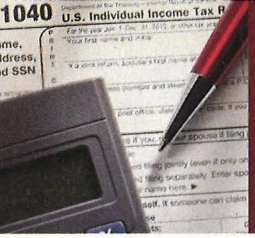

By **Jessica Galligan Goldsmith** & **David Y. Choi**

Saving the Store

Lifetime planning for business owners using IRC Section 6166

Internal Revenue Code Section 6166 is one of the most favorable sections for taxpayers who own closely held businesses. Attorneys who represent business owners must understand the technical rules that apply with respect to IRC Section 6166. Many decedents who could qualify for deferral of federal estate tax under Section 6166 (6166 deferral) will miss this opportunity solely due to a lack of lifetime planning. Without Section 6166 planning, a family business may need to be sold to pay estate taxes.

The estate of a U.S. citizen or resident decedent[1] with assets in excess of the federal estate tax exclusion amount is required to pay approximately 40 percent of such excess in federal estate tax.[2] A decedent's worldwide assets are subject to federal estate tax,[3] and the deadline to pay such estate tax is generally nine months following date of death (the payment date).[4] The specter of substantial federal estate tax is a significant concern for business owners. Fortunately, 6166 deferral can provide relief from an immediate federal estate tax burden, thereby helping to preserve a family business.

Section 6166 provides a statutory right for an executor of a qualifying estate to make one of four different elections (each a 6166 election) on a timely filed federal estate tax return, including valid extensions thereto. A 6166 election extends the time for paying the federal estate tax on a decedent's closely held business interests.[5] As long as an estate makes a timely election under Section 6166, the Internal Revenue Service can't deny the extension of time to pay such federal estate tax that would otherwise be due by the payment date.

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Closely Held Business Interest

To qualify for 6166 deferral, a decedent must own an interest in a "closely held business" established as a sole proprietorship, a partnership or a corporation.[6] Limited liability companies (LLCs) aren't expressly mentioned in the statute. However, the IRS appears to have accepted LLCs as partnerships for Section 6166 purposes.[7] A decedent's interest in a corporation or partnership will be treated as an interest in a closely held business if the business entity has 45 or fewer partners (or shareholders) (the 45-member requirement), or the gross estate of the decedent owns: (1) 20 percent or more of the total capital interest of a partnership, or (2) 20 percent or more of the voting stock of a corporation (the 20 percent capital requirement).[8]

> **Example 1:** A decedent dies owning a 20 percent interest in ABC Partnership. No other members of the decedent's family own interests in ABC Partnership. At the date of the decedent's death, ABC Partnership has 46 partners, including the decedent. The partnership doesn't meet the 45-member requirement. However, the decedent's interest meets the 20 percent capital requirement. The decedent's interest in the partnership is an interest in a closely held business for Section 6166 purposes.

To determine whether a business meets the 45-member requirement, a decedent is deemed to own all of the business interests owned by certain of the decedent's family members.[9] In addition, any joint interests held by spouses are treated as owned by a single partner or shareholder.[10] These family

attribution rules make it easier for a business to meet the 45-member requirement.

Example 2: A decedent dies owning an interest in ABC Partnership. At the date of the decedent's death, ABC Partnership has 48 partners, including the decedent. Three of the partners are family members of the decedent, including the decedent's sister, father and child. ABC Partnership meets the 45-member requirement. ABC Partnership is deemed to be a closely held business, regardless of whether the decedent's interest in ABC Partnership meets the 20 percent capital requirement.

Any business interest owned by a trust or estate will be deemed to be owned by its current beneficiaries.[11] Therefore, if business interests are owned by sprinkling trusts, the number of business owners can expand dramatically. Siblings are included as family members, but others, such as nieces, nephews and cousins, aren't. Estate planners should exercise caution when using sprinkling trusts with respect to succession planning, as trust ownership may cause a family business to fail the 45-member requirement.

The 35 Percent Test

To qualify for 6166 deferral, the value of a decedent's closely held business interest must be greater than 35 percent of the decedent's adjusted gross estate (the 35 percent test).[12]

Valuation adjustments. For Section 6166 purposes, the value of a business interest is its fair market value (FMV) after adjustments for minority interests,[13] reduced by any passive assets held in the business.[14] By contrast, the decedent's adjusted gross estate includes both the active and passive assets in the business.[15] The existence of passive assets in a closely held business can make it difficult to satisfy the 35 percent test.

Many family businesses begin with a senior generation, and the ownership of such businesses is often diluted in succeeding generations. After adjustments for lack of control and/or lack of marketability, the value of a decedent's business interest may not meet the 35 percent test. Because passing that test is critical to a Section 6166 election, gift planning for non-business assets should be considered during a business owner's lifetime. Although lifetime gifts are added back for federal estate tax purposes, transferring non-business assets during a decedent's lifetime will give the estate a better chance of passing the 35 percent test.

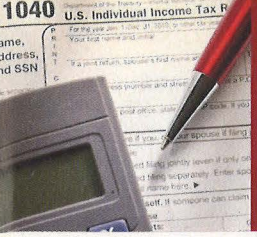
Passive assets. As noted above, passive assets aren't included in determining whether the value of a decedent's closely held business interest meets the 35 percent test.[16] The term "passive asset" is defined as any asset other than an asset used in carrying on a trade or business.

Example 3: A decedent dies owning an interest in ABC Partnership, a closely held business. ABC Partnership owns a retail store and a hedge fund interest. For estate tax purposes, the decedent's adjusted gross estate will include the value of the active business assets of ABC Partnership as well as the hedge fund interest. However, to qualify for Section 6166 deferral, the value of the decedent's interest in ABC Partnership, excluding the interest in the hedge fund, must be greater than 35 percent of the decedent's adjusted gross estate.

Clients should be aware of the 35 percent test when financing or refinancing a closely held business.

Clients should be aware of the 35 percent test when financing or refinancing a closely held business. Cash in a business that isn't needed for operating expenses is a passive asset that will be included for estate tax purposes but disregarded for Section 6166 purposes. Similarly, refinance proceeds that are distributed to the business owner but not reinvested will be included in the estate. Estate planners also need to be mindful when selling business assets to trusts for future generations. If business assets are sold for promissory notes, then any unpaid notes held in an estate will be non-business assets. In each instance, poor planning can negatively impact the 35 percent test.

Revenue Ruling 2006-34 clarifies when a family business is sufficiently active to qualify for Section 6166 deferral. Rev. Rul. 2006-34 sets forth factors



that determine whether a decedent's real estate management activities constitute an active trade or business.[17] Important factors include the time the decedent, the decedent's agents and/or the decedent's employees devote to the business, whether an office is maintained with regular business hours and whether the decedent, agents and/or employees are actively involved in maintaining and expanding the business. Rev. Rul. 2006-34 is an important guideline in determining whether a closely held business is active rather than passive for Section 6166 purposes.

The 6166(a)(1) election entitles an estate to pay estate taxes in 10 equal annual installments and to defer the initial tax payment for five years from the payment date.

The Four Elections

Each of the four 6166 elections extends the time for paying the federal estate tax on closely held business interests.[18] The most beneficial Section 6166 election is the election under Subsection 6166(a)(1) (the 6166(a)(1) election). The 6166(a)(1) election yields the longest 6166 deferral. The other three elections under Sections 6166(b)(7), 6166(b)(8) and 6166(b)(10) yield shorter deferral periods and will be discussed below.

The 6166(a)(1) Election

Fourteen-year deferral. The 6166(a)(1) election entitles an estate to pay estate taxes on the closely held business interests in 10 equal annual installments and to defer the initial tax payment for five years from the payment date.[19] The 6166(a)(1) election is the only 6166 election that provides an interest-only deferral period. If an estate makes a successful 6166(a)(1) election, then the final installment payment of federal estate tax can be deferred up to 14 years from the payment date.[20]

Aggregation. To qualify for a 6166(a)(1) election, a decedent's interest in a closely held business must pass the 35 percent test. An estate can make separate 6166(a)(1) elections for two different business interests. Alternatively, an estate can aggregate a decedent's closely held business interests when the FMV of each business interest, after applicable valuation adjustments, is at least 20 percent of the value of the specific business as a whole (the 20 percent threshold).[21]

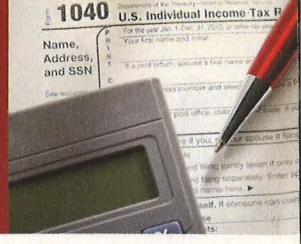
Section 6166(c) aggregation is available for all four 6166 elections, but an estate must meet the 20 percent threshold without family attribution to make a 6166(a)(1) election. Notably, the spouse's interest in the business is included automatically when computing the decedent's 20 percent threshold.[22] It's irrelevant whether the decedent's businesses are related for aggregation purposes.

> **Example 4:** A decedent dies owning a 30 percent interest in both ABC Partnership and DEF Partnership. The decedent's interest in each partnership doesn't by itself pass the 35 percent test. After cumulative 25 percent adjustments, the decedent's interest in each partnership is valued at 22.5 percent of the partnership. Therefore, the estate's interest in each partnership meets the 20 percent threshold. The estate can aggregate the interests in the two partnerships into one closely held business interest to meet the 35 percent test for purposes of the 6166(a)(1) election.

When a client has multiple business interests, estate planners should determine whether the client's interest in each business will meet the 20 percent threshold and be careful not to fall below it. In addition, attorneys should be consistent when applying valuation adjustments across multiple business interests and avoid being overly aggressive when appraising business interests for 6166 purposes.

The 6166(b)(7) Election

Twenty percent capital requirement. By making an election under Subsection 6166(b)(7) (the 6166(b)(7) election), an estate can attribute the business interests owned by a decedent's family members to the decedent. The 6166(b)(7) election can be useful in meeting the 20 percent capital requirement. With a 6166(b)(7) election, an estate can pay the estate taxes due on the decedent's business interests in 10 annual installments beginning on the



payment date, but there's no interest-only deferral period.[23]

Example 5: A decedent dies owning a 15 percent interest in ABC Partnership. The partnership doesn't meet the 45 member requirement. The decedent's sister also owns a 15 percent interest in ABC Partnership. The estate can make a 6166(b)(7) election and combine the sister's interest with the decedent's interest to meet the 20 percent capital requirement. If the value of the decedent's 15 percent interest in ABC Partnership passes the 35 percent test, then the estate can qualify for a 6166(b)(7) election and pay estate tax in 10 annual installments beginning on the payment date.

Aggregation through attribution. The 6166(b)(7) election can also be useful in meeting the 20 percent threshold. As noted above, the estate can aggregate two or more closely held businesses under Section 6166(c), but to make a 6166(a)(1) election, the estate must meet the 20 percent threshold for each separate business. If instead, the estate makes a 6166(b)(7) election, the estate alone can attribute the business interests of the decedent's family members to the decedent for purposes of meeting the 20 percent threshold, thereby allowing for 6166(c) aggregation. If the 20 percent threshold isn't met by the estate alone but is met with family attribution, then the estate can elect under Section 6166(b)(7) to pay the federal estate tax in 10 annual installments beginning on the payment date.[24]

Example 6: A decedent dies owning a 16 percent interest in both ABC Partnership and DEF Partnership. The decedent's interest in each partnership doesn't pass the 35 percent test. After cumulative 25 percent adjustments, the decedent's interest in each partnership is valued at 12 percent of the entire partnership. Therefore, the interest in each partnership doesn't meet the 20 percent threshold. However, the decedent's family members collectively own interests valued after adjustments at 10 percent of each partnership. With family attribution, the estate's interests in each of the two partnerships will meet the 20 percent threshold. The estate will be entitled to aggregate the decedent's interests in ABC Partnership and DEF Partnership to meet the 35 percent test.

There's one inherent problem in combining a 6166(b)(7) election with 6166(c) aggregation. If any business interest requires family attribution under Section 6166(b)(7), then aggregating such interest with any other interest that qualified under Section 6166(a)(1) will cause such 6166(a)(1) business interests to lose the 5-year interest-only period. For this reason, estate planners must carefully consider whether to use Section 6166(b)(7) family attribution for smaller business interests when aggregating a decedent's business interests under Section 6166(c). In certain situations, it may be better to forego deferring the estate tax on business interests that require family attribution and to aggregate only those interests that meet the 20 percent threshold on their own. The business interests owned by each decedent need to be analyzed carefully to decide which approach will ultimately yield the best result for the estate. When planning lifetime gifts, relinquishing business interests that will require a 6166(b)(7) election can also be advantageous.

It's important to distinguish between readily tradeable assets used in the business and passive assets that will be disregarded for Section 6166 purposes.

The 6166(b)(8) Election

In general, any assets held in a multi-tiered structure are deemed to be passive. Fortunately, an exception (the 80 percent exception) exists for a closely held holding corporation that holds underlying closely held corporations. If 80 percent of the assets of an underlying corporation (an underlier) are part of a trade or business, then the holding corporation and each underlier are deemed to be one entity for purposes of the 6166(a)(1) election. Any underlying corporation that doesn't meet the 80 percent exception is deemed to be passive.[25]

If too many underlying corporations fail the 80 percent exception, then an estate can make an

election under Subsection 6166(b)(8) (a 6166(b)(8) election) for the holding corporation. The estate will then be deemed to own the underlying corporations directly, even if they fail the 80 percent exception.[26] If the estate makes a 6166(b)(8) election, and if both the holding corporation and all of the underlying corporations are "non-readily tradeable," then the estate can pay the estate tax on the holding corporation stock in 10 annual installments, beginning on the payment date.[27] If any of the stock in the holding corporation or underlying corporations is "readily tradeable," then the estate will be limited to five annual installment payments, beginning on the payment date. In this context, it's important to distinguish between readily tradeable assets used in the business and passive assets that will be disregarded for Section 6166 purposes.

Unless the spouse, the spouse's agents and/or the spouse's employees actively participate in the business, the surviving spouse's estate may not qualify for 6166 deferral.

It isn't clear whether the 6166(b)(8) election applies only to corporations and excludes multi-tiered partnerships and LLCs. Commentators have asserted that the 6166(b)(8) election should apply to all types of business entities.[28] To date however, no modification of the statute or the regulations thereunder has been issued. Attorneys need to be aware of this when creating family LLCs for planning purposes. Family LLCs are often combined with grantor retained annuity trusts (GRATs) to transfer family business assets. There's always a mortality risk with a GRAT. If a client dies during the annuity term, business assets that could have qualified for Section 6166 deferral may no longer qualify because they're now held in a multi-tiered LLC structure. It's important to discuss this risk with clients before creating such a structure.

The 6166(b)(10) Election

If the decedent owns stock in a qualifying lending and finance business, then an election under Subsection 6166(b)(10) may allow an estate to pay estate taxes in five equal annual installments beginning on the payment date.[29] This election is rarely used given the specific nature of the assets involved.

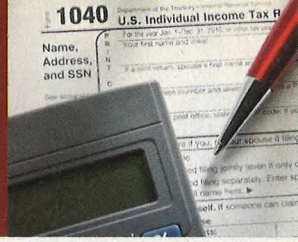
Surviving Spouses

Often, the spouse of a closely held business owner doesn't have any active involvement in the business. If the business passes outright to the surviving spouse on the death of the business owner, such business assets will qualify for a marital deduction, and no estate tax will be due on such property on the owner's death. However, on the subsequent death of the surviving spouse, unless the spouse, the spouse's agents and/or the spouse's employees actively participate in the business, the surviving spouse's estate may not qualify for 6166 deferral.

Estate planners can avoid the foregoing situation by placing the owner's business interests in a qualified terminable interest property (QTIP) trust.[30] Estates with business assets in QTIP trusts can elect 6166 deferral on the death of the surviving spouse.[31] If the predeceased spouse's estate could have made a 6166 election with regard to such business assets, then the business assets in the QTIP trust will also qualify for 6166 deferral in the spouse's estate so long as there's no material change in the form or operation of those assets.[32]

Example 7: A decedent dies owning a 50 percent interest in a closely held business. All of the decedent's interest in the business passes outright to the surviving spouse. The decedent's business partner will run the business. Unless the surviving spouse actively participates in the business, or the business partner is acting as the surviving spouse's agent, the surviving spouse's interest may not qualify for federal estate tax deferral under Section 6166.

Example 8: Same facts as in Example 7, but the decedent's business interests pass into a QTIP trust for the surviving spouse. If the decedent's estate could have elected Section 6166 deferral at the time of the decedent's death, then absent any material changes to the business during the surviving spouse's lifetime, the interest held by the



QTIP trust will qualify for Section 6166 deferral on the surviving spouse's death.

Given the results discussed above, estate planners should consider leaving closely held business interests in a QTIP trust for a surviving spouse if the surviving spouse won't actively participate in the business following the death of the decedent.

When used properly, Section 6166 is an extraordinarily powerful tool. By carefully considering the nuances of Section 6166, estate planners can ensure that clients have a tax efficient path to maintaining and growing a closely held business for future generations.[33]

Endnotes

1. Internal Revenue Code Section 6166(a)(1).
2. IRC Section 2001(a).
3. IRC Section 2031(a).
4. IRC Section 6075(a).
5. IRC Section 6166(d).
6. Section 6166(b)(1).
7. *See* Revenue Ruling 2006-34, in which the Internal Revenue Service includes limited liability companies in the analysis for Section 6166 purposes. *See also* Private Letter Ruling 200340012 (Oct. 3, 2003) and PLR 201343004 (July 17, 2013).
8. *See supra* note 6.
9. Section 6166(b)(2)(D) mandates that all of the partnership interests and stock held by the decedent or any member of the decedent's family under IRC Section 267(c)(4) (which includes the decedent's spouse, siblings, ancestors and lineal descendants) shall be treated as owned by the decedent.
10. Section 6166(b)(2)(B).
11. Section 6166(b)(2)(C).
12. Sections 6166(a)(1) and 6166(b)(2)(A).
13. Rev. Rul. 59-60.
14. Section 6166(b)(9)(A).
15. *Ibid.*
16. *Ibid.*
17. Rev. Rul. 2006-34. Rev. Rul. 2006-34 superseded Rev. Rul. 75-365, in which the IRS declared that the decedent's management of commercial and farm properties was merely investment activity and not sufficiently active for purposes of Section 6166.
18. *See supra* note 5.
19. Section 6166(a)(1).
20. Section 6166(a)(3) permits the executor to elect to make the first installment of estate tax on the fifth anniversary of the payment date. If the executor has elected to pay the deferred estate taxes over 10 installments, the last installment will be due 14 years after the payment date.
21. Section 6166(c).
22. *See supra* note 10.
23. Section 6166(b)(7).
24. *Ibid.*
25. Section 6166(b)(9)(B)(ii).
26. Section 6166(b)(8)(A)(i).
27. Section 6166(b)(8)(B).
28. Louis A. Mezzullo, *Planning to Pay Estate Taxes* (2005); Dennis I. Belcher and William I. Sanderson, *Estate Planning for the Closely Held Business* (2010).
29. Section 6166(b)(10).
30. Such marital bequests may be pre-residuary or residuary in nature.
31. Treasury Regulations Section 20.2044-1(b).
32. PLR 200521014 (May 27, 2005).
33. A discussion of the 6166 notice of election, 6166 annual computations, Section 6324A special liens, state 6166 elections and other topics related to administering 6166 estates will be discussed next month in a follow up to this article.

SPOT LIGHT

Jungle Fever

"Panthère" by Gabriel Alix, sold for $11,494 at Christie's recent Impressionist and Modern Art sale in London, South Kensington on March 3, 2017. A Haitian artist, Alix moved from his native Saint Marc to Port-au-Prince, the capital, to join the Centre d'Art. His best known paintings depict daily life scenes, jungle imagery and still life subjects.