324(a) against all of such individual's assets. No notice or recorded filing is necessary for such lien to be effective. The IRS can enforce



this inchoate lien for a 10-year period commencing on the decedent's date of death.²³ The lien attaches to each estate asset until either the 10-year period ends or all of the federal estate tax is paid. Notably, estate tax deferral under Section 6166 can last nearly five years beyond the termination of the inchoate lien. Therefore, Section 6324(a) doesn't fully protect the IRS in certain 6166 estates.²⁴

Special lien. Because Section 6324(a) liens are often insufficient for Section 6166 estates, the IRS can require a substantial bond of up to double the amount of the deferred federal estate tax.²⁵ Obtaining and paying for such a bond can be extremely onerous. Alternatively, under IRC Section 6324A, the IRS and the estate can agree instead to place a special lien on certain estate assets in lieu of a bond.²⁶ The IRS can request a special lien on estate assets valued up to the total amount of the deferred estate taxes and the interest computed thereon for the first four years.²⁷ A special lien replaces the inchoate lien, provides a full release of any estate assets not subject to the special lien agreement and expires when the deferred estate tax is paid in full.²⁸

Estate of Roski. In 2002, the IRS adopted a bright-line rule that required either a bond or a special lien on every Section 6166 estate.²⁹ However, the Tax Court, in *Estate of Roski v. Commissioner*,³⁰ subsequently found that the IRS couldn't require all Section 6166 estates to provide a bond or special lien. In *Roski*, the Tax Court decided that the IRS must determine, on a case-by-case basis, whether the government's ability to collect the deferred estate taxes and interest thereon was actually at risk prior to requiring added security from a Section 6166 estate.

Revenue Notice 2007-90. In response to *Roski*, the IRS issued Revenue Notice 2007-90, setting forth three main factors used to determine whether the IRS could require a bond or special lien. These factors were: (1) the duration and stability of the business; (2) the ability of the estate to pay the deferred tax and interest in a timely manner; and (3) the tax compliance history of the closely held business as well as the executors individually.³¹ Other related factors included the expertise of the current managers in running the business and the general economic climate.

Case-by-case determination. When an estate makes a Section 6166 election, the IRS opens a Section 6166 account for the estate and sends a "Roski letter" requesting that the estate either provide a bond or submit

to a special lien. If the estate doesn't respond within 30 days, the IRS will determine what security is required without any further input from the estate. Therefore, the executors should prepare a response to the *Roski* letter even before it's received. The executors may decide that a special lien on assets they choose is preferable to an inchoate lien on all of the estate's assets and a bond. If a special lien is preferable, the estate should immediately seek a written agreement to this effect with the IRS. Alternatively, the estate may request relief from both the special lien and the bond. To do so, the estate must show that the closely held businesses are healthy, the estate's cash flow is sufficient to pay the deferred estate tax and interest and the business entities and fiduciaries are in good standing with the IRS. With good facts, it's possible to reduce or entirely eliminate the need for either a special lien or a bond.

Acceleration Under Section 6166(g)

To preserve the right to 6166 deferral, executors must pay the deferred estate tax and interest due in any given year³² and abide by the minimum value requirements set forth in any special lien agreement.³³ If the estate fails to do either of the above, the IRS can accelerate the remaining deferred estate tax payments. There are two additional triggers that can cause acceleration under Section 6166(g).


Section 6166(g) dispositions. Executors must certify each year that the closely held business assets owned by the estate have remained substantially the same since the prior payment. If an estate distributes, sells, exchanges or otherwise disposes of 50 percent or more of its closely held business interests, or withdraws assets equivalent to such amount from the business, then under Section 6166(g), the IRS can accelerate all of the remaining federal estate tax.³⁴ Section 6166(g) acceleration won't be caused by the transfer of assets pursuant to the decedent's will, or by intestacy, to the decedent's beneficiaries (or trusts for their benefit).³⁵

Payment of UNI. Once an estate begins making deferred estate tax payments, an estate must also pay any undistributed net income (UNI) of the estate to the IRS before the end of the estate's fiscal year or risk estate tax acceleration.³⁶ Note that the UNI computation relates to the estate's fiscal year and may not correlate with the date the annual installment of estate tax and interest is due. In addition, the computation of UNI doesn't take into account any state income taxes or state estate taxes



paid by the estate, which can be highly problematic. The estate's UNI is calculated by determining the estate's distributable net income (DNI) for the estate's taxable year (as defined in IRC Section 643) and then subtracting the DNI deductions under Section 661(a) for such year, the federal income tax imposed on the estate for such year and the amount of the federal estate tax and interest paid in such year.³⁷ The IRS will treat the payment of UNI as a credit against the unpaid portion of the deferred estate tax and will apply such credit evenly across all remaining Section 6166 installments even if the estate has elected maximum deferral.³⁸ As long as the UNI is timely paid, the 6166 deferral continues.

If an estate is projected to have UNI in a given year, the executors must decide whether to distribute additional assets to the estate's beneficiaries that will carry out DNI, pay the UNI to the IRS or prepay the estate's deferred estate tax liabilities with a maximum deferral election. Because the executors are personally responsible for the estate taxes, any distribution of DNI to the beneficiaries should include a refunding agreement. Unfortunately, if an estate owes substantial state income tax as well as deferred state estate taxes and interest in a given year, the estate may have UNI that exceeds its available liquid assets. In this case, it may be necessary to liquidate some business interests rather than forfeit the estate's entire deferral under Section 6166.

Administering a Section 6166 estate is extremely complex. The effective use of Section 6166 is one of the most important tools available to preserve a closely held business. Decisions made during the first nine months of an estate administration can have serious ramifications for many years to come. To administer a Section 6166 estate effectively, it's crucial that executors and their advisors understand the nuances of Section 6166, harnessing all of its power while avoiding numerous pitfalls along the way. 

Endnotes

1. Jessica Galligan Goldsmith and David Y. Choi, "Saving the Store," *Trusts & Estates* (April 2017), at p. 14.
2. Internal Revenue Code Section 6166(d).
3. Private Letter Ruling 200721006 (May 25, 2007). The Internal Revenue Service has consistently refused to consider any reasons why an estate didn't file timely. Regardless of whether executors act in good faith, a late-filed Form 706 will prevent a 6166 election. See also *Estate of Wallace R. Woodbury v. Commissioner*, T.C. Memo. 2014-66.

4. IRC Section 6075(a).
5. Treasury Regulations Sections 20.6166-1(b)(1)-(6).
6. *Ibid.*
7. IRC Section 6166(d) authorizes the IRS to issue a regulation indicating the method of making the 6166 election, and Treas. Regs. Section 20.6166-1(b) provides the only method of making the 6166 election.
8. As computed under IRC Section 6166(b)(6).
9. Section 6166(a)(2).
10. Section 6166(a)(1).
11. IRC Section 6601(j).
12. Section 2.45 of Revenue Procedure 2016-55 (Oct. 25, 2016) provides under IRC Section 6601(j), \$1 million is inflation adjusted to \$1.49 million for calendar year 2017.
13. Section 6601(j)(1)(B).
14. IRC Section 6621(b)(1).
15. Round 0.96 percent to the nearest full percent, add 3 percent and then multiply the sum by 45 percent to determine the excess Section 6166 underpayment rate of 1.8 percent. See IRC Sections 6621(b)(3), 6621(a)(2) and 6601(j)(1)(B).
16. IRC Section 163(k).
17. IRC Section 2053(c)(1)(D).
18. McGuireWoods LLP, "State Death Tax Chart" (Jan. 9, 2017). The jurisdictions with a state estate tax include Connecticut, Delaware, District of Columbia, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Rhode Island, Vermont and Washington. See <http://bit.ly/2n2NfHK>.
19. IRC Section 2058(a).
20. Treas. Regs. Section 20.2053-3.
21. Treas. Regs. Section 20.2053-1(d)(4).
22. *Estate of Shapiro v. Comm'r*, 111 F.3d 1010 (2d Cir. 1997).
23. IRC Section 6324(a).
24. As noted by the IRS in Revenue Notice 2007-90 (Nov. 13, 2007).
25. Sections 6166(k) and 6165.
26. IRC Section 2204(c).
27. IRC Section 6324A(b)(2).
28. Sections 6324A(d)(2) and 6503(d).
29. In *Estate of Roski v. Comm'r*, 128 T.C. 113, 122 (2007), the Tax Court noted that the IRS had changed its position four times, most recently in 2002, with respect to whether Section 6166 estates are required to agree to a special lien or post a bond.
30. *Ibid.*
31. Rev. Notice 2007-90.
32. Section 6166(g)(3).
33. Section 6324A(d)(5).
34. Section 6166(g)(1)(A).
35. Section 6166(g)(1)(D).
36. Section 6166(g)(2).
37. *Ibid.*
38. Internal Revenue Manual, Section 4.25.2.1.17 (Sept. 11, 2009).