



By **Robert W. Finnegan**

IRC Section 6166 Revisited

A way to avoid a forced or fire sale of a closely held business to pay taxes

Closely held businesses comprise a substantial percentage of the U.S. economy. One study estimated that only 30 percent of closely held businesses survive the first generation, 22 percent survive the second and only 3 percent survive beyond the third.¹ Considering the economic importance of maintaining family businesses, Congress enacted Internal Revenue Code Section 6166 in 1958 to help prevent the forced sale of a closely held business to pay estate taxes. Let's focus on some of the advantages and disadvantages of IRC Section 6166, the economics of deferral and the role of life insurance in avoiding or enhancing Section 6166.

Background

Section 6166 allows the estate of a decedent who was a U.S. citizen or resident at the time of death to defer estate taxes attributable to closely held business interests for up to 14 years provided the business interests comprise at least 35 percent of the adjusted gross estate (AGE), and the executor makes a timely election. Section 6166 allows "interest-only" payments for up to four years, followed by up to 10 level payments of principal (plus interest) with the first principal payment commencing on the fifth anniversary of the due date of the return.

For 2019, the first \$620,000 of estate tax deferred carries a 2 percent interest rate.² The balance is initially charged at 45 percent of the federal underpayment rate in effect at the time of decedent's death (the excess rate).³ For the first quarter of 2019, the underpayment rate equals 6 percent, and the corresponding excess rate equals 2.7 percent. Interestingly, over the duration of the

deferral period, the 2 percent amount stays fixed, while the excess rate varies quarterly. Unfortunately, the excess rate isn't known until the decedent's death, and it changes each quarter during the deferral period.⁴

A closely held business is defined as a trade or business operated as a sole proprietorship or as a corporation or partnership with 45 or fewer shareholders or partners. In the case of a partnership, at least 20 percent of the capital interest of the partnership and, in the case of a corporation, at least 20 percent of the voting stock, must have been included in the decedent's gross estate. Attribution rules may help in meeting these tests. Corporate stock must not be tradable on a stock exchange or over-the-counter market, and deferral isn't allowed for passive assets, defined as assets that aren't being used in carrying on a trade or business.

As discussed below, the Internal Revenue Service isn't required to allow the use of Section 6166, and the IRS may require that the estate post a bond or secure a lien for the outstanding amount. Failure to make a payment within six months of its due date will trigger a penalty of 5 percent for each month after the due date until paid. Ultimately, the IRS may accelerate payment of the deferred taxes.

Section 6166 provides an attractive alternative to the forced or fire sale of a closely held business to pay estate taxes. Section 6166 generally makes the most sense in three situations: (1) the decedent didn't fully plan for the estate tax liabilities yet had a successful closely held business interest with sufficient cash and cash flow to support the required payments, and the executor expects to use Section 6166 for the full 14-year term; (2) the estate merely wants to buy enough time to find a suitable buyer and realize a fair price for the closely held business interests or another estate asset to pay estate taxes due and terminate the Section 6166 election as soon as the asset is sold; and (3) an estate with sufficient



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liquid assets to pay the estate taxes and a strong business with substantial and steady cash flows simply wants to take advantage of the favorable Section 6166 rates.

Consider a \$100 million AGE, \$50 million of which is a qualifying closely held business interest with federal estate taxes of \$40 million. On death, \$20 million of the federal estate tax is due immediately, while \$20 million may be deferred at an assumed level 2.7 percent excess rate (6 percent underpayment rate). “Required Payments,” p. 49, illustrates the required

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Section 6166 interest and principal payments assuming the underpayment rate remains constant over the 14-year deferral period.⁵

Section 6166 Considerations

Consider:

1. The excess rate (45 percent of the underpayment rate) isn't known until the decedent's death, and it changes each quarter during the deferral period. Historical rates demonstrate that the excess rate can vary substantially. Looking at underpayment rates back to 1983 and treating 2019 as a full year, the difference between the minimum and maximum over any 14-calendar year period has averaged nearly 5.43 percent, and the corresponding excess rate can be expected to have an average 2.4 percent swing over the period! The estate may be making the election when the underpayment rate is high, low or mid-range, and the executor will have to consider whether rates are trending up or down. There is, however, no

crystal ball, and perhaps the best advice is to model the deferred payments based on a variety of possible excess rate scenarios.

2. Section 6166 only defers estate taxes attributable to the business interest and, in some states, only the federal estate taxes may be deferred.⁶ That is, the estate will still be responsible for estate taxes on other non-business assets. For example, if the estate tax due is \$40 million and the business represents 50 percent of the AGE, then \$20 million of estate taxes may be deferred, while \$20 million will be due within nine months of date of death.
3. An estate may qualify for Section 6166 today (35 percent of AGE), but what about in the future? A portion of the business may be sold, either to a third party or as part of the client's estate plan. For example, assume the business represents 50 percent of the \$100 million estate, and the closely held business interest has the greatest appreciation potential. If \$20 million of the business assets are sold to a dynasty trust that's a defective grantor trust for an interest-only note, the estate's remaining \$30 million of business interest would only represent 30 percent of the estate, the other \$20 million of business interest having been converted into a note. To get the stepped-up basis at death and qualify for the percentage test, the intention might be for the client to swap the business interest out of the trust in exchange for a high basis non-business asset prior to death, but that can become a trap either through neglect or if the grantor dies unexpectedly.

Also consider that the non-qualifying assets may grow faster than the business interests, the business interests may simply decline in value over time or the client may receive a substantial inheritance that doesn't include qualifying business interests—all of which could cause the estate to fail the percentage test. Although ensuring that the estate will meet the percentage test can be managed, it requires diligence and care and may require regular valuations when qualifying for the percentage test is a close call.

4. The IRS has the option to require that the executor either post a bond or place a lien on estate property.⁷ IRC Section 6324A provides the requirements for the lien and the corresponding lien agreement.⁸ The lien amount equals the estate tax liability plus interest due equal to the initial four interest-only



Required Payments

Amount due over a 14-year period

Year	2% Portion		Excess 2.70% Portion		Payments		
	Principal Balance	Interest	Principal Balance	Interest	Principal Paid	Interest Paid	Total
1	\$620,000	\$12,524	\$19,380,000	\$530,368	\$0	\$542,893	\$542,893
2	620,000	12,524	19,380,000	530,368	0	542,893	542,893
3	620,000	12,524	19,380,000	530,368	0	542,893	542,893
4	620,000	12,524	19,380,000	530,368	0	542,893	542,893
5	558,000	12,524	17,442,000	530,368	2,000,000	542,893	2,542,893
6	496,000	11,272	15,504,000	477,331	2,000,000	488,603	2,488,603
7	434,000	10,020	13,566,000	424,295	2,000,000	434,314	2,434,314
8	372,000	8,767	11,628,000	371,258	2,000,000	380,025	2,380,025
9	310,000	7,515	9,690,000	318,221	2,000,000	325,736	2,325,736
10	248,000	6,262	7,752,000	265,184	2,000,000	271,446	2,271,446
11	186,000	5,010	5,814,000	212,147	2,000,000	217,157	2,217,157
12	124,000	3,757	3,876,000	159,110	2,000,000	162,868	2,162,868
13	62,000	2,505	1,938,000	106,074	2,000,000	108,579	2,108,579
14	0	1,252	0	53,037	2,000,000	54,289	2,054,289
Total Payments:					\$20,000,000	\$5,157,480	\$25,157,480

Note that the 2.70% excess rate is assumed to remain the same over the 14-year deferral period.

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payments.⁹ When placing a lien on property, all owners of the property must consent to the lien, and an agent (with his own set of responsibilities including reporting to the IRS) may be appointed to act on behalf of the beneficiaries of the estate.¹⁰ If at any time the value of the property covered by the lien is less than the deferred amount plus required interest, the IRS may require that additional property be added to secure the lien.¹¹ The IRS won't

require a bond or lien in all cases.¹²

Securing the lien with property other than the closely held business interest may be useful when other business owners are unwilling to sign the lien agreement or the parties are concerned that the lien would hamper the business operations, for example the business' access to capital. It's also important to note that, at 14 years, the lien will restrict the beneficiaries' use and enjoyment of the property for a long



time and prevent the beneficiaries from using that asset in their own estate planning.

Finally, the executor of the estate is personally liable for unpaid estate taxes, including during the Section 6166 deferral period, and the lien doesn't discharge this liability. The District Director does have the authority to discharge the liability if the lien property is at least twice the outstanding liability.¹³

- 5. Section 6166 is only applicable to an active trade or business. Revenue Ruling 2006-34 provides a road-map on this issue when the closely held business interest constitutes real estate. The ruling distinguished between an active trade or business and the

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mere management of investment assets, focusing on whether the decedent: (1) had hands-on involvement in managing the real estate and active involvement in its day-to-day operations, which would qualify for Section 6166, or (2) hired an independent management firm to perform all of the necessary services, in which case the interest wouldn't qualify. The ruling provides a number of specific factors to consider in making the determination on a case-by-case basis.

- 6. The use of Section 6166 is a privilege granted by Congress, not a right.¹⁴ Even if the estate meets the percentage test and makes the timely elections, the IRS can deny the use of Section 6166. *Internal Revenue Manual (IRM)* Section 5.5.6.2 provides:

2. The IRC section 6166 estate tax installment plans are approved by Exam Estate & Gift Specialty Tax. The Estate & Gift Tax Campus unit will make a preliminary determination

if the estate qualifies for the installment payment privilege.

Although it may be an exceptional case, if an estate or the business doesn't seem financially stable and won't be able to make the required payments, the IRS may deny the use of Section 6166.¹⁵

- 7. Once granted, the estate must strictly conform to the requirements of Section 6166. In *Adell v. Commissioner*,¹⁶ a 2013 Tax Court memorandum decision, the Tax Court granted summary judgment in favor of the IRS terminating the Section 6166 election and accelerating payments. The estate, after the IRS sent numerous interest due notices, failed to pay the interest due.¹⁷ It's noteworthy that the IRS gave the estate numerous opportunities to correct the situation. Also, an excerpt from *IRM* Section 5.5.5.5 is instructive:

3. If the estate is unable to pay the annual installment payment or non-deferred tax this is an indicator/factor that the estate may be financially unstable. At this time the advisor will conduct an evaluation of the current assets ... and determine if the Government is adequately secured for the remaining tax due during the duration of the deferral period.

- 8. Section 6166 merely defers the estate taxes attributable to the closely held business interest, passing the estate tax bill and the interest carrying costs on to children and future generations. The next generation may not be ready to handle the responsibilities and may not have developed the skills necessary to successfully run the business. In that case, a strong interim management team is recommended.

The Role of Life Insurance

A life insurance death benefit can be a powerful tool to replace or complement Section 6166. To the extent that it's available and affordable today, funding the full estate tax liability with life insurance avoids or minimizes the use of Section 6166 and the limitations discussed above and provides the executor with options. For estate-planning purposes, permanent life insurance is typically owned by and payable to an irrevocable life insurance



trust (ILIT). On the death of the insured, the ILIT uses the insurance proceeds to purchase assets from the decedent's estate, providing the funds to pay estate taxes.

In the context of Section 6166, insurance proceeds provide the executor with options. If the Section 6166 excess rate is high, the executor can sell assets to the ILIT and use the proceeds to pay the taxes, minimizing the use of Section 6166. If the Section 6166 excess rate is low, the executor can make the full Section 6166 election. The ILIT's retention of the insurance proceeds may offer an arbitrage opportunity, for example, investing the life insurance proceeds at a substantially higher rate of return than the Section 6166 excess rate. If necessary, for example, if the quarterly excess rates are trending up, the ILIT-owned proceeds are available to bailout the Section 6166 transaction by buying or lending assets to the executor or to the business.

The range of options can be illustrated by an example. Assume that on death there's a \$125 million estate

including \$75 million of qualifying closely held business interests (60 percent of the estate), a \$50 million estate tax liability and \$40 million of life insurance owned in trust. The trust may use the insurance proceeds in concert with Section 6166 as illustrated in "Range of Possibilities," p. 52.

The best option will depend on a number of factors including: What are the current underpayment and excess rates and in what direction are they trending? What other assets does the estate have to pay taxes? What assets, including life insurance proceeds, are available to purchase estate assets? What other assets are available to be pledged as security for the lien? What are the business prospects in terms of its market and the current economy? Is a successful and proven management team in place? The important point is that the life insurance provides the executor with flexibility in selecting what it believes to be the best path forward.

When the assets retained by the executor secure the



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Section 6166 lien, the trust purchase of assets from the executor during the deferral period presents practical issues. IRS approval is required for any transaction to remove the lien on the assets sold, or the trust could purchase those assets subject to the lien. The lien shouldn't, however, prohibit the business from borrowing funds from the trust. The loan proceeds could then be used to redeem interests from the estate, providing the estate with cash to make the Section 6166 payments.

There are a number of important considerations with this loan/redemption strategy. The effect of a redemption on ownership of the business should be considered, because a redemption will alter ownership percentages. Gain on redemption would be minimal in the early years due to the stepped-up basis at death. The business would be swapping a Section 6166 loan for a loan to the trust, possibly with higher rates, so the economics should be carefully considered and perhaps only used if business cash flow is insufficient to make the Section 6166 payments. If the business is a C corporation: (1) the redemption would have to qualify as an IRC Section 303 redemption so the redemption won't be treated as a dividend; and (2) because the redemption would decrease earnings and profits for all shareholders pro rata, the ownership of the other shares (and who benefits) needs to be considered. In making the loan, the trustee is subject to fiduciary duties to trust beneficiaries. As a result, the loan should be at a rate that's comparable to a similar arm's length loan, and the trust should be fully secured in the amount loaned.

A Possible Lifesaver

Section 6166 can be a lifesaver for the estate that hasn't adequately planned for estate taxes and is facing the forced or fire sale of assets to pay those taxes. The rates at the time of death are currently unknown but are likely to be favorable. However, its use comes with a substantial number of issues and risks, some of which can be managed. If cash is available to pay the estate taxes, the executor may use Section 6166 merely to take advantage of the low rates. Life insurance is one source of cash that can provide the executor with flexibility and options to help ensure a successful transfer of the business and the best result for estate and trust beneficiaries. 

Endnotes

1. Raymond Institute/MassMutual American Family Business Survey (2003).

Range of Possibilities

Three options to consider for a \$50 million estate tax liability

Option	1	2	3
Pay estate taxes	\$40 million	\$30 million	\$20 million
Taxes deferred under IRC Section 6166	\$10 million	\$20 million	\$30 million
Invest excess insurance proceeds	\$0	\$10 million	\$20 million

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- The \$620,000 of estate tax corresponds to \$1.55 million of estate assets at a 40 percent federal estate tax rate.
- Internal Revenue Code Section 6601(a).
- The underpayment rate equals the short-term applicable federal rate for the first month of the quarter, plus 3 percent rounded to the nearest full percentage point.
- The current underpayment rate for March 2019.
- It's important to check state laws. Most states that currently have a state estate tax appear to have statutes that allow deferral, but not all follow IRC Section 6166.
- See *Internal Revenue Manual (IRM)* Section 5.5.6.6. Bonds appear to be used infrequently.
- Form 13925 is the lien agreement form, adhering to the requirements of IRC Section 6324A.
- Section 6324A(b)(1) and (e)(2).
- Section 6324A(a) and (c).
- Section 6324A(d)(5).
- IRM* Section 5.5.6.6 No. 4, *Roski v. Commissioner*, 128 T.C. No. 10 (April 12, 2007).
- See Dennis I. Belcher and William I. Sanderson, "Estate Planning for the Closely Held Business" (2010), William and Mary Annual Tax Conference, citing Technical Advice Memorandum 8147009 (unpublished).
- The privilege aspect of Section 6166 was emphasized recently in *Adell v. Comm'r*, T.C. Memo. 2013-228 (Sept. 30, 2013). If the estate fails to qualify for Section 6166, deferral may be allowed under Section 6161, but at much less favorable terms.
- There's a review/appeal process if the Internal Revenue Service denies the use of Section 6166.
- Adell*, *supra* note 14.
- Supra* note 15.