UNITED STATES SENATE

Committee on Finance

OUTSIDE THE BOX ON ESTATE TAX REFORM: REVIEWING IDEAS TO SIMPLIFY PLANNING

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Testimony of
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I thank you for inviting me to testify about simplifying planning to address the payment of federal estate taxes. I am testifying on my own behalf and do not speak for any other person, organization, or entity. My testimony is based on my 30 years' experience in private practice representing individual clients, particularly closely held business owners, and assisting my clients in planning to deal with the burden of federal gift, estate and generation-skipping taxes. (I will refer to these taxes collectively as "transfer taxes.")

I applaud this Committee's efforts to resolve this year the uncertainty concerning the transfer tax laws. Taxpayers can deal more effectively with the federal transfer tax burden on their property when taxpayers know what the law will be in the foreseeable future. I have heard many complaints from clients about being unable to plan for the federal transfer tax burden given the uncertainty under the existing transfer tax laws.

I will testify about two matters (1) the *Report on Reform of Federal Wealth Transfer Taxes*, which addresses numerous aspects of federal transfer taxes, and (2) an issue of importance to closely held business owners, the installment payment of estate taxes attributable to a closely held business under Internal Revenue Code section[1] 6166. [2]

REPORT ON REFORM OF FEDERAL WEALTH TRANSFER TAXES

I was the Chair of the Task Force on Federal Wealth Transfer Taxes which produced the *Report on Reform of Federal Wealth Transfer Taxes*. The Task Force was formed by seven organizations representing professionals who advise clients on federal

[1] Each reference to "section" is a reference to a section of the Internal Revenue Code of 1986, as amended.
[2] I will use the term "installment payment provision" to refer to section 6166.

wealth transfer taxes.[3] The Task Force members were some of the most knowledgeable professionals in the United States who advise clients in transfer tax planning. The organizations participating in the Task Force were:

- The American College of Trust and Estate Counsel,
- The American Bar Association Section of Real Property, Trust and Estate Law,
- The American Bar Association Section of Taxation,
- The American Institute of Certified Public Accountants,
- The American Bankers Association, and
- The American College of Tax Counsel.

The purpose of the Task Force was to produce a report that would provide expert analysis of the changes enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Tax Act) regarding federal wealth transfer taxes. The Task Force did not consider policy questions having to do with the economic effects of a wealth transfer tax system as compared to other systems of taxation or whether redistribution of wealth was an appropriate goal of the transfer tax system. The Task Force's central concern was to assess on the basis of simplicity, compliance, and consistency of enforcement, the temporary repeal of the estate and generation-skipping transfer taxes, the phaseout period, the continuation of the gift tax after repeal, the modified carryover basis rule, and alternatives to federal wealth transfer tax repeal.

The Task Force prepared the Report to provide diverse views and perspectives on a wide range of issues concerning the current federal wealth transfer tax system and the

[3] The American College of Trust and Estate Counsel Foundation, the American Tax Policy Institute and the American Bar Association Section of Real Property, Trust and Estate Law provided grants to enable the Task Force to publish their Report on Reform of Federal Wealth Transfer Taxes.

changes the 2001 Tax Act made to that system. The Report suggested options that Congress may consider but did not make any specific recommendations for regulatory or legislative action. The Task Force members and sponsoring organizations support the analysis of the alternative solutions to the issues identified but did not endorse any specific solution.

I believe the two most significant changes suggested in the Report are:

- Reunification of the gift and estate tax systems, and
- Portability of the unified credit and the GST exemption.

The Task Force distributed a copy of the Report to each member of the Congressional tax writing committees and their staff. The Report can be found at http://www.abanet.org/tax/pubpolicy/2004/04fwtt.pdf.

I hope that the Committee and its staff will call upon the Task Force as you consider changes to the federal wealth transfer tax system.

PAYING THE FEDERAL ESTATE TAX IN INSTALLMENTS ON CLOSELY HELD BUSINESS INTERESTS

Significance of Closely Held Businesses

Family owned businesses are a major part of the United States economy, making up 80 to 90 percent of all businesses in North America and contributing significantly (in excess of $5 trillion) to the United States Gross Domestic Product.[4] In a study of the companies making up the S & P 500, one study[5] found that one-third of

[4] J.H. Astrachan and M.C. Shanker, “Family Businesses’ Contribution to the U.S. Economy: A Closer Look,” Family Business Review, September 2003.

[5] Anderson, Ronald C., Mansi, Sattar A. and Reeb, David M., "Founding Family Ownership and the Agency Cost of Debt" (hereinafter “Anderson, Mansi, Reeb Study”). Available at SSRN: http://ssrn.com/abstract=303864

these companies have deep family connections.[6] These families are heavily invested in the family business, and, on average, 69 percent of the family's total wealth is invested in the family enterprise. Because of the large, concentrated investment, family businesses operate in unique and efficient ways, including looking to the long term future of the business and the reputation of the family. The study also found that family businesses generally out-perform non-family businesses, posting a 6.65 percent greater return on assets than non-family businesses.[7]

The death of a closely held business owner often foretells the death of the business. Only 30 percent of all privately owned businesses survive past the first generation.[8] Although it is the goal of many business owners to transfer ownership of the business to future generations, only 12 percent of private businesses survive into the third generation, and a mere three percent are still in existence at the fourth generation and beyond.[9] There are many reasons for the lack of survival of closely held business for future generations including lack of succession planning, business failure, and inability to meet liquidity needs (some of which is caused by the federal transfer tax laws).

The Statistics of Income Division of the Internal Revenue Service produces data files from samples of tax and information returns filed with the Internal Revenue Service. The Statistics of Income Division publishes information on the number of returns filed, the amount of tax collected, and other tax return information. The Statistics of Income Division released recently a report entitled "Estate Tax Returns Filed in 2006: Gross

[6] The study defined a "deep family connection" to be the family responsible for starting the company was still heavily invested in the company, and has, on average, 18 percent of company equity.
[7] Anderson, Mansi, Reeb Study.
[8] Raymond Institute/MassMutual, American Family Business Survey, 2003.
[9] Raymond Institute/MassMutual, American Family Business Survey, 2003.

Estate by Type of Property, Deductions, Taxable Estate, Estate Tax and Tax Credits, by Size of Gross Estate."[10]

The Statistics of Income Report showed that approximately 49,000 estate tax returns were filed in 2006 and approximately 15 percent (7,567) of the tax returns listed as an asset stock in one or more closely held businesses**.**[11] The Statistics of Income Report also showed that those estates classified as the largest gross estates (greater than $20 million) held a higher percentage of stock in a closely held business than smaller estates. Approximately 50 percent of those estates greater than $20 million listed stock in a closely held business as an asset. In addition, the Statistics of Income Report showed that closely held stock was approximately five percent of the gross estate for all estates, but closely held stock constituted approximately 14 percent of the gross estate of estates greater than $20 million. It appears that for estate tax returns filed in 2006, the larger the estate, the more likely the estate will own a higher percentage of closely held stock. From a review of statistics for years before 2006, there is a similar pattern of ownership of closely held stock in prior years. Accordingly, notwithstanding that the assets that can pass free of federal estate tax is scheduled to increase to $3,500,000 in 2009, there will still be a significant number of closely held business owners who will be subject to federal estate tax and whose estates will need relief in the form of the installment payment provision.

Because of the illiquid nature of a closely held business, federal transfer taxes present a serious obstacle to a closely held business surviving the death of the business

[10] The Report can be found at http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96442,00.html.
[11] It does not appear that farm assets, including farm land, limited partnerships or limited liability companies are classified as closely held business interests for purposes of these statistics. If these assets were included, there would be a significantly larger percentage of estates holding closely held businesses.

owner. The shortfall of sufficient liquid assets to pay the federal transfer taxes incurred as a result of the business owner's death may necessitate a forced sale or liquidation of the business, thereby preventing the continuation of the business.

For many closely held business owners, the business represents the most valuable, and usually the most illiquid, asset in the business owner's estate. During the business owner's lifetime, the business is generally the primary vehicle of economic and emotional support for the business owner's family. As the primary asset of the business owner's estate, the business will be the source of funds to pay federal and state transfer taxes, debts, and administration expenses, as well as to pay for the support of the business owner's surviving spouse and other dependents. With careful planning to ensure the availability of the installment payment provision, the family may be able to retain the business and not sell the business to meet liquidity needs. If the family is forced to sell the business, the sale may occur at an inopportune time, either because of external forces, such as a down turn in the economy, or internal forces, such as a lack of business succession planning, internal strife, and emotional distress.

There are several provisions of the Internal Revenue Code offering benefits to the estate of a closely held business owner, including sections 303, 2032A, 2057, and 6166. Section 303 provides an income tax benefit by allowing the transfer of assets from a closely held business for an amount equal to the federal and state estate taxes and costs of administration. Section 2032A provides an estate tax benefit by valuing real property (generally farm real property) for federal estate tax purposes at the use value of the real property instead of the fair market value of the property. Until section 2057 terminated in 2003, section 2057 provided an estate tax benefit by excluding $675,000 in value from certain family businesses. Section 6166, the installment payment provision, provides an estate tax benefit by allowing the installment payment of the federal estate taxes attributable to a closely held business interest over a 14-year period at a bargain interest rate.[12]

If certain stringent requirements are met, each of the above provisions can offer relief to the estate of a closely held business owner. Unfortunately there are issues that make planning to meet the qualification for this relief uncertain. The purpose of my testimony is to discuss the issues that I believe Congress should address associated with the installment payment of estate taxes attributable to a closely held business.

History of Installment Payment of Estate Taxes Attributable to Closely Held Business Interests

In 1958, Congress provided the first installment payment provision for the estate tax attributable to closely held businesses by enacting section 6166. In the 1958 version, section 6166 provided payment in installments over nine years for the estate tax attributable to closely held business interests if the business interests constituted more than 35 percent of the decedent's adjusted gross estate or 50 percent of the decedent's taxable estate. The 1958 version of section 6166 did not provide any bargain interest rate.

In 1976, Congress expanded the installment payment relief by designating the 1958 version of section 6166 as new section 6166A and enacting a replacement section 6166. The new section 6166 expanded the installment payments by providing for a four-

[12] For estates of individuals dying in 2008, the interest rate on the unpaid tax is two percent on the tax attributable to the first $1,280,000 of value of closely held business interests (or two percent interest rate on $576,000 of estate taxes) and 45 percent of the interest rate applicable to underpayment of tax (3.15 percent with an underpayment rate of seven percent). Section 6166 does not reduce the estate taxes payable and the savings under section 6166 relate solely to the deferral of the payment of estate taxes and the bargain interest rate.

year period of interest only payments followed by ten equal payments of the federal estate tax (a fourteen-year deferral period) if the business interests constituted more than 65 percent of the decedent's adjusted gross estate. In addition, the 1976 version of section 6166 provided for a bargain interest rate of four percent for a portion of the federal estate tax.

In 1981, Congress, as a part of the Economic Recovery Tax Act of 1981, repealed section 6166A and reduced the percentage test of qualifying for installment payments under section 6166. Under the 1981 version of section 6166, Congress changed the closely held business interest percentage test from 65 percent to 35 percent and retained the fourteen-year payout period. The Tax Reform Act of 1984 added a provision dealing with the treatment of stock of any holding company that represents direct or indirect ownership and a provision dealing with passive assets held by business entities.

The last significant change to the installment payment provision occurred in 1997 when Congress reduced the interest rates charged on the unpaid tax and increased the amount of unpaid tax eligible for the reduced interest rate. In exchange for the lower interest rates, Congress eliminated the federal estate and income tax deduction of the interest paid on the tax deferred under the installment payment provision. In 2001 Congress amended the installment payment provision to provide special rules for closely held business interests in qualifying lending and finance businesses and also amended the holding company rules.

Although installment payments of federal estate tax attributable to a closely held business can be a helpful alternative to a closely held business owner's estate, closely held business owners have encountered difficulties concerning the application, operation and interpretation of the installment payment provision. I have observed the following significant issues with the installment payment provision:

- **Closely Held Business Owners Need the Ability to Pay Estate Taxes in Installments.** Closely held business owners need the ability to pay the estate taxes attributable to their business interests in installments. Closely held businesses are illiquid and cannot be converted to cash. Without the ability to pay federal estate taxes in installments, some closely held businesses will fail.
- **Congress Should Modernize the Installment Payment Provision.** The installment payment provision has not kept pace with modern business practices. The installment payment provision addresses the corporate and partnership forms of doing business but does not address new forms of doing business such as limited liability companies, limited liability partnerships, or business trusts. A closely held business owner must select carefully the type of business entity for the business enterprise to preserve the ability for the business owner's estate to pay the estate tax in installments under the installment payment provision. Congress should modernize the installment payment provision to reflect the new forms of business entities and treat limited liability companies, partnerships, and business trusts the same as corporations.
- **Congress Should Cure the Inadequate Treatment of Holding Companies under the Installment Payment Provision.** Under modern business practices, closely held business owners will frequently use a holding company and subsidiary structure (referred to as "tiered entities") to conduct various business

activities. The installment payment provision does not deal adequately with holding companies and tiered entities. Because of the complex and confusing holding company rules under the installment payment provision,[13] a closely held business owner needs to consult a knowledgeable (i.e. expensive) tax advisor when using a holding company structure so as to preserve the benefits of the installment payment provision.

- **Congress Should Improve the Definition of Passive Assets under the Installment Payment Provision.** Because the benefits of the installment payment provision are intended to be limited to active businesses, the installment payment provision precludes the installment payment of the federal estate taxes attributable to assets not used in the business (called "passive assets").[14] The present definition of passive assets under the installment payment provision,[15] however, needs modification to accommodate the way closely held business owners are conducting businesses. Otherwise, a business owner is forced to artificially structure the owner's business entities to comply with the rigid requirements of the installment payment provision.
- **Congress Should Allow Business Owners to Obtain Advance Rulings from the Internal Revenue Service on Whether the Business Owner's Estate Will Meet the Requirements of the Installment Payment Provision.** Unlike many tax planning situations where a taxpayer can request an advance ruling from the Internal Revenue Service on the tax effect of a proposed business structure, a closely held business owner cannot request the Internal Revenue Service to rule

[13] Section 6166(b)(8).
[14] Section 6166(b)(9).
[15] Section 6166(b)(9)(B).

on whether the business owner's assets will qualify for installment payment of the estate tax. Congress should authorize and direct the Internal Revenue Service to issue advance rulings so a business owner can determine whether the deferral under the installment payment provision is available under the business owner's current business structure.

- **Congress Should Improve the Burdensome Lien Procedures under the Installment Payment Provision.** The Internal Revenue Service has implemented lien procedures to maximize the collectibility of the federal estate tax deferred under the installment payment provision. These lien procedures have been implemented unevenly by Internal Revenue Service agents in the field and can create an undue and unnecessary impediment to the closely held business owner's successors. Congress should change the lien procedures so as to minimize the administrative impediments for a closely held business owner's estate.

I will discuss briefly each of these issues.[16]

Closely Held Business Owners Need the Ability to Pay Estate Taxes in Installments

Estate taxes are due nine months after a business owner's death. The executor of a closely held business owner's estate generally needs liquidity to pay estate taxes, debts, beneficiary needs, and costs of administration. In some instances, the closely held business owner has sufficient liquidity because of planning through the use of life insurance and other techniques. In those instances where the business owner's estate

[16] For a detailed discussion of these issues and other deficiencies with the installment payment provision, see Internal Revenue Code Section 6166: Comments to Tax Counsel for the Senate Finance Committee, Steven B. Gorin, E. Burke Hinds, Benjamin H. Pruett, Don Kozusko, and Michael Patiky Miller, Real Property, Probate and Trust Journal, page 73 - 121 (Spring 2006).

does not have sufficient liquidity (the business owner may have been uninsurable or the business may have grown faster than the business owner could plan), the business owner's executor generally faces a difficult time in raising funds to meet liquidity needs, particularly funds to pay estate taxes (estate tax payments provide no new benefit to the business and only maintain the status quo). Accordingly, the executors of some closely held business owners' estates are faced with the need to raise significant funds at the most inopportune time, when the closely held business is in transition because of the death of an owner.

Modernization of the Installment Payment Provision

Before a closely held business owner's estate can receive the benefits of the installment payment provision, the estate must meet several requirements. One requirement is that the estate must have an interest in a "closely held business."[17] The Internal Revenue Code defines a closely held business under the installment payment provision[18] as a proprietorship, a partnership, and a corporation and does not mention a limited liability company, a limited liability partnership, or a business trust.

Business owners have changed the way they do business since the installment payment provision was enacted in 1976. When the installment payment provision was first enacted, most business owners conducted their businesses either in the form of a corporation or partnership. Since the enactment of the installment payment provision, new business forms, such as limited liability companies, limited liability partnerships, and business trusts, have been used by business owners to conduct their business

[17] Section 6166(a)(1).

[18] Section 6166(b)(1)(B) and (C).

operations. Unfortunately, the definition of a closely held business for purposes of the installment payment provision has not kept up with the times.

Although I have not encountered personally an instance where the Internal Revenue Service has denied the benefits of the installment payment provision where the closely held business was a limited liability company, the definition of the installment payment provision should be brought up to date to make sure that the benefits of the installment payment provision are available to a business owner's estate regardless of the business form.

In addition to the inadequate definition of a closely held business interest, the installment payment provision does not treat all business forms uniformly. For example, stock in a corporation will qualify as a closely held business interest if 20 percent of more of the *voting stock* is owned by the estate[19] while a partnership interest will qualify if 20 percent or more of the *total capital interest* is owned by the estate.[20] A better rule would be to allow qualification if a business owner's estate included either a 20 percent voting interest or a 20 percent capital interest. There are other examples under the installment payment provision of inconsistent treatment of business forms.[21]

Recommendation: *Amend the definition of "closely held business" under the installment payment provision to make it clear that all forms of businesses qualify for the benefits of the installment payment provision. Provide for the consistent application of the requirements under the installment payment provision regardless of business form.*

[19] Section 6166(b)(1)(B)(i).

[20] Section 6166(b)(1)(C)(i).

[21] Sections 6166(b)(8) and (9). See Internal Revenue Code Section 6166: Comments to Tax Counsel for the Senate Finance Committee, Steven B. Gorin, E. Burke Hinds, Benjamin H. Pruett, Don Kozusko, and Michael Patiky Miller, Real Property, Probate and Trust Journal, page 84 (Spring 2006).

Holding Companies and the Installment Payment Provision

Many closely held business owners now conduct their business operations in multiple entities owned by a holding company. The installment payment provision has not adapted to these changes which creates significant uncertainty for the business owner in determining whether the installment payment provision will be available upon the business owner's death.

Many business owners place assets used in an active business in separate entities with the entities being owned by a holding company. For example, an individual may create a limited liability holding company called "Brookdale Farms Holding Company." The individual may transfer: (1) the farm real property to a separate limited liability company called "Brookdale Farm Real Estate Company," (2) cattle and other livestock to a third limited liability company called "Brookdale Farm Livestock Company," and (3) the operating equipment to a fourth limited liability company called "Brookdale Farm Operating Company." Brookdale Farms Holding Company would own all of the interests in the three separate limited liability companies. If the individual wants to take advantage of the installment payment provision, the individual must be careful in making gifts and how the individual conducts the business activities. Otherwise, the installment payment provision may not be available.

Business owners use a holding company structure for many reasons, including estate planning (giving interests in the farm real property limited liability to one child and giving interests in the operating business to another child) and the limitation of tort liability. Because the Internal Revenue Service took the position that a corporation with its sole asset stock of another corporation is not a closely held business,[22] Congress amended the installment payment provision to allow the portion of stock of a holding company that directly or indirectly owns stock in a closely held active trade or business to be considered stock in the business company for purposes of the installment payment provision.[23] Before the holding company stock may qualify for installment payment, however, the holding company stock must meet several requirements and the executor must make an election.

The holding company structure presents numerous issues. What is the level of activity required by a subsidiary in order to qualify as a closely held business under the installment payment provision? Are intra-company loans (a loan from Brookdale Farms Operating Company to Brookdale Farms Real Estate Company) considered passive assets and not entitled to installment payment? Because the installment provision uses the term "company" in describing personal holding entities, is the application of the installment provision limited to corporate entities?

Recommendation: *Amend the definition of "holding company" under the installment payment provision to combine all interests owned by the closely held business owner for all purposes of the installment payment provision.*

Definition of Passive Assets

The installment payment provision limits the installment payment of estate taxes attributable to business interests that conduct an active trade and business. Passive assets held by an interest in an entity conducting a trade or business are excluded in determining whether the estate qualifies for the benefits of the installment payment

[22] Technical Advice Memoranda 8219007 and 8134012; Private Letter Rulings 8448006 and 8130175; and R.E. Moore (DC) 87-2 USTC ¶ 13,741.

[23] Section 6166(b)(8) and (9).

provision and the amount of estate tax that can be paid in installments. A passive asset is defined as "any asset other than an asset used in carrying on a trade or business."[24] Although the limitation is a proper goal, the passive asset rules are unclear.[25]

The provisions of the installment payment provision do not provide when the amount of passive assets are to be deducted in determining the value of the closely held business interests. The Senate Committee Report relating to the provisions of the installment payment provision dealing with passive assets stated:

> The committee intends that the Treasury Department issue regulations defining the circumstances under which partnership and corporate assets are to be treated as passive investments, and therefore, disregarded for purposes of the installment payment provision.[26]

Because Treasury has not issued these regulations, closely held business owners have no or little guidance as to the definition of passive assets.

Recommendation: *Amend the definition of "passive assets" under the installment payment provision to make it clear what is a passive asset and how the amount of passive assets is to be deducted in determining the value of a closely held business interest.*

Ability to Obtain Advance Ruling

In many tax planning situations, a taxpayer can request an advance ruling from the Internal Revenue Service on the tax effect of a proposed business structure. Under current law, however, a closely held business owner cannot request the Internal Revenue Service to rule on whether the business owner's assets will qualify for installment payment of the estate tax while the business owner is alive and able to make

[24] Section 6166(b)(9)(B).
[25] See Practical Drafting, 1757 – 1776 (R. Covey, ed., July 1989).
[26] S. Rep. No. 98-169, 98th Cong., 2d Sess., at 715 (1984).

appropriate changes. This creates significant uncertainty for some business owners. Congress should authorize and direct the Internal Revenue Service to establish procedures for the issuance of advance rulings so a business owner can determine whether the deferral under the installment payment provision is available under the business owner's current business structure.

Recommendation: *Allow taxpayers to request advance rulings from the Internal Revenue Service on issues relating to the installment payment provision.*

Lien Procedures

In March 2000, the Treasury Inspector General for Tax Administration issued a Final Audit Report - The Internal Revenue Service Can Improve the Estate Tax Collection Process. In the Report, the Inspector General found that the United States Treasury was owed $1.4 billion of estate taxes unpaid attributable to closely business interests under the installment payment provision and of this amount $1.3 billion was not secured by liens. The Report recommended that the Internal Revenue Service secure liens for the amount of the unpaid tax at the time of the approval of the installment payment election. The Internal Revenue Service has been implementing this recommendation.

Section 5.5.6.1 of the Internal Revenue Manual covers the installment payment provision dealing with bonds and liens to secure the unpaid federal estate tax. According to the Manual, the Internal Revenue Service has these options to secure payment of the estate tax deferred under the installment payment provision:

- Require the estate to furnish a performance bond with a face value up to double the amount of tax being deferred, or

- Allow the estate to substitute the filing of a special lien (Form 668J) pledging the estate's right, title, and interest to specific property to the government.

Although the Federal Register lists approximately 100 acceptable bonding companies, one individual with the Internal Revenue Service stated that she was not aware of any bond ever having been written for an estate that elected the installment payment provision. Because a bond is impractical (no bonding company will issue a bond for a 14-year period without marketable collateral equal to the amount of the bond), the Internal Revenue Service requires a lien to secure the amount of the unpaid estate tax. Although this is a reasonable position in theory, the issue arises as to what is the proper collateral for the unpaid estate tax.

A general estate tax lien[27] arises upon the decedent's death and attaches to all assets in the decedent's estate and lasts ten years which cannot be extended. When an estate elects to pay the estate tax in installments, the Internal Revenue Service is secured by the general estate tax lien for only the first nine years and three months of the installment payment period unless the Internal Revenue Service obtains a special lien for the estate tax paid in installments.[28]

The Internal Revenue Service agents in the field determine what collateral is necessary to secure the unpaid tax. Many agents are acting responsibly and are accepting as collateral the property owned by the decedent that qualifies for the installment treatment. This is usually stock in a closely held corporation or a partnership interest in a limited partnership, and is generally not disruptive to most

[27] Section 6324(a).

[28] The Internal Revenue Service may obtain a special lien under section 6324A for the estate tax deferred under section 6166.

business operations. Without definitive statutory guidance, however, some Internal Revenue Service agents are not accepting the closely held business interests as collateral for the deferred federal estate tax and are requiring an executor to put up other assets, such as real estate or marketable securities owned by the estate or owned by members of the decedent's family, to secure the lien. Because a lien on these assets may prevent the decedent's family from borrowing funds necessary to operate the business, this is very disruptive to the business of the closely held business owner.

Recommendation: *Amend section 6324(a) to extend the general estate tax lien for estates electing to pay the federal estate tax in installments under section 6166 for the duration of the installment payment period plus a reasonable period of time (such as one year) to provide the Internal Revenue Service sufficient time to collect if there is a default in payment by the estate. Provide that the Internal Revenue Service can only require as collateral assets that were owned by the decedent unless the executor elects to provide other collateral.*

Conclusion

I hope that the Committee and its staff will call upon the Task Force who prepared the *Report on Reform of Federal Wealth Transfer* Taxes as you consider changes to the federal wealth transfer tax system. In addition, the estates of private business owners need the ability to pay in installments the federal estate taxes attributable to a closely held business interest. I encourage the Committee and its staff to address the following significant issues with the installment payment provision:

- Modernize the installment payment provision,
- Cure the inadequate treatment of holding companies,

- Improve the definition of passive assets,
- Improve the burdensome lien procedures, and
- Allow advance rulings.

I thank you for allowing me to express my views on this important subject.

Appendix

Biography

Internal Revenue Code Section 6166: Comments to Tax Counsel for the Senate Finance Committee, Steven B. Gorin, E. Burke Hinds, Benjamin H. Pruett, Don Kozusko, and Michael Patiky Miller, Real Property, Probate and Trust Journal, pages 73 – 121 (Spring 2006)

Biography

Dennis I. Belcher is a partner in the Richmond, Virginia and Tysons Corner, Virginia offices of McGuireWoods LLP, having practiced with the firm since graduating from the T. C. Williams Law School at the University of Richmond. Mr. Belcher did his undergraduate studies at the College of William and Mary. Mr. Belcher is a past Chair of the American Bar Association's Section of Real Property, Estate and Trust Law and the President-elect of the American College of Trust and Estate Counsel. Mr. Belcher is a Member of the Advisory Committee of the Heckerling Institute of Estate Planning sponsored by the University of Miami School of Law, and a frequent speaker at the Heckerling Institute, ALI-ABA estate planning seminars, and other seminars. He is a member of the Advisory Board of BNA Tax Management, Estate, Gifts and Trusts Magazine. In addition, he was listed in Town & Country Magazine as one of the top 45 estate planning lawyers in the United States. Mr. Belcher is active in the management of his law firm presently serving on the Board of Partners and he has served as Chair of the firm's Strategic Planning Committee and the Nominating Committee. Mr. Belcher's proudest achievement is that he is the father of three wonderful children, Sarah, Matthew, and Benjamin, and the husband of a charming and beautiful wife, Vickie.

INTERNAL REVENUE CODE SECTION 6166: COMMENTS TO TAX COUNSEL FOR THE SENATE FINANCE COMMITTEE

Task Force of the American Bar Association's
Real Property, Probate and Trust Law Section*

Editors' Synopsis: This Article contains the written comments made to the Tax Counsel for the United States Senate Finance Committee by a Task Force composed of members of the Business Planning Group of the American Bar Association's Real Property, Probate and Trust Section suggesting how section 6166 of the Internal Revenue Code could be improved. The comments conclude that the language and administration of section 6166 are antiquated and no longer achieve the fundamental purpose of the statute, which is to provide estates holding substantial closely held business interests an opportunity to pay estate taxes on an installment basis. The Article illustrates several specific ways section 6166 could be updated to better conform to the realities of modern-day business structures.

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* The Task Force members are all members of the American Bar Association's Real Property, Probate & Trust Law Section. Steven B. Gorin, of Thompson Coburn LLP, St. Louis, Missouri, chairs the Real Property, Probate & Trust Business Planning Group of committees and chaired the Task Force. He is a member of the American College of Trust and Estate Counsel's ("ACTEC") Business Planning Committee and a past chair of the Business Law Section of the Bar Association of Metropolitan St. Louis. E. Burke Hinds, of Messerli & Kramer P.A., Minneapolis, Minnesota, is an Adjunct Professor for the University of Minnesota's Masters in Taxation program and helped with edits for publication in the *Real Property, Probate & Trust Journal*. He is a member of ACTEC's Business Planning Committee and a past chair of the Minneapolis Estate Planning Council and the Estate and Financial Planning Committee of the Minnesota Society of CPAs. Benjamin H. Pruett, of Bessemer Trust, Washington, D.C., was with King & Spalding LLP, Atlanta, Georgia, when he worked on the Task Force. He is a member of ACTEC's Business Planning Committee, chair of the Fiduciary Legislation Committee of the State Bar of Georgia, and chair of the Estate Planning & Probate Section of the Atlanta Bar Association. Don Kozusko, of Kozusko Harris Vetter Wareh LLP, Washington, D.C. and New York, practices in the field of tax, estate planning and business planning. He is a member of ACTEC and the Society of Trust and Estate Practitioners. Michael Patiky Miller, of Weinberg, Ziff & Miller, Palo Alto, California, is certified as a Specialist in Taxation Law, California Board of Legal Specialization. He is a past chair of the California Taxation Advisory Commission.

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PREFACE

Internal Revenue Code section 6166 allows an estate holding a qualified interest in a closely held business to defer the payment of estate tax so that the estate need not hold a "fire sale" to pay estate taxes on the business interest. When the American Jobs Creation Act of 2004[1] expanded the number of shareholders permitted for S corporations, Elizabeth Crewson Paris, a tax counsel for the Senate Finance Committee, mentioned that she was considering amendments to section 6166 to conform to the increased number of shareholders. When the chair of the Business Planning Group of the Probate and Trust Division of the Real Property, Probate and Trust Law Section of the American Bar Association ("RPPT") mentioned concerns with the way the Internal Revenue Service was administering this provision, Ms. Paris invited comments from the Bar on how useful section 6166 is and how it might be changed to make it more useful, consistent with its original purpose.

Consistent with this request, Steven B. Gorin of St. Louis, Missouri, and Stephen Ernest Martin prepared a survey that RPPT publicized to its members. A link to this survey was also emailed to a number of fellows of the American College of Trust and Estate Counsel. Made available to the public at http://www.abanet.org/rppt/cmtes/pt/c-group/6166survey.html, the survey accumulated the comments of 157 people.

All who responded to the survey were invited to participate in writing comments. Steven B. Gorin exercised principal responsibility, and the other authors are noted in the author's biographical footnote at the beginning of this Article. In addition, Louis A. Mezzullo and Linda B. Hirschson of the RPPT's Committee on Coordination of Government Submissions reviewed the comments.

The following is a version of the comments that were sent to Ms. Paris on July 11, 2005, edited to conform to this *Journal's* formatting. The comments, as submitted, together with Mr. Gorin's transmittal letter, are available for viewing online at http://www.abanet.org/rppt/cmtes/pt/c-group/6166survey.html.

[1] Pub. L. No. 108-357 (2004).

I. COMMENTARY HISTORY

The following comments and recommendations represent the individual views of those members of the Real Property, Probate and Trust Law Section of the American Bar Association who prepared them and do not necessarily represent the position of the American Bar Association or the Real Property, Probate and Trust Law Section.

The comments were prepared by members of the Business Planning Group of the Probate and Trust Division of the Real Property, Probate and Trust Law Section of the American Bar Association. Principal responsibility was exercised by Steven B. Gorin of Thompson Coburn LLP, St. Louis, Missouri, Chair of the Group. Also participating in the preparation of the comments were Benjamin H. Pruett of King & Spalding LLP, Atlanta, Georgia; E. Burke Hinds, Messerli & Kramer PA, Minneapolis, Minnesota; Michael Patiky Miller of Weinberg, Ziff & Miller, Palo Alto, California; and Don Kozusko of Kozusko, Harris Vetter Wareh LLP, Washington, DC. The comments were reviewed by Louis A. Mezzullo and Linda B. Hirschson of the Probate and Trust Division's Committee on Coordination of Government Submissions.

Although many members of the Business Planning Group of the Real Property, Probate and Trust Law Section of the American Bar Association who participated in preparing these comments and recommendations have clients who would be affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

These comments were influenced by the results of a survey to which 157 people responded. The survey was prepared by Steven B. Gorin and by Stephen Ernest Martin of Martin & Eskelson, P.L.L.C., Idaho Falls, Idaho. The survey was publicized to members of the Real Property, Probate and Trust Law Section and the American College of Trust and Estate Counsel and was available to the public at http://www.abanet.org/rppt/cmtes/pt/c-group/6166survey.html. All who responded to the survey, including an investment advisor who found the survey searching the Internet regarding § 6166, were invited to participate in the process. Only those listed above chose to participate actively.

II. INTRODUCTION

Section 6166 was added to the Internal Revenue Code in 1958 to allow estates to pay estate taxes attributable to substantial closely held businesses in installments. Prior to that time, the Internal Revenue Service ("IRS") had the discretion to permit installment payments, but such discretion was rarely given. Consequently, it was necessary for Congress to provide the estate with the right to defer estate tax payments if the requirements of § 6166 were met. Congress expressed the purpose for the change as follows:

> This provision is primarily designed to make it possible to ***keep together a business enterprise where the death of one of the larger owners of the business results in the imposition of a relatively heavy estate tax***. Where the decedent had a substantial portion of his estate invested in the ***business enterprise***, under existing law, this may confront the heirs with the necessity of either ***breaking up the business or of selling it to some larger business enterprise***, in order to obtain funds to pay the Federal estate tax. . . . Therefore, although not removing any Federal estate tax in these cases, your committee hopes that by spreading out the period over which the estate tax may be paid, it will be possible for the estate tax in most cases to be paid for out of the earnings of the business, or at least that it will provide the heirs with time to obtain funds to pay the Federal estate tax ***without upsetting the operation of the business. Your committee believes that this provision is particularly important in preventing corporate mergers and in maintaining the free enterprise system***.[2]

A. Affirmative Policies Underlying Our Recommendations

Section 6166 has been amended several times to broaden availability to owners of closely held businesses, often in response to the administrative policies of the IRS that have restricted that availability.[3] Our recommendations are based upon the fundamental tax policy expressed in the legislative history—Congress intends that estates holding substantial closely held business interests have the right to elect to pay estate taxes in installments. Guided by this fundamental tax policy, our recommenda-

[2] H.R. REP. NO. 85-2198, at 713 (1958) (emphasis added).

[3] *See infra* Appendix A. All references to sections are to the Internal Revenue Code of 1986, as amended, or to the Internal revenue Code of 1954 for references prior to 1986.

tions are designed to address the needs identified in the survey responses we obtained from members of the Real Property, Probate and Trust Law Section and the American College of Trust and Estate Counsel (published at http://www.abanet.org/rppt/cmtes/pt/c-group/6166survey.html). Accordingly, our recommendations grow out of the experiences of tax advisors in trying to assist closely held business owners to secure the tax deferral benefit that Congress intended to provide. Our recommendations reflect the following key conclusions, which represent our best efforts to apply the tax policy behind § 6166 to the current business environment:

1. *Avoid "Fire Sales" on Illiquid Assets.*

The primary Congressional policy underlying § 6166 is to recognize that closely held business interests and assets are inherently illiquid. It is often, quite difficult and, in many cases, impossible, for an estate to obtain the cash necessary to pay the related estate tax short of disposing of assets or the entire business at deeply discounted "fire-sale" prices. Accordingly, business assets that have no public market should qualify for deferred payment of estate taxes if all other requirements are met.

2. *Business Interest Should Be Substantial Part of the Estate.*

The fundamental requirement that the value of the closely held business interest exceed 35% of the decedent's adjusted gross estate is reasonable and should be retained.

3. *Closely Held Business Definition.*

The definition of what constitutes a "closely held business interest" should continue to be based upon alternate criteria of the number of owners of the business or the significance of the decedent's interest in the business. The criteria themselves should be updated to reflect current business practices and to be consistent with other parts of the Code. The estate also should be able to attribute ownership to the estate from other family members for this purpose without being penalized by shorter payment terms or a higher interest rate, if the value of the holdings included in the decedent's estate exceeds 35% of the adjusted gross estate.

4. *Form of Business Should Be Irrelevant.*

The rules for qualification for § 6166 should be applied consistently regardless of the type or number of legal entities or the structure of those entities. The statute should apply in the same basic way without regard to whether the business is conducted as a sole proprietorship, partnership, corporation, LLC, business trust, or other legal entity, or as a combination of multiple legal entities, including multiple tiers of subsidiary entities.

5. *Only Business Assets Qualify*.

Only the assets held for the reasonable needs of the business should qualify for installment payments of estate taxes. Other assets should not qualify for installment payments, but the determination of which assets are truly "business" assets should be based upon standards that Congress identified in prior legislative history, and not on rigid rules that can frustrate the statute's purpose with inequitable or unintended results.

6. *Reasonable But Flexible Security Provided for Future Payments.*

Once an estate has qualified to pay estate taxes in installments, the rules should ensure that the government's need to secure payment of future installments does not override the business' need for flexibility to obtain financing for continuing business operations and expansion. The requirements for compliance with § 6166 should not become so onerous as to render its benefits unavailable for practical purposes.

7. *Simplicity*.

Qualification under § 6166 exemplifies the Internal Revenue Code's complexity. This complexity increases not only the IRS' administrative costs but also taxpayers' compliance costs. Our recommendations seek to simplify the statute, add certainty, and reduce administrative costs.

B. Structural and Administrative Reasons for Change

Section 6166, in its current form, is a product of legislation enacted nearly 50 years ago, together with intermittent efforts to rectify unintended limitations on its availability. Since the last major substantive amendment was in 1984,[4] the statute is outdated because of changes to the types of business entities and structures that were not contemplated when last amended. The resulting inconsistency, uncertainty, inflexibility, and confusion require, in our view, an integrated restructuring of the statute. The language and administration of § 6166 no longer achieve the fundamental purpose intended by Congress in 1958, and the piecemeal efforts to amend the statute over the years have not kept pace with business developments:

[4] Section 6166 has been amended several times since then. However, none of those changes affected the statute's fundamental structure.

1. Need to Adapt to New Forms of Doing Business.

The current statute is antiquated in failing to accommodate modern day business realities and address business structures commonly used today.

For example, many closely held business entities are now limited liability companies (LLCs). In response, the Treasury promulgated regulations in 1997 that made partnership taxation the norm for multi-member LLCs. However, § 6166 has not been updated to take into account the proliferation of LLCs, and 98% of the respondents to our survey stated that partnerships (including LLCs taxed as partnerships) should generally be treated the same way under § 6166 as corporations. Yet the qualification rules for § 6166 unnecessarily differ depending upon whether the business is taxed as a sole proprietorship, a corporation or a partnership.

Businesses are increasingly likely to operate and finance their activities through more complex structures than in the past. These complex structures are compounded by the further complexity of § 6166. The result is that a business organized as multiple legal entities is treated differently under § 6166 than the same business would be treated if organized as a single entity. This inequity would be corrected if the statute were amended to apply (1) a functional standard to determine whether an asset is held for the business's reasonable needs, so an entity holding business assets is not misconstrued as being a passive asset, and (2) family attribution to determine whether a business is closely held without reducing § 6166 relief. Congress recently amended the rules for determining whether a business is a small business eligible to make an S election when it enacted the American Jobs Creation Act of 2004. Considering that S corporations are growing in popularity faster than any other type of business entity,[5] the § 6166 ownership rules should be consistent with the closely held business qualification for S status. Respondents to our survey agreed, supporting definitions that apply family attribution without adverse consequences in determining the number of owners of a business (65%) and an increase in the maximum number of owners to 100 (56%).

[5] According to http://www.irs.ustreas.gov/pub/irs-soi/04proj.pdf (last visited March 21, 2006) S corporation tax return filings have increased from 736,900 in 1985 to a projected 3,718,300 in 2005. Partnership tax return filings have increased from 1,755,300 in 1985 to a projected 2,684,100 in 2005. C corporation tax return filings have decreased from 2,632,000 in 1985 to a projected 2,318,100 in 2005.

2. *Lack of Guidance for Planning*.

Planning to meet the current complex rules under the statute is made still more difficult by the lack of guidance on which taxpayers can rely over the necessarily long periods of time involved in planning for and paying estate tax liabilities due to the death of a business owner.

Court decisions provide little guidance since Tax Court jurisdiction for declaratory judgments under § 6166 has existed only since 1984.

Treasury has issued very little in the way of regulations or other guidance on § 6166, including regulations that Congress specifically mandated when key amendments were made in 1984. When Congress enacted §§ 6166(b)(8) and (9), it directed the Treasury to promulgate regulations "defining the circumstances under which partnership and corporate assets are to be treated as passive investments"[6] and, thus, which portion of the business would not be eligible for estate tax deferral. Congress specifically directed that the regulations provide "rules similar to [those] governing the accumulated earnings tax" under § 537[7] to distinguish assets held for the reasonable needs of the business and those that are not. No such regulations have ever been issued by the Treasury, but the regulations under § 537 remain consistent with Congress's intentions with respect to § 6166(b)(9) and should be followed in articulating rules for § 6166.

The IRS currently declines to issue advance rulings to living taxpayers seeking guidance on unclear provisions of § 6166, thus making it extremely difficult for taxpayers to effectively plan for their estates to qualify. It has not publicly adopted a no-ruling policy, but as a practical matter, it has turned down recent requests. This refusal to issue advance rulings contrasts sharply with the IRS's willingness to issue hundreds of private letter rulings on the application of estate and generation-skipping transfer tax to living taxpayers.[8]

[6] S. REP. NO. 98-369, at 715 (1984).

[7] *Id.*

[8] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 96-44-053 (1996). The IRS recently issued Rev. Proc. 2005-33, outlining the steps executors must take to exhaust administrative remedies before seeking a Tax Court declaratory judgment under Code Sec. 7479 with respect to a Code Sec. 6166 election. Within the 2004–2005 Priority Guidance Plan promulgated by the Office of Tax Policy (the IRS's "Business Plan"), the IRS included projects to update "Rev. Ruls. 75-365, 366 and 367 regarding interests in real estate held by a decedent" as item 12 on the "Tax Administration" list. http://www.irs.gov/pub/irs-utl/2005-2006_guidance_priority_list.pdf (last visited February 28, 2006.) However, guidance has not been issued yet.

3. Flexibility Needed for Making Elections.

If the value of the qualifying business interests does not exceed 35% of the decedent’s gross estate, the estate cannot make a § 6166 election. This conclusion may change after the estate tax return is filed as a result of newly discovered information or audit changes that increase the business value or decrease the value of other assets. Currently, § 6166(d) does not allow an election to be made beyond the extended due date of the estate tax return. Survey respondents overwhelmingly (93%) supported extending § 6166 elections beyond the original return date.

4. Practical Barriers Caused by Security Requirements.

Even if an estate qualifies under § 6166, it may be unable to operate the business effectively while deferring the estate tax if the security required by the government is too expensive or makes normal business financing difficult or impossible to obtain.

At various times in the past, the security requirements imposed by the IRS to permit estates to pay the estate tax in installments have varied extensively across the country, restricting the opportunity for business owners to plan ahead. In response to a report by the Treasury Inspector General for Tax Administration,[9] the IRS has begun to apply more uniform standards, but, unfortunately, in the direction of routinely imposing rigid security requirements. Anecdotal evidence indicates that some IRS collections offices are more reasonable than others. Although only 12% of respondents to our survey have heard of cases in which the IRS’s lien and bonding authority was asserted when alternative methods would have adequately protected the IRS’s legitimate interest in securing its tax collections, 90% of respondents to our survey stated that the IRS’s authority to impose pubic tax liens or bonds should be modified to authorize the IRS to impose them only when alternative methods do not adequately protect the IRS’s legitimate interest in securing its tax collections.

The estate or the decedent’s family might not be able to pledge assets that are acceptable to the IRS, such as marketable securities or real estate. Furthermore, a strict requirement for public tax lien filings or commercially issued bonding can also be very troublesome. The stigma of a public tax lien can be disastrous to a business; and bonding requirements can be onerous, considering the expense and length of time for which a bond would be required. If the IRS is unwilling to accept a security interest in

[9] I.R.S. Tech. Adv. Mem. 2000-30-059 (March 29, 2000).

shares or other equity interests in closely held businesses, the statute's purpose is frustrated.

When an estate tax is imposed due to the death of a business owner, the government should not be a preferred creditor whose need for tax collections overrides the need to continue to operate the business, particularly when doing so is contrary to the stated purpose of § 6166.

III. GENERAL RECOMMENDATIONS

Based on these conclusions, our recommendations for Code § 6166 are as follows:

A. As under current law, the value of the closely held business enterprise included in the decedent's gross estate must exceed 35% of the decedent's adjusted gross estate.

B. A business enterprise (without regard to the form of legal entity) is closely held if:

   (1) The estate is one of up to 100 owners (determined in the same manner as S corporations) or is part of a family that holds at least 20% of the vote or 20% of the right to distributions.

   (2) The estate can aggregate interests it owns, directly or indirectly, into one "business enterprise" to which the 35% test applies.

C. Estate tax deferral can be made with respect to only those assets that the business enterprise holds for reasonable business purposes. Whether assets are held for reasonable business purposes would be determined after aggregating the interests included in the decedent's gross estate.

D. The election should be available on amended or late returns.

E. The government's security should be limited only to making sure that the government's interest is protected when the business enterprise is transferred and that business assets are not diverted from reasonable business purposes. Broader tax liens or bonding requirements should be used only when taxpayers abuse the benefit of estate tax deferral.

IV. DETAILED RECOMMENDATIONS AND ANALYSIS

Our recommended changes are intended to clarify the application of the existing statute, simplify the qualification rules, create fairness among similarly situated taxpayers and improve administrative efficiency by reducing disputed interpretations between taxpayers and the IRS. Specific details of our recommendations are summarized as follows:

A. Consistent Treatment for All Entity Types and Ownership Structures.

We generally recommend that § 6166 be amended to apply consistently, regardless of the type of entity in which the business is operated—corporation, partnership, limited liability company, business trust or in any other legal form. This theme of consistent treatment regardless of legal form is inherent in many of the specific recommendations detailed below.

Section 6166 currently distinguishes between closely held businesses operated as ***partnerships*** and closely held businesses operated as ***corporations***, even though there is no apparent policy reason for doing so. Where there are specific provisions for one form of business entity, the question necessarily arises as to whether or not a similar rule applies with respect to other types of entities, such as limited liability companies and business trusts. For example, consider the following:

- Section 6166(b)(1)(B)(ii) provides that if a *partnership* has more than 45 partners, it will qualify as a closely held business only if 20% or more of the total **capital interest** in the partnership is included in the decedent's gross estate, but § 6166(b)(1)(C)(ii) provides that if a *corporation* has more than 45 shareholders, then it will only qualify as a closely held business if 20% or more of the **voting stock** of the corporation is included in the decedent's gross estate.
- Section 6166(b)(7) provides that in some circumstances, in order to meet the 20% tests of § 6166(b)(1)(B)(ii) and (C)(ii), the estate may elect to treat a business interest attributed from family members or others to the decedent under § 6166(b)(2) as if such interest were included in the decedent's gross estate. This election is only available with respect to partnership interests and non-readily tradable stock. *Partnership* interests are eligible for this election, whether or not they are readily tradable, but *corporate* stock must be non-readily tradable.
- Section 6166(b)(8), which provides that the estate may elect to treat a business as a "holding company" in some circumstances, appears to apply only to *corporations* that hold stock in other corporations, without explaining whether such an election is available if either the parent or the subsidiary is a *partnership* or some other type of entity, or whether the benefits of such an election are available in all other cases without regard to the election.

- Section 6166(b)(9), which provides that installment payments are not available with respect to that portion of the estate tax attributable to passive assets held in a business, specifically defines *corporate stock* held by another corporation as a passive asset, subject to certain exceptions (one of which is § 6166(b)(8) discussed above), but is silent as to how interests in, or held by, non-corporate entities are treated.

While it is true that historically most small businesses were operated as corporations rather than partnerships, the business and tax climate has changed significantly in the last twenty years—such that limited liability companies (LLCs) treated as partnerships for many tax purposes are becoming the business entity of choice for many closely held businesses. Moreover, business trusts are becoming more prevalent with each passing year, and it is entirely possible that the passage of time might see the emergence of other types of business entities that are unknown today.

If the purpose of § 6166 is to avoid the necessity of either breaking up a closely held business or selling it to a larger enterprise, then the legal form in which the business is organized—whether as a corporation, partnership, LLC, business trust, or other entity—should not adversely affect the ability of those receiving a bequest of an interest in such a business to qualify for payment of estate tax in installments. As the statute is structured currently, however, the form of business entity can profoundly affect such qualification. Much of the discussion that follows also points out the ambiguities in § 6166 that arise due to the different (or at least apparently different) treatment accorded corporations and partnerships.

B. Consistent Definition of a Closely Held Entity.

We recommend that:

(1) The existing definition of "closely held business" be applied equally regardless of the type of entity and be renamed a "Closely Held Entity" to avoid confusion.

(2) An interest in a business entity that is included in the decedent's estate should qualify as a interest in a "Closely Held Entity" if it satisfies either of two tests, one of which is based upon the number of owners of the entity (referred to as the "Number of Owners Test"), and the other of which is based upon the percentage interest (and the character of that interest) in the entity that is included in the decedent's gross estate (referred to as the "20% Test").

(3) Family Attribution should apply to the "Number of Owners Test" in the same manner as for S corporations as amended by the American Jobs Creation Act of 2004 ("AJCA"),[10] regardless of the legal form of entity.

(4) Family Attribution should apply to the 20% Test.

Section 6166 currently provides that a business interest included in the decedent's estate will qualify as an interest in a "closely held business" if it satisfies either a "Number of Owners Test" or a "20% Test." The AJCA increased the maximum number of owners for S Corporation purposes but did not consider whether to make the § 6166 "Number of Owners Test" consistent.

As for the 20% Test, the existing statute applies a different measurement test for corporations and partnerships and is silent as to other types of entities. Our recommendations apply elements of both the existing corporate and partnership 20% Test rules and simplify the measurement for qualification.

The existing statute permits family attribution only for partnership interests and certain corporate interests. Our recommendations permit family attribution regardless of the type of entity.

Each of these recommended changes and reasons for change is described below in more detail.

1. Qualification Based upon Number of Owners.

Section 6166(b)(1)(B)(ii) and (C)(ii) provide that a decedent's interest in a business will qualify as an interest in a *closely held business* if the business has 45 or fewer partners or shareholders, respectively.[11] In this regard, corporations and partnerships appear to be treated the same. We generally recommend that the existing "Number of Owners Test" be amended to be consistent with similar S corporation provisions under § 1361(c)(1)(A)(ii), as amended by the AJCA, which increased the maximum number of S Corporation shareholders to 100 and, if the family elects, treats members of the decedent's family to be counted as one

[10] I.R.C. § 1361(c)(1)(A)(ii)(2005).

[11] Before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), a business could not have more than 15 owners and qualify as a closely held business based upon the number of owners. While we agree that 45 or fewer owners is a much more realistic number of owners than is 15, it should be kept in mind that the increase in the permissible number of owners, like all of the estate tax provisions of EGTRRA, "sunsets" in 2010, after which the number of permissible owners drops back to 15, unless the increase is made permanent by further legislation.

shareholder. The same counting rules should apply to all types of entities to determine what is "closely held." Using the same rules as for S corporation status also promotes simplicity in administration and certainty in planning. It will assure owners of S corps that their interests will be considered "Closely Held" for purposes of § 6166 and owners of other types of entities that their interests will be treated consistently.

Accordingly, we recommend that:

(a) Section 6166(b)(1)(B) be changed to provide, consistent with § 1361, that an interest in a closely held business means an interest in a corporation, partnership or other legally recognized entity carrying on a trade or business, if such entity has 100 or fewer equity owners, meaning persons who are entitled to a share of the entity's assets upon liquidation of the entity (after payment of all entity obligations);

(b) Section 6166(b)(2)(B) be changed to provide, consistent with § 1361(c)(1), that for purposes of determining the number of equity owners of a business entity, a husband and wife (and their estates) are treated as one person;

(c) Section 6166(b)(2)(C), the entity attribution rule, be amended to provide that an individual who directly owns an equity interest in a business entity or who is treated as owning an equity interest in a business entity as a result of the application of the entity attribution rule will be counted as no more than one equity owner, irrespective of the number of direct or indirect interests (through one or more corporations, partnerships or trusts) the individual might hold;

(d) Section 6166(b)(2)(D) be changed to provide, consistent with § 1361(c)(1), that for purposes of determining the number of equity owners of a business entity, all members of an individual's family, as defined in § 1361(c)(1), be treated as one shareholder.

Before AJCA, § 1361 defined a "small business corporation" as a corporation meeting certain requirements, one of which was that the corporation have no more than 75 shareholders, with a husband and wife being treated as one shareholder for purposes of that limitation. AJCA increased the number of permissible shareholders to 100, and added certain family attribution rules to provide for purposes of determining the number of shareholders, with certain members of the same family being treated as a single shareholder.

Many closely held enterprises included in decedents' estates are owned not only by the decedent and other *individual* members of the decedent's family, but also by corporations, partnerships and trusts, the shareholders, partners or beneficiaries of which are also family members. In many cases, a closely held enterprise may have been started by two or three unrelated individuals who, over time, sell, give or otherwise transfer interests in the closely held enterprise to various members of their families, or to trusts or partnerships for their benefit (for asset protection, control or other reasons) with the result that the number of owners of the business can easily exceed 45 persons, even though the enterprise is still very illiquid.

For purposes of determining whether an entity has more than 45 owners,[12] § 6166 includes certain attribution rules, as follows:

(i) Section 6166(b)(2)(B), the *husband and wife attribution rule*, provides that certain business interests co-owned by a husband and wife as community property, as joint tenants, as tenants by the entireties, or as tenants in common, are treated as owned by one owner.

(ii) Section 6166(b)(2)(C), the *entity attribution rule*, provides that certain business interests held by corporations, partnerships or trusts are treated as owned proportionally by the shareholders, partners or present interest beneficiaries, as the case may be.

(iii) Section 6166(b)(2)(D), the *family attribution rule*, provides that all business interests held by the decedent or by any member of the decedent's family (within the meaning of § 267(c)(4))[13] are treated as owned by the decedent.

At least two issues are raised but not answered by these provisions. First, in counting owners for purposes of determining whether there are more than 45 owners, it seems that the *entity attribution rule* should operate not

[12] Nothing in § 6166(b)(2) indicates that the attribution rules are in any way limited in application, so it would appear on the face of the statute that the attribution rules would apply for any purpose of § 6166. However, the legislative history of the attribution rules states that their only purpose was to prevent taxpayers from avoiding the limitation on the number of owners by using partnerships or trusts to artificially reduce the number of direct owners, and that the rules may not be used for other purposes, such as meeting the 20% ownership requirements of §§ 6166(b)(1)(B)(ii) and (C)(ii), or the more-than-35% of Adjusted Gross Estate test of § 6166(a), and the IRS has issued at least one private letter ruling. *See* H.R. REP. NO. 94-1380, at 32 (1976), HR, REP. NO. 95-1286, at 12-3, I.R.S. Priv. Ltr. Rul. 84-28-088 (Apr. 4, 1988), I.R.S. Priv. Ltr. Rul. 96-44-053 (Aug. 1, 1996).

[13] This includes brothers, sisters, spouse, ancestors and lineal descendants.

only to avoid the artificial *reduction* in the number of owners of a business, but also to avoid the artificial *increase* in the number as well. In other words, if the shareholders, partners and beneficiaries of corporations, partnerships and trusts are treated as proportionally owning any interest in the business held by the entity, then presumably the entity itself is not counted as an additional owner, and if only real parties in interest are considered, then any given individual will count as only one owner, irrespective of the number of corporations, partnerships or trusts through which the individual may indirectly own interests. It would be helpful if the statute was clarified on this point.

Second, it seems that, under the *family attribution rule*, since all interests held by members of the decedent's family (within the meaning of § 267(c)(4)) are treated as owned by the decedent, then all of such persons as a group would therefore be counted as only ***one*** owner for purposes of the 45 owner limitation. If so, and if the entity attribution rule is interpreted as described above, then the following would count as one person: the decedent; all family members of the decedent; all corporations, the stockholders of which are limited to such persons; all partnerships, the partners of which are limited to such persons; and all trusts, the present interest beneficiaries of which are limited to such persons. Again, there has been no guidance on this point.

2. *Qualification Based upon Proportion and Character of Decedent's Interest*

We recommend that the definition of a "Closely Held Entity" include any entity, regardless of legal form, in which a decedent's gross estate includes a 20% interest, measured as follows:

(a) **20% of Equity Test.** The 20% of equity test should be defined as the right to receive 20% of distributions either currently or on liquidation. This can avoid qualification disputes over valuation issues. It should apply to corporations as well as partnerships.

(b) **20% of Voting Rights.** The alternative test of 20% of voting rights should remain and apply to partnerships as well as corporations.

If the business has too many owners to qualify as a closely held business, then qualification as a closely held business under the existing § 6166 depends upon whether the decedent's estate includes a sufficient equity interest in the business. Section 6166(b)(1)(B)(i) and (C)(i) provide that a decedent's interest in a business will qualify as an interest in a *closely* *held business* if 20% or more of the *capital interest of a partnership* or 20% or more of the *value of*[14] *the voting stock* of a corporation is included in the decedent's gross estate.

Here there is a striking difference in treatment between corporations and partnerships. In the partnership setting, *any* capital interest, whether voting or non-voting, will qualify, but the interest must be a minimum of 20% of the equity of the business. In the corporate setting, by contrast, only *voting* stock will qualify and 20% of the value of the voting stock will qualify irrespective of how much of the total equity of the corporation is represented by the voting stock.

Thus, for example, where a *corporation* is capitalized as 5% voting stock and 95% non-voting stock, an estate holding 20% of the *voting* stock would qualify for installment payments, even though 20% of the value of the *voting* stock only represents 1% of the *total* capital equity. In contrast, an estate holding 100% of the *non*-voting stock would *not* qualify, even though 100% of that non-voting stock represents 95% of the capital equity. If a *partnership* is capitalized as 5% voting units and 95% non-voting units, an estate would have to include 20% of the *total* units, not just 20% of the voting units, to qualify; and the holding would so qualify even if all of the decedent's units were *non-voting* units (because the rule with respect to partnerships makes no distinction between voting and non-voting units). There is no apparent policy reason for such a difference in treatment between the two types of entities.

In our view, whether the entity is a corporation, partnership or other entity, the interest held by the decedent should qualify as an interest in a closely held business if the decedent holds 20% equity ownership or 20% voting rights, because in either case, that degree of voting control or equity ownership being vested in one person is indicative of a closely held business, and in either case, the business interest would still have to represent more than 35% of the decedent's adjusted gross estate.

3. *Family Attribution*

We recommend that Family Attribution apply for purposes of determining whether an entity interest qualifies as a "Closely Held Entity" under both the "Number of Owners Test" and the "20% Test." The estate still must own entity interests directly that constitute more than 35% of

[14] Exactly what is meant by 20% of the ***value*** of the voting stock, rather than simply saying 20% of the voting stock, is unclear, since the "value of" distinction does not appear with respect to partnerships.

the value of the adjusted gross estate to qualify for estate tax payments in installments.

We also recommend that the shortened payment period of § 6166(b)(7)(A)(i) and the increased interest rate of § 6166(b)(7)(A)(ii) be repealed.

Some estates do not own substantial enough closely held business interests to qualify for § 6166 payment deferral. The current statute permits estates to qualify under the "20% Test" by electing to attribute to the estate entity interests owned by the decedent's family members.[15] If the "family attribution election" is made, however, § 6166(b)(7) requires the deferred payments to be made over a shorter period of time and bear a higher interest rate than if the decedent had personally owned all of the family interests in the entity. The application of § 6166 would be simplified and consistent with the AJCA, if the payment and interest rules were the same regardless of whether family attribution were elected. In the AJCA, Congress applied family attribution in defining whether a business is a small business for purposes of eligibility to make an S election. The AJCA, specifically Code § 1361(c)(1), allows members of the decedent's family to be counted as one owner in determining the number of owners.[16] If ownership of any entity is concentrated enough to qualify as an S Corporation, it should be considered closely held for § 6166 deferral purposes. Both sections of the Code address the same fundamental class of business owners.

We can identify no policy reason for providing lesser benefits to a decedent's estate that owns in excess of 35% of the adjusted gross estate in

[15] *See* I.R.C. § 6166(b)(7). For purposes of the "20% Test," family members are determined by § 267(c)(4) and include the decedent's spouse, siblings, ancestors and lineal descendants. Family attribution may only be used to initially qualify the entity interest as a "Closely Held Entity." The estate must own entity interests that constitute more than 35% of the value of the adjusted gross estate without inclusion on interests owned by other family members. The S corporation rule for counting shareholders under § 1361(c) is technically not an "attribution" provision, so we have assumed that the § 267(c)(4) family definition rules would be retained for the 20% Test. The S corporation family definition rules could attribute shares to the estate as an alternative to § 267(c)(4).

[16] The amendment must make it clear that, when § 1361(c) is applied for § 6166 purposes to the "Number of Owners Test," "members of the family" means the members of the decedent's family since the actual owner of the entity interest after death would often be an estate or trust. Section 1361(c)(1)(B) views up to six generations of a family as counted as a single owner. We also recommend that such treatment as a shareholder be automatic and should not require an election by the estate or owner of the entity interest as would otherwise be required by § 1361(c)(1)(D).

closely held entity interests that technically fail to qualify because the decedent's spouse, children, siblings or other relatives own interests in the same entity, requiring family attribution to qualify for §6166 installment payments.

C. Consolidating Multiple Entities into a Single Business Enterprise.

We recommend that:

(1) An estate be permitted to combine all interests in Closely Held Entities qualified as described above to determine if, together, such interests constitute more than 35% of the adjusted gross estate. Such combined entities may be directly owned (brother-sister entities) or indirectly owned (subsidiary entities).
(2) Repeal of the "Holding Company Election" of § 6166(b)(8). Our proposal would allow tiers of subsidiary entities to qualify as "Closely Held Entities" when combined with other entities, without penalty for a shorter payment period or increased interest rate.[17]
(3) Existing § 6166 references to a "trade or business" be amended to refer to the combined "Closely Held Enterprise," thus referring to all such combined Closely Held Entity interests (instead of each individual entity) to determine if assets are business assets or non-business assets that fail to qualify for § 6166 installment payment deferral.

The rules for determining whether any entity is "closely held" should be the same for (1) a single entity, regardless of the legal form (corporations, partnerships, LLCs, etc.), (2) commonly owned entities, (3) multiple tiers of entities within a group, or (4) any combination of these. We found no compelling policy reason why the rules for qualification should differ for any of those business structures.

1. *Consolidating Multiple Commonly Owned (Brother-Sister) Entities*

We recommend that § 6166(c) entity combination occur merely by reference to the "Closely Held Entity" qualifications provisions described above. Such "trade or business" inquiry would occur after all qualifying entities have been combined into a single "Business Enterprise," as described below.

[17] *See* I.R.C. § 6166(b)(8)(A)(ii) and (iii).

As previously noted, § 6166 currently permits commonly owned entities (brother-sister entities) to qualify as a single business enterprise[18] by rules that differ from the rules defining a "closely held business."[19] Anomalies and inequities can arise under the current statute by reason of its attempt to define a "closely held business interest" by starting with the estate's ownership of individual entities, rather than by focusing instead on the "business enterprise," that may be conducted through multiple entities. This confusion also leads to inconsistencies in determining whether assets are part of the business.

2. *Consolidating Tiered Entities*

We recommend that the "Holding Company Election" of § 6166(b)(8) be repealed to allow subsidiary tiers of entities to qualify as "Closely Held Entities" without penalty for a shorter payment period or increased interest rate.[20] To implement this recommendation, a "proportionate look-through rule" similar to § 6166(b)(2)(C) would apply to each tier of entities; thus, to qualify, the estate must indirectly meet the "Number of Owners Test" or "20% Test" described above to qualify to combine the subsidiary interests for estate tax deferral.

We believe that these changes would make the statute better operate as intended. When a business entity, whether a corporation, a partnership, or other entity ("parent"), holds an interest in another business entity, whether a corporation, a partnership or other entity ("subsidiary"), then the value of the parent's interest in the subsidiary should be treated as value *attributable to assets used in carrying on a trade or business* to the extent of the value of the assets used in carrying on a trade or business, either by the parent, the subsidiary, or a lower tier subsidiary. Likewise, the value of the parent's interest in the subsidiary should be treated as value attributable to passive assets to the extent that the value of the assets of the subsidiary is attributable to passive assets (either directly owned or attributed from a lower tier subsidiary). Such attribution should apply in the following circumstances:

(a) Where the subsidiary is *wholly owned* by the parent.

(i) Treas. Reg. § 301.7701-2(c)(2) already provides that a business entity that has a single owner and is not a corporation under Treas. Reg. § 301.7701-2(b) is disregarded as an entity separate

[18] *See id.* § 6166(c).
[19] *See id.* § 6166(1)(b)(1)(B) and (C).
[20] *Id*. § 6166(b)(8)(A)(ii) and (iii).

from its owner. Therefore, any business carried on directly by a non-corporate entity that is wholly owned by a higher tier entity should be treated as if it was carried on directly by the higher tier entity for purposes of § 6166.

(ii) Even if the lower tier entity ***is*** a corporation, if it is wholly owned, it is obviously fully under the control of the parent entity, and any assets or business activities of the wholly owned corporate subsidiary should be attributed to the parent entity. There is no apparent reason, for purposes of § 6166, to treat a wholly owned corporate subsidiary any different from a wholly owned non-corporate subsidiary.

(b) Where both the parent and the subsidiary are part of the same "*controlled group of corporations*" as defined in § 1563, or would be, but for the fact that the parent or the subsidiary or both is not a corporation.

(i) The legislative history shows the express intent that, where two or more corporations are so closely related that they form a controlled group of corporations under § 1563, they should be treated as a single business entity for purposes of § 6166. Section 1563 applies only to corporations, but for purposes of § 6166, there is no reason why two or more non-corporate entities should not be treated as part of the same business where the relationship of those entities to one another would cause them to be part of the same controlled group under §1563 if they *were* all corporations.

(c) Where the parent and the subsidiary would not be part of the same controlled group of corporations (if both were corporations), but based on all facts and circumstances, the entities are either *functionally related* or *subject to common managerial control or direction*.

(i) The legislative history shows that Congress expressly intended for two or more corporations that have such a relationship to be treated as a single business, such that the interest in one held by the other would not be considered passive, even if they did not meet the criteria for being part of the same controlled group of corporations.

(ii) This same concept should apply with respect to assets owned directly by the decedent, rather than in another entity. For example, if the decedent owns an interest in a corporation or partnership that operates its business from property owned directly by the decedent, the value of the property should be included in the value of the closely held business interest for all purposes of § 6166.

This is often necessitated where the business is subject to regulatory restrictions on real estate ownership such that the business itself cannot own the property directly.

(d) *Where the business of the subsidiary is attributed to the parent under § 537*, with respect to the excess accumulations tax under § 531, or would be, but for the fact that one or both of the entities is not a corporation.

  (i) Congress expressly stated its intention that the IRS promulgate regulations under § 6166 that would provide the circumstances under which two business entities would be treated as one, stating that the rules should be similar to the rules under § 531 for determining when the business of one corporation would be attributed to another corporation for purposes of the accumulated earnings tax. See Treas. Reg. § 1.537-3(b).

(e) Where the parent holds 20% or more of the equity ownership of the subsidiary, or the subsidiary has fewer than 45 owners (or 100 owners, if our recommendations are adopted), and 80% of the value of the assets of both entities are attributable to assets used in carrying on a trade or business, after applying these attribution rules.

  (i) This applies the "active corporation exception" to any type of business entity, and eliminates the requirement, with respect to corporations, that stock be voting stock, so that the rules for corporations and partnerships are consistent.

We believe that the foregoing is not a change to the intended function of § 6166, but merely a clarification that Congress had intended be made administratively through regulations. Application of the foregoing recommendations would not defeat Congress's intent that estate taxes should not be paid in installments with respect to passive assets not used in the trade or business.

We also believe that the legislation should clearly direct the IRS to issue further guidance on the application of § 6166 in the form of regulations, revenue rulings and private letter rulings to living taxpayers, and not just to estates of deceased taxpayers, and that the IRS should be liberal in resolving ambiguities in favor of the estate's qualification for installment payments. We especially emphasize private letter rulings to living taxpayers so that they can plan how to pay estate taxes without disrupting their businesses. After all, § 6166 neither eliminates nor reduces an estate's tax liability, but merely provides a vehicle for allowing the estate to pay the estate tax over time, with interest, to avoid the necessity of breaking up or liquidating family businesses. We recommend that

§ 6166(b)(2)(C) or a similar proportionate asset "look-though" rule apply to members of the controlled group that are not ***indirectly*** owned 100% by the decedent or ***primary*** holding company.[21]

Current law. Currently, when an estate owns a business that holds its assets in multiple tiers of entities (subsidiaries) for financing or regulatory purposes, to limit liability or for other non-tax reasons, the estate may entirely fail to qualify for installment payments, or, if it does qualify, it may be required to pay the estate tax in fewer installments and pay more interest than for a business owned in a single entity.

Furthermore, the existing statute is unclear as to whether Holding Company Elections are available for multiple tiers of entities, particularly when lower tier entities are owned by several upper tier entities in which the estate owns an interest. It is also unclear whether a single election is sufficient to elect for all tiers and subsidiaries or whether separate elections must be made for each entity.

In addition, it appears that if an estate makes a Holding Company Election as to *any* subsidiary entity, the payment term is shortened and interest charges are increased for the *entire* amount qualifying for deferral, even if the value of the entity qualified under the Holding Company Election is a relatively small amount of the total value qualifying for installment payment of estate taxes.[22]

There is no apparent policy reason why § 6166 payment deferral benefits should be significantly reduced for closely held businesses organized in multiple tiers of entities, as under the holding company election in § 6166(b)(8). We believe that Congress's intent to avoid forced sales of closely held businesses will be far better served if substance is elevated above form.[23] We believe the proposed change more closely implements

[21] *See* Treas. Reg. § 1.1362-2(c)(4) (2005) that simply states, "In the case of tiered partnerships, the rules of this section apply by looking through each tier."

[22] For example, assume an estate holds closely held stock in a business, apart from the value of the subsidiary, equal to 36% of the adjusted gross estate, and the value of the subsidiary stock is an additional 4% of the adjusted gross estate. If the estate makes the Holding Company Election to qualify the value of the subsidiary for § 6166 deferral, the estate loses the 2% interest rate and 5 year interest-only deferral on the *entire 40%* and not merely the incremental 4%. Therefore, the estate likely would forego such an election because the "penalty" exceeds the benefit of making the Holding Company election.

[23] This change would repeal the "holding company election" of § 6166(b)(8), which is currently available only to corporations and which shortens the deferral period and increases the interest rate. If the deferral limits and increased interest rate must be retained to preserve revenues, we recommend that the same election be available to all types of entities and that a single election would apply to all tiers of closely held entities, regardless of the

Congressional intent (including the intent of the holding company election and other changes made in 1984), than does the current state of the law and practice under § 6166 with respect to multiple-entity businesses.

Historical Background and Context to Existing §6166 Provisions Regarding Tiered Entities. Before 1984, § 6166 included no specific provision regarding tiered entities.[24] The passive asset rule arose because pre-1984 regulations permitted passive assets held by partnerships or corporations to qualify for installment payments, while passive assets held by an individual operating a proprietorship did not qualify for installment payments. In 1984, the law was changed to try to harmonize this treatment and, in the process, the Holding Company Election was also enacted, but the complexity and other inconsistencies that arise when multiple entities are used in a business have never been addressed as Congress then intended when this change was made. In any event, the 1984 change is now an inadequate tool for dealing with the proliferation of entity structures in business today. When § 6166(b)(8) and (b)(9) are read together, the policy reason for why these two provisions were added to the Code in 1984 is easy enough to grasp. Yet the structure and operation of these provisions adds needless complexity to the process of qualifying a multiple-entity enterprise under § 6166.

Before the addition of § 6166(b)(8) and (b)(9) as part of the Deficit Reduction Act of 1984,[25] if a decedent operated a business as a *sole proprietorship*, deferral of estate tax was only available for the portion of the tax attributable to the decedent's assets used in carrying on the trade or business, and deferral was not available for any of the decedent's other assets. If, however, the decedent operated his or her business in the *corporate* or *partnership* form, then all of the estate tax attributable to the corporation or partnership interest was eligible for deferral, even if a substantial amount of the assets of the entity were passive, portfolio-type assets, not used in carrying on a trade or business.[26] This rewarded taxpayers who stuffed such assets into business entities to obtain estate tax deferral, a

number of tiers.

[24] § 6166(b)(2)(C) included a provision regarding indirect ownership, but that apparently applied only to the narrow question of how the number of owners were counted for the "Number of Owners Test" to determine if the interest in the entity was a "closely held business."

[25] Pub. L. No. 98-369, § 1021(a), (b)(1984).

[26] Therefore, until 1984, the existence of lower tier entities owned by corporations and partnerships was irrelevant because ALL of the assets, including the value of the lower tier entities, qualified for § 6166.

result clearly not consistent with the policy behind § 6166. Accordingly, § 6166(b)(8) and (b)(9) were added to limit the deferral to those corporate and partnership assets "used in carrying on a trade or business."[27]

"Passive Asset" Definition. More specifically, the "holding company election" of § 6166(b)(8) is actually an exception to a more general rule set out in the following § 6166(b)(9), and is therefore best understood by first reviewing § 6166(b)(9). Section 6166(b)(9)(A) sets forth the general rule that deferral is not available for that portion of a closely held business interest attributable to passive assets held by the business.[28] Subparagraph (B)(i) defines a "passive asset" as any asset "*other than an asset used in carrying on a trade or business*."[29] The legislative history demonstrates that while § 6166(b)(9) is generally aimed at liquid investment assets, such assets can still be considered to be "used in carrying on a trade or business" where they are:

> part of a partnership's or corporation's working capital or constitute reasonable reserves for financing of a specifically identified project. For example, a reserve for expansion of a factory building that is reasonably expected to be completed within two years of the time the contributions to the reserve fund are made would be a reasonable reserve.[30]

Subparagraph (B)(ii) specifically provides that the term "passive asset" includes any stock in another corporation *unless either:*

(1) The *two corporations* are treated as a single corporation under the "active corporation" exception of § 6166(b)(9)(B)(iii); *or*

(2) The stock of the subsidiary corporation is treated as held *directly* by the decedent, rather than indirectly through the parent corporation, by reason of a *holding company election under § 6166(b)(8)* and such stock is qualified under § 6166(a)(1), meaning that the stock, if held directly by the decedent, would satisfy all of the requirements of § 6166(a)(1).[31]

"Active Corporation Exception." The first exception to this "per se passive" rule of § 6166(b)(9)(B)(ii) is the *active corporation exception*

[27] I.R.C. § 6166 (b)(8), (b)(9).
[28] *Id.* § 6166 (b)(9)(A).
[29] *Id.* § 6166 (b)(9)(B)(i).
[30] S. REP. NO. 98-369, at 714.
[31] Presumably this means that the stock deemed to be held directly by the decedent is 20% or more of the voting stock of the corporation.

found in subparagraph (iii), which provides that two corporations will be treated as a *single corporation*—and, therefore, the stock of the subsidiary will not be treated as a passive asset of the parent corporation—if three requirements are met:

First, either:

(1) The subsidiary has 45 or fewer shareholders, *or*
(2) The parent owns 20% or more *in value* of the *voting* stock of the subsidiary;[32] *and*

Second, 80% or more of the *value* of the assets of the parent, not counting the stock in the subsidiary, is *attributable* to assets used in carrying on a trade or business, *and*

Third, 80% or more of the *value* of the assets of the subsidiary is *attributable* to assets used in carrying on a trade or business.

If all three of the foregoing requirements are satisfied, then the per se passive rule does not apply, because the two corporations will be treated as a single corporation and the parent will be treated as if it owned the *assets* of the subsidiary, rather than the *stock* in the subsidiary. However, the statute is not clear as to whether, for the *value* of the assets of the parent or the subsidiary to be *attributable* to assets used in carrying on a trade or business, those assets must be directly owned by the parent or subsidiary and used in carrying on a trade or business, or if indirect ownership, through one or more other subsidiaries, is sufficient. After all, even if the other assets of the parent consist of interests in other businesses, the *value* of those *interests* will be based upon the *value* of the *businesses* themselves, and if the value of the businesses derives from assets used in carrying on a trade or business, then the value of an *interest* in the business would seem to be attributable to assets used in carrying on a trade or business, even if only indirectly.

In short, there is no guidance as to how to apply this exception (or any other part of § 6166) to a multi-tiered entity structure. It is unlikely that Congress intended that an enterprise consisting entirely of assets used in the business of the enterprise would not qualify under § 6166 merely because there were three tiers of entities in the organizational structure.

“Holding Company Election.” The second exception to the per se passive rule, the *holding company election* under § 6166(b)(8), may be used in circumstances where the parent and the subsidiary cannot meet the

[32] Note that the same language is used here as in § 6166(b)(2), with respect to ***value*** of ***voting*** stock.

requirements of the *active corporation exception*, which could be the result of any of the following:

(1) The subsidiary having more than 45 shareholders and the parent holding less than 20% of the voting stock of the subsidiary; or
(2) Less than 80% of the value of the subsidiary's assets being attributable to assets used in carrying on a trade or business; or
(3) Less than 80% of the parent's assets, other than the stock in the subsidiary, being used in carrying on a trade or business.

The holding company election results in diminished deferral, however. The estate which has made the holding company election is not entitled to make interest-only payments during the first four years, so the tax must be paid in 10 installments of principal and interest, with the first installment being due nine months after death. Moreover, the special 2% interest rate will not apply. Further, if the stock of the subsidiary *business company* is *not* "non-readily tradable" (i.e. if there is a market on a stock exchange or in an over-the-counter market for the stock), then the tax attributable to the stock will be payable in five installments of principal and interest, with the first installment being due nine months after death.[33]

Uncertain Application to Non-Corporate Multi-Tier Entities. Both the *active corporation exception* and the *holding company election* appear to be limited in their application to situations where *both* the parent and the subsidiary are *corporations*, rather than either or both being a partnership or other entity, presumably because these two provisions are both exceptions to the per se passive rule, which, by its terms, only applies where both the parent and the subsidiary are corporations. Nevertheless, these provisions raise the question of how non-corporate entities are to be treated. Are interests in partnerships necessarily not considered passive? Are partnerships *automatically* eligible for "look through" treatment such that where the parent is a partnership, the decedent is automatically treated as owning the subsidiary directly? If the parent is a corporation and the subsidiary is a partnership, are the partnership assets automatically attributed to the corporate parent? Alternatively, if a partnership interest owned by a corporation or *vice versa* is considered passive merely because it is an interest in another business entity, would the active corporation exception or the holding company election be available, if all of the requirements

[33] Note that the availability of the holding company election where the business company stock is readily tradable was added by EGTRRA, and is subject to the sunset provisions that take effect in 2011, unless the sunset provision is repealed. Pub. L. No. 107-16, § 901 (a)(1), (b)(2001).

are satisfied, *other than* the fact that one or both entities is not a corporation? Must the requirements of these exceptions be met where one entity is *wholly owned* or even *mostly owned* by another?

What if the corporation in which the decedent holds an interest owns liquid, readily-tradable corporate stock that is part of the corporation's working capital or part of the corporation's "reasonable reserves for financing of a specifically identified project that is reasonably expected to be completed within two years"?[34] In such a case, the stock would be passive under the plain meaning of § 6166(b)(9)(B)(ii), would not qualify for the active corporation exception of § 6166(b)(9)(B)(iii), and would, at best, qualify for only very limited deferral under the holding company election of § 6166(b)(8), even though Congress specifically said that such assets are not necessarily passive.

The complexity and difficulty of qualifying for installment payments as discussed above could be eliminated, and many of the questions raised above can be answered, by amending the statute to bring it more in line with the original intent as expressed by Congress in the legislative history of the amendment that added § 6166(b)(8) and (9). In explaining the amendment, the Senate Finance Committee stated as follows:

> The committee is aware that corporations may often own stock in other corporations for purposes other than as passive investments. For example, a group of corporations may be functionally related (e.g., a manufacturing corporation may own all or a part of the stock in one or more of its supplier corporations). Similarly, corporations that are engaged in unrelated lines of business may be subject to varying degrees of common ownership and managerial control and direction. *The committee intends that stock owned by a corporation, an interest in which qualifies for the installment payment provision, be considered as an active business asset (rather than a passive investment) if the corporations, viewed together, form a controlled group of corporations as defined in section 1563*. Additionally, even though the requirements for a controlled group (under sec. 1563) are not satisfied, stock owned by one corporation in another corporation *may be viewed as an active business asset, provided that based on all facts and cir-*

[34] Staff of Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 1113 (Comm. Print 1984).

> *cumstances, the businesses are either functionally related or subject to common managerial control and direction.*
>
> *The committee intends that the Treasury Department issue regulations defining the circumstances under which partnership and corporate assets are to be treated as passive investments, and therefore, disregarded for purposes of the installment payment provision.* In general, these regulations should provide rules similar to the rules governing the accumulated earnings tax (sec. 531).[35]

The above-cited legislative history demonstrates that Congress did not intend for the 1984 amendments to make it more difficult for operating businesses to qualify for installment payments, merely because of choice of entity or structure of organization. Nevertheless, in the more than twenty years since § 6166(b)(8) and (9) were added to the Code, neither the regulations referenced above, nor any other guidance, has been forthcoming from the IRS. Accordingly, we believe that Congress should act either to clarify these rules within the statute itself or to mandate that, within a prescribed amount of time, the IRS issue the regulations that Congress intended, with rules of construction applying liberally for the benefit of taxpayers until those regulations are issued. We also recommend that Congress instruct the IRS to issue private letter rulings to living taxpayers.

We believe that the Congressional intent was that the payment of estate tax in installments should be available to ***any*** *business, irrespective of the number or type of entities used in the structure of the business, as long as the value of the business ultimately derives from trade or business activity rather than from the mere holding of passive investment assets*. We do not believe that there is any policy to be served by requiring that all of the trade or business assets be held in a single business entity to qualify for installment payments, especially since there are many legitimate reasons why businesses are structured as multiple tiers of entities. Consider the following examples:

(a) In California, if a closely held business's operating assets include real estate, such as the office building or retail store or warehouse where the business is carried on, there are certain *state* law incentives for *individuals* to own commercial real estate outright, rather than within any form of business entity, even though all of the other assets of the business may be held in a corporation or partnership. Accordingly, in

[35] S. REP. NO. 98-369, at 715 (emphasis added).

many cases, the business is operated in the form of, for example, an LLC treated as a partnership (where there are two or more owners) or as a disregarded entity (if there is one owner and the entity is not treated as a corporation) for tax purposes, which holds title to all assets used in the business except for the real estate from which the business conducts its operations. The real estate is owned outright by the individual or various family members, and leased to the business under a "triple net lease" arrangement, meaning essentially that the "landlord" only has to collect rent and the business "tenant" pays for all upkeep, taxes, insurance, etc. If the real estate is viewed on its own, it might appear to be one business, and the LLC might appear to be another business. The substance, however, is that the building and the assets of the LLC are all assets used in carrying on the same trade or business, and should be viewed as such, irrespective of formalities of title caused by peculiarities of state law. Therefore, the building and the LLC should, for purposes of § 6166, be treated as if they were all held in the same entity.

(b) Compare PLR 9015009 (1/5/1990) to PLR 200518011 (1/14/2005). In the former PLR, the IRS gave technical advice that an interest in a partnership leasing a hotel property was not conducting a "trade or business" activity even though the decedent also owned an interest in the hotel operating corporation as well. The IRS tested each entity separately. Although the value of the combined assets constituted more than 35% of the adjusted gross estate, the value of the estate's interests in the operating corporation alone did not, so the estate was denied § 6166 benefits.[36] In the latter PLR, the decedent leased real estate to an automobile dealership he also owned and the IRS gave technical advice that the real estate "proprietorship" was not a passive asset, so the real estate and operating corporations could be combined and qualify for § 6166 benefits.[37]

(c) Another example is set forth in *Moore v. United States*, discussed further below.[38] *Moore* was decided before the enactment of § 6166(b)(8) and (9), but even under those provisions, the estate might not qualify for the full benefit of § 6166, even though the legislative history clearly indicates that it should. After all, the holding company in which the decedent owned an interest had assets that,

[36] I.R.S. Priv. Ltr. Rul. 90-15-009 (Jan 5. 1990).

[37] I.R.S. Priv. Ltr. Rul. 2005-18-011 (Jan.14, 2005).

[38] 87-2 T.C.M. (CCH) ¶ 13,741 (1987).

> as far as we can tell, consisted solely of stock in two other corporations, and that stock would necessarily be passive under § 6166(b)(9)(B)(i), *unless* one of the exceptions applied. It is not at all clear that the active corporation exception would apply, because the holding company would not be able to show that the value of 80% of its other assets was *attributable to assets used in carrying on a trade or business* unless that phrase includes assets owned indirectly through another subsidiary. The holding company election under § 6166(b)(8) would be available, but the benefits of deferral under that election are less favorable than would be the case if that election was not necessary, thus penalizing the estate for having been structured in a manner that was required by state law.

IRS Policy Not to Issue Advance Rulings. Not only has Treasury not issued any of the guidance Congress intended, but the IRS appears to have a policy of not issuing any private letter rulings on the meaning or application of § 6166 to ***living*** taxpayers trying to ensure that their estates will qualify for installment payments, even though the IRS routinely issues rulings to living individuals as to the prospective estate tax treatment of arrangements or transactions. Therefore, absent Congressional mandate, there is no way for a taxpayer to determine what position the IRS might assert with respect to any fact situation that does not fit squarely within the language of § 6166. In any event, the *Moore* case above demonstrates that the IRS might disallow the payment of estate tax in installments even where the facts demonstrate a classic case of a large estate tax liability attributable to a closely held business.

3. Applying the 'Trade or Business' Standard to the Entire Business Enterprise

We recommend that § 6166 be amended to distinguish "trade or business" assets from non-business assets with respect to the entire *Business Enterprise* including all qualifying Closely Held Entities rather than on an entity-by-entity basis. This change could be made relatively simply to define "Closely Held Entities" as those qualifying for combination above (by ownership percentages, control or function) without regard to which of those entities are engaging in an "active business." The "entities" would then be combined and the resulting "Business Enterprise" would then be tested (1) to determine if one or more active businesses exists within the related group of entities, and (2) which assets are used in the trades or businesses within the related group and which assets are not.

IRS rulings and court decisions have frequently determined whether assets are "business" assets or "non-business" assets on an entity-by-entity basis, rather than evaluating the assets based upon the entire enterprise that may be operated through multiple entities. When assets used in a single business enterprise are held in multiple entities, the definition of "the business" becomes unclear, which is why it is important to clearly define the "business enterprise" instead of the confusing "business" terminology under the existing statute. If each entity is viewed alone, the IRS may consider some assets to be "passive" assets, even though, when the related entities are viewed together as a single, combined enterprise, those assets may obviously be used in that business endeavor. To determine which assets are "Business" and "Non-Business"[39] assets, their function should be considered in the context of the larger "business enterprise." A business asset would be one that is held for the reasonable needs of the entire business enterprise and would be determined in a manner consistent with the accumulated earnings test under Code § 537, as recommended by Congress when it enacted amendments to § 6166 in 1984.

Section 6166 does not define the term "trade or business," which is subsumed into the definition of an "interest in a closely held business" in § 6166(b)(1). Section 6166(b)(9)(B)(i) generally defines ***passive*** assets as those assets that are ***not*** trade or business assets. Therefore, the terms are mutually exclusive.

A potential circular determination of "trade or business" can exist for business structures with multiple entities. Therefore, we recommend that the determination of whether a "trade or business" exists should be made only after multiple entities that form a group of related entities are consolidated as provided above.

By way of example, assume a decedent owned a 30% interest in a hotel building that is "triple net" leased to a hotel management company that operates the hotel and in which the decedent also owned a 30% interest. Assume the value of each separate entity is 34% of the decedent's adjusted gross estate and combined make up 68% of the decedent's adjusted gross estate. If the entities are separately tested for a "trade or business," the IRS has taken the position that ownership of real estate without also

[39] Section 6166(b)(9) currently refers to "Passive Assets." We recommend that the term be changed to "Non-Business Assets" because the word "passive" carries common connotations from other provisions of the Code, notably § 469, that do not apply to § 6166 and tend to be confusing.

providing services is not an active business.[40] Therefore, the IRS might rule, after taxpayer was deceased,[41] that the real estate entity does not qualify to be combined with the operating management company and, consequently, the decedent's estate would not meet the more-than-35% of adjusted gross assets test so that none of the estate would qualify for installment payment of estate tax. On the other hand, if the entities were combined by virtue of the decedent's greater than 20% ownership interest in each entity and the "trade or business" determination were made as to all assets, then the value of the interests in both entities would qualify as being used in the hotel business. The entire value of both entities would qualify for § 6166 installment payments.

As a further example, assume a related group of entities exists and that some entities have made loans to other entities within the group, as is common where, for example, liability concerns require the use of multiple entities, transfers of cash from one entity to another must be documented as loans to respect the separate identity of each entity, thus avoiding any creditor attempt to "pierce the corporate veil." If the "trade or business" and "passive asset" test is applied on an entity-by-entity basis as a pre-condition to being eligible to be combined within the related group, the IRS might rule that an entity that has no operating business but has lent substantial amounts to other entities within the group (1) is not operating a business of lending, (2) owns no business assets, (3) is not eligible to be combined into the related party group and (4) owns only passive assets that do no qualify for installment payment of estate tax. If the "trade or business“ test is irrelevant in determining whether the *entities should be combined*, and the "business of the related group" is that of the operating businesses borrowing the funds internally from a related entity, then the loans would clearly be related to the "business" of the group.

D. Distinguishing Business Assets from Non-Business Assets.

We recommend that Congress:

(1) Provide a clear definition of business assets eligible for estate tax deferral and that the term "Non-Business Asset" be substituted for "passive asset" as used in § 6166(b)(9)(B)(i).

(2) Provide testing the business purpose of the assets within the context of an entire business enterprise rather than on an entity-by-entity basis

[40] *See* I.R.S. Priv. Ltr. Rul. 90-15-009 (Jan. 5, 1990).

[41] Reference is again made to the IRS's unwillingness to issue advance rulings on § 6166.

and by screening out purely passive assets by reference to the § 537 Accumulated Earnings Tax standard.[42]

(3) Repeal § 6166(b)(9)(B)(ii), defining stock in another corporation as a passive asset. This change would further include repeal of § 6166(b)(9)(B)(iii) and § 6166(b)(8)(A) as unnecessary.

Installment payments of estate tax are available only for assets held for the reasonable needs of a business. When assets used in a single business enterprise are held in multiple entities, the definition of "the business" becomes unclear. If each entity is viewed alone, the IRS may consider some assets to be "passive" assets[43] even though, when the related entities are viewed together as a single, combined enterprise, those assets may obviously be used in that business endeavor.[44] Combining interests in business for purposes of this test could increase or decrease the assets considered to be held for business purposes. To the extent § 6166 treats related entities as a single "business,"[45] the determination of whether assets are passive or used in the trade or business must similarly be made on a combined basis. Treasury has not issued regulations to clarify the distinction for over twenty years, failing to comply with Congressional intent as follows:

> ***The committee intends that the Treasury Department issue regulations defining the circumstances under which partnership and corporate assets are to be treated as passive investments, and therefore, disregarded for purposes of the installment payment provision***. In general, these regulations should provide rules similar to the rules governing the accumulated earnings tax (§ 531).[46]

[42] Subchapter G was enacted to tax subchapter C corporations that unreasonably accumulated earnings or closely held C corporations that failed to make distributions to avoid double taxation of dividends. *See I.R.C.* §§ 531–37, 541–47. The purpose of Subchapter G was essentially to identify (and tax) excess accumulations of non-business assets within an entity. Therefore, reference is made to Treas. Reg. §§ 1.537-1 and -2 for determination of reasonable needs of a business.

[43] Section 6166(b)(9) currently refers to "Passive Assets." We recommend that the term be changed to "Non-Business Assets" because the word "passive" carries common connotations from other provisions of the Code, notably § 469, that are not applicable to § 6166 and tend to be confusing.

[44] The recommendation earlier that tiered entities should be viewed as a whole discusses this concept more fully. *See supra* note 20 and accompanying text.

[45] *See* I.R.C. § 6166 (b)(9)(B)(flush language), (b)(8)(A)(i), (b)(10) (A)(i), (c).

[46] S. REP. NO. 98-369, at 715 (emphasis added).

To remedy Treasury's failure to issue necessary regulations, we recommend that the legislative history clearly indicate that, until regulations are issued, the provisions of § 537 should be liberally applied to the benefit of the taxpayer with respect to the definition of "passive assets" under § 6166.[47]

This approach would put to rest the continuing uncertainties that arise over time as a result of piecemeal interpretations of § 6166 and changes in the way business entities are structured. A classic example of the IRS's possible narrow interpretation of § 6166 when dealing with a multiple-entity structure, and the willingness of some courts to accept that interpretation, is demonstrated in *Moore v. United States*.[48] This 1987 case involved an estate's stock in a closely held bank holding company, the sole assets of which consisted of virtually all of the stock of a subsidiary that operated a bank and all of the stock of another subsidiary that owned the bank's operating premises. Even though it was stipulated that this holding company structure was created in order to comply with Texas banking regulations, the IRS asserted, and the court agreed, that the estate could not qualify as to the holding company stock under the then applicable version of § 6166 because the holding company did not ***directly*** carry on a trade or business. The court recognized that there were "compelling policy reasons" for allowing § 6166 to apply but nevertheless held that it did not apply under the letter of the law, since the trade or business activity was carried out by the subsidiary corporations.[49] This particular anomaly was corrected, at least for some cases, by the 1984 enactment of the Holding Company Election under § 6166(b)(8), but that election is not avail-

[47] If Congress were to look beyond the accumulated earnings regulations, the regulations that are the most analogous definition of "passive assets" under § 6166 are the S corporation regulations, primarily § 1362, relating to S corporation tax or termination of S corporation status as a consequence of "passive investment income." Subchapter S cross references to "passive investment income" or the related tax also appear in §§ 1366, 1375 and 6655. With respect to most types of income generally defined as "passive income," the regulations include exceptions for income derived in "the ordinary course of business" or "the active trade or business of renting property." Treas. Reg. § 1.1362-2(c)(5)(ii)(A)–(D)(iii)(2005); *See also* Treas. Reg. § 1.1362-2(c)(6) exs. (2005). Since the § 1.1362-2(c)(5) regulations were finalized in 1992, the IRS has issued numerous private letter rulings and technical advice to determine whether income is "passive income." Most of those PLRs were favorable to the taxpayers. The IRS appears unwilling to respond to PLR requests by taxpayers as to whether the entities and assets held by those entities would qualify for § 6166 installment payments before the death of the taxpayer, even while willing to rule on similar issues for S corporation purposes.

[48] 87 T.C.M. (CCH) at ¶ 13,741.

[49] *Id.*

able to businesses with a multiple entity structure in the form of partnerships or LLCs rather than corporations. Moreover, Congress at that time called for regulations to answer the fundamental question as to all business entities—as to when an interest in an entity is a business interest rather than a passive investment—but over 20 years later those regulations have not been issued, leading to confusion, uncertainty, and failure to use § 6166.

Furthermore, in some activities such as real estate ownership and management, the IRS appears to apply a de facto "material participation" requirement for qualification as a "trade or business," even though the statute imposes no such requirement.[50] By the time of death a decedent often will have retired from active participation in a closely held business but retain a substantial ownership interest. Accordingly, the statute should be amended to ensure that § 6166 qualification does not depend upon the personal efforts of the decedent or family members, but instead on whether, as a factual matter, the value of the assets is attributable to a business, regardless of who is operating that business.

E. Late Elections

We recommend that Section 6166 be amended to expressly permit an election to pay estate tax in installments to be filed on an amended (supplemental) or late return or one that is changed as a result of an audit.

The current statute prohibits an election on a late return and only permits deficiencies arising out of an audit to be added to the installments if the election previously was made on a timely filed return. Extending the right to elect should not cause abuse or disrupt compliance, and would eliminate the adverse impact when newly discovered information or audit adjustments otherwise make estate tax deferral necessary or appropriate.

It has been suggested that it may be "possible" to make an election to pay an estate tax deficiency in installments even though no election was made when the return was filed.[51] Increases in the tax due as a result of an

[50] "Decedent's level of activity in connection with Properties 1, 2, and 3 determines whether the properties are part of a trade or business for purposes of section 6166." I.R.S. Priv. Ltr. Rul. 2005-18-047 (Jan. 27, 2006). "Although Decedent hired property management companies to manage the day-to-day operation of Properties 6, 7, and 8, this factor does not necessarily weigh against a determination that an active trade or business exists because the activities of an agent can be attributable to a decedent." *Id*. This seems to be an incorrect statement of law. The only issue is whether the activity is a "trade or business," and it makes no difference who manages that activity.

[51] *See* JERRY A. KASNER, POST-MORTEM TAX PLANNING § 9.03 [14] n. 101 (3d ed.

audit are not uncommon, particularly when closely held business interests are involved, because they are difficult to value. An upward adjustment in the value of the business interest can cause the value of the business interest to exceed 35% of the adjusted gross estate, and thus meet one of the requirements of qualification, where the value of the business, on the return as originally filed, did not meet that requirement, so no election was possible. In such a case, a tax could be due that was not otherwise due.

The liquidity relief provided by § 6166 should not depend on when the election is filed. We do not believe that there is any reason to prohibit an election to be made on a late or "amended" return because § 6166 is intended to facilitate payment of taxes but, unlike other elections, it does not reduce the amount of the tax. Furthermore, § 6166 does not authorize a refund of taxes already paid if a late election is made. Allowing an election for the first time on a late or amended return or resulting from examination changes would not have the potential for abuse or disrupt compliance. The computational difficulties presented when elections are not made on a timely return are no different than those arising from deficiencies when a timely election was made.[52]

F. Liens, Bonds and Security Issues

We recommend that § 6325(d) be amended to require that regulations articulate standards for subordination of the government's lien under § 6166 and the statutory standard be the same for § 6166 as for § 2032A special use valuation. We also recommend that the amendment or legislative history expressly provide that no request for subordination be denied until such regulations are issued, although such regulations may be issued as temporary.

We recommend that, instead of requiring the estate to post a bond in an amount up to twice the deferred tax as a condition of electing deferral under § 6166, the Code should expressly allow the executor to provide alternative means of assuring payment as a substitute for the special bond under § 6165 or the special lien under § 6324A. Regulations (supplemented by revenue procedures) should be required in order to offer alternatives such as (1) a lien against only those assets for which tax deferral is sought that is subordinated to existing creditors and renewals of existing lines of credit, and (2) covenants by which the executor undertakes not to take certain actions such as distributing funds from the secured assets oth-

1998) (referencing Rev. Rul. 67-161, 1967-1 CB 342).

[52] *See* Rev. Rul. 89-32, 1989-1 C.B. 307 (1989).

er than for permitted purposes (e.g., income taxes for pass-through entities) or to dispose of those assets in any way until the tax liability has been paid in a corresponding amount. Such covenants may also provide commercially reasonable terms such as limitations that only reasonable compensation be paid to related parties or that payments on loans to related parties not exceed arm's length terms.

In support of these recommendations, please note the following:

1. Subordination

Where an estate elects the deferral of estate tax payments under § 6166, the government has a special estate tax lien against the assets of the estate. The presence of such a pre-existing lien can make it difficult, if not impossible, for the business included in the estate to obtain third party financing unless the estate tax lien can be subordinated to the third party financing lien.

The lien provided for in § 6166 is a critical part of statutory scheme because, absent the lien, there is usually no other practical way for an executor to be relieved of personal liability for the unpaid taxes during the long deferral period under § 6166.

If the executor desires to be discharged from personal liability with respect to the deferred estate taxes, the executor is required to provide a bond, which is usually prohibitively expensive or not available, or to elect that a lien will be imposed with respect to the "6166 lien property." The lien under § 6324A also replaces the special estate tax lien imposed pursuant to § 6324(a)(1).

Since, however, such a lien can potentially cut the business off from access to third party credit, § 6325 provides for subordination. The statutory standard contemplates that regulations will be issued providing for more detail as to how and when subordination will be granted. Such regulatory standards are essential to provide consistency and some measure of predictability; without such regulations, the potential for inconsistency is equivalent to a national bank running a loan department without a loan committee or lending criteria. The special estate tax lien for the deferred tax liability under § 6166 can be subordinated under circumstances described in § 6325(d). However, in the 30 years since § 6325 was passed, no such regulations have been issued to provide predictability or consistency in how the relief is granted. Furthermore, the subordination relief is more limited with respect to liens under § 6166 than for liens under special use valuation under § 2032A (despite the fact that § 2032A offers a greater benefit to the estate than § 6166, because it reduces liability rather than merely deferring payment (with interest)). In addition, the standard for subordination needs to be consistent with the same considerations applied in protecting the government's payment right without using liens and bonds, as described below.

2. Alternatives to Liens and Bonds

The Code now appears to allow the IRS to require a § 6324A lien as a condition of § 6166 deferral. Certainly a bond in the amount of twice the tax deferred can be required under § 6165, and the IRS does indeed impose that requirement.[53] Since these bonds are often very difficult or expensive to obtain, the executor is often forced to offer a lien under § 6324A instead. Our understanding of current IRS policy is that a notice of tax lien is filed with respect to all such liens. The commercial stigma of a "tax lien" of any sort has an incredibly adverse effect on the reputation and credit standing of the business, suggesting, for example, non-compliance with the tax laws, and particularly imperiling businesses, such as construction companies, that require bonding capacity for their customer contracts. After all, a notice of tax lien does not state that the tax lien is imposed to secure an estate's obligation to make installment payments of estate tax, but appears the same as a lien imposed on a taxpayer for failure to pay taxes in bad faith. As a result, § 6166 deferral is out of the reach of many business owners and their families who are unwilling to take a chance on what will be required at the time to obtain deferral and keep it in place.

Furthermore, we have heard that procedures are starting to be implemented wherein a lien generally will not be accepted by the IRS in lieu of a bond if the only asset available to pledge is closely held stock or similar ownership interests, but that the IRS will accept a security interest in real estate in lieu of a bond or lien. If the business does not itself own sufficient equity in real estate (a circumstance that is likely to be increasingly common in today's service company), then the IRS will accept a pledge of real estate from another party, as we understand the current administrative practice. However, while this approach understandably simplifies the government's interest in obtaining adequate security, it at the same time would limit § 6166 relief to those businesses with real estate or to those families that have wealth independent of the business.

The foregoing IRS policy also seems to assume that the estate controls the enterprise and can arrange for a security interest to be placed on

[53] *See* I.R.S. Priv. Rul. 2000-27-046 (Jul. 7, 2000).

enterprise property for the personal benefit of the owner, when, in fact, many interests qualifying for § 6166 payments are minority interests with non-family members or even adverse parties as co-owners. In this case, the administrative policy essentially eviscerates the entire purpose of § 6166 to avoid forced sales of businesses or interests in businesses. The inability to obtain § 6166 treatment for an owner of a illiquid, non-controlling interest in a closely held business essentially puts the estate owning that interest at the mercy of those controlling the business which is, in the purest sense, precisely the forced sale that Congress intended to avoid.

V. CONCLUSION

The saga of § 6166 establishes a consistent pattern of Congress adding provisions to § 6166, struggling to meet its clear intention that installment payment of estate taxes be available to owners of closely held businesses. The structure of § 6166 is antiquated and inconsistent between differing forms of ownership (corporations and partnerships) that do not address the form in which businesses are conducted in the real world.

APPENDIX A: ADDITIONAL BACKGROUND

Extensions of Time for Payment of Estate Tax—A Historical and Economic Perspective[54]

A. Tax Reform Act of 1976[55]

In 1976, significant changes were made to the federal gift and estate tax law, including unifying the gift and estate tax, creating the "unified credit," substantially increasing exemption amounts (and filing requirements), modifying the inclusion for property jointly owned by spouses, adding the § 2036(b) anti-Byrum provision, setting definitive rules for disclaimers and enacting ill-fated (and subsequently repealed) carry-over basis and generation-skipping taxes, as well as other changes.

Chief among the changes were to provide protections against forced sales of farms and closely held businesses through enactment of § 2032A special use valuation, a significantly changed automatic extension for the time to pay estate taxes for estates under § 6166A for estates holding a significant portion of the estate (65% of the adjusted gross estate or 50% of the taxable estate) and adding a new provision (§ 303) permitting redemption of shares for payment of estate tax without incurring dividend treatment for the redemption. The new automatic extension also permitted the executor to be discharged from personal liability and to enable the estate to provide security for the deferred tax through a lien, thereby avoiding a bond unless there was insufficient security for the unpaid tax.

Prior to the changes, estate tax payment could only be extended (1) by a discretionary (and non-reviewable) determination of hardship by the IRS or (2) an election to pay the tax over ten years if the closely held business constituted more than 35% of the gross estate or 50% of the taxable estate (50% of the gross estate for two or more businesses), secured by a bond of up to double the unpaid tax. The House report concluded, in its reasons for the changes:

> The present provisions have proved inadequate to deal with the liquidity problems experienced by estates in which a substantial portion of the assets consist of a closely held business or other illiquid assets. In many cases, the executor is forced to sell a dece-

[54] This Appendix is intended to provide a historical context to fundamental changes in § 6166 over its history rather than a comprehensive review of every technical and administrative revision.

[55] Pub. L. No. 94-455 (1976).

> dent's interest in a farm or other closely held business in order to pay the estate tax. This may occur even when the estate qualifies for the 10-year extension provided for closely held businesses. In these cases, it may take several years before a business can regain [enough cash to pay estate taxes] after the loss of one of its principal owners. Moreover, some businesses are not so profitable that they yield enough to pay both the estate tax and interest especially if the interest rate is high. . . . On the other hand, where a substantial portion of an estate consists of illiquid assets other than a farm or closely held business, it has been extremely difficult to obtain an extension on the grounds of "undue hardship" because the IRS generally takes a restrictive approach toward granting such extensions. Your committee believes that additional relief is needed by estates with liquidity problems.
>
> In addition, many executors have found it both difficult and expensive to obtain a bond to satisfy the extended payment requirements. Therefore, many executors refuse to elect the extended payment provisions because they must remain personally liable for tax for the entire length of the extension.[56]

Although significant improvements were made, changes in how businesses are structured that were relatively rare in 1976 have again placed estates in positions similar to the circumstances in 1976 that necessitated reform.

B. Economic Recovery Tax Act of 1981.[57]

Even greater changes were made to federal gift and estate law in 1981 by enacting an unlimited marital deduction, including QTIPs, and increasing the unified credit to $225,000 (scheduled to increase to $600,000) from the $60,000 exemption that had existed prior to the 1976 Act. ERTA repealed § 6166A and effectively integrated it with § 6166, making deferral of estate taxes available to more estates.[58] ERTA decreased the percentage threshold for qualification from 65% to 35% and liberalized the acceleration rules to permit dispositions of up to 50% from the prior 33 1/3%.[59]

[56] H.R. REP. NO. 94-1380, at 3384–85.

[57] Pub. L. No. 97-34 (1981).

[58] Pub. L. No. 97-34, § 422. ERTA also changed the § 6166(c) multiple-entity combination rule requiring "more than 20" to "20 or more" of the value of the business. *Id.*

[59] *Id.*

In giving reasons for changes to § 6166 in ERTA, the House reported:

> The committee believes that simplification and clarity are needed in the provisions permitting deferred payment of estate taxes attributable to closely held businesses. Under present law, although both sections 6166 and 6166A permit deferred tax payments for illiquid estates, there are unnecessary differences between the two sections. The definition of a closely held business, the percentage of estate assets required to be represented by such an interest, the length and conditions of the deferral, the appropriate interest rate, and the conditions for acceleration vary between the sections.
>
> Because the existence of two deferral provisions with differing requirements creates confusion, the committee believes that these provisions should be simplified by merging the two sections to provide a single set of rules to govern the installment payment of estate taxes. . . .
>
> In addition, the committee believes that the provision of present law section 6166, which restrict eligibility for deferral to an estate in which the closely held business interest comprises 65% of the adjusted gross estate, have proven unduly restrictive. . . .
>
> Under present law, the decision of the IRS to deny an election to pay all or a portion of the estate tax attributable to closely held businesses generally is not subject to judicial review because no deficiency is involved. The committee believes that taxpayers should be provided with a judicial forum to resolve disputes involving an estate's eligibility for the deferral of estate tax attributable to interests in closely held businesses.
>
> Under present law, the redemption of certain stock in certain closely held businesses to pay estate taxes, funeral expenses, and administrative expenses is treated as a sale or exchange instead of a dividend (sec. 303). However, this provision contains a definition of an interest in a closely held business and rules for aggregating multiple interests in closely held businesses which are different from either of the provisions which permit deferred payment of the estate taxes attributable to interests in closely held businesses. The committee believes that the rules governing redemption of closely held business stock to pay estate taxes, fu-

> neral expenses, and administration expenses should be coordinated with the provisions governing the deferral of estate taxes attributable to interest in closely held businesses.[60]

From a practical standpoint, ERTA's generous income tax benefits, including depreciation deductions and incentive tax credits, which were intended to expand the economy had an unintended effect of spawning the "tax shelter" economy, overbuilding, see-through buildings and the eventual collapse of the Savings and Loan industry. In order to achieve the "tax shelter" effect, more and more businesses structured themselves as partnerships to enable them to pass through tax losses and credits to their partners. More and more businesses were formed as pass-through entities. Prior to that time, most businesses were operated as proprietorships and corporations. The Subchapter S Revision Act of 1982[61], coupled with the reduction in individual income tax rates compared to Subchapter C corporate rates, hastened the increase of pass-though entities by lowering barriers to Subchapter S elections.

C. Deficit Reduction Act of 1984[62]

Further amendments were made by Deficit Reduction Act of 1984 ("DRA") to again expand the application of § 6166 from the more restrictive interpretation of the regulations adopted by the Treasury Department. The Conference Report provided, in part:

> ***Present Law***
>
> Qualifying closely held businesses may be conducted as proprietorships, partnership, or corporations. Generally, only directly owned interests in active business operation are considered for purposes of the installment payment provisions. Present Treasury regulations take the position that the value of a trade or business carried on as a proprietorship includes only the value of those assets actually used in the trade or business. On the other hand, if the business is carried on as a partnership or a corporation, the value of the trade or business includes the value of all partnership or corporate assets, even though a portion of the partnership or corporate assets may be used for purposes other than carrying on a trade or business.

[60] H.R. REP. NO. 97-201, at 180–181 (1981).
[61] Pub. L. No. 97-354 (1982).
[62] Pub. L. No. 98-369.

House Bill

The House bill permits executors to elect to look through a passive holding corporation for purposes of determining whether the decedent owned an interest in a closely held business if 80% or more of the value of the holding corporation consists of the value of non-readily tradable stock in a single active business corporation. Only the value of qualifying stock owned by the holding corporation which is attributable to the value of assets (including working capital) actually used in an active business operation is considered for purposes of the installment payment provisions. If the election is made, the special 4% interest rate and 5-year deferral of principal payments are not available.

Senate Amendment

The Senate amendment is the same as the House bill except the Senate amendment also permits executors to elect to look through multiple tiers of passive holding corporation to determine whether the decedent owned an interest in a closely held business. The multiple tier look through is available only if at least 20% of the value of each corporation to be looked through is included (directly or indirectly) in the value of the decedent's gross estate. The Senate amendment also expands the House rule under which only the value of assets (including working capital) actually used in an active business are considered for purposes of the installment payment provision to provide that, in the case of all interests in partnership and corporations (whether or not a passive holding corporation is present), only the value of assets directly related to the reasonable needs of the business are considered.

Conference Agreement

The conference agreement follows the Senate amendment with technical modifications. Under the conference agreement, interest in active closely held corporations may be considered for purposes of the installment payment provision provided the indirectly owned interest would meet the requirements of that provision were it directly owned. Therefore, an indirectly owned interest in a single closely held corporation qualifies if the corporation has 15 or fewer shareholders or the decedent owned 20% or more of the corporation's voting stock. Also, the value of the business interest must constitute more than 35% of the value of the dece-

> dent's adjusted gross estate. As under present law, if a decedent owns interests in more than one closely held business, at least 20% of the value of each such business must be included in the decedent's estate if the business interests are to be aggregated for purposes of the installment payment provision.
>
> Additionally, the conference agreement retains the rule that in the case of all corporations and partnerships, only active business assets are considered for purposes of the installment payment provision….
>
> Finally, the conference agreement includes an exception under which multiple wholly owned subsidiaries of a passive holding company may be treated as one subsidiary corporation if the holding company has fifteen or fewer shareholders on June 22, 1984, and at all time prior to the owners' death, and if at least some of the subsidiaries are carrying on a trade or business. . . .[63]

D. Tax Reform Act of 1986.[64]

The Tax Reform Act of 1986 did not amend § 6166, but its effects significantly affected the application of § 6166 as well as the economy. The establishment of the passive loss rules and elimination of advantageous liquidation of Subchapter C corporations drove more and more businesses to forms of business that were pass-through entities for tax purposes. The rise of litigation involving businesses that failed from the tax-driven strategies encouraged by ERTA and the following economic fall as well as the consequent failure of significant accounting and law firms resulted in the development of the limited liability company and similar structures. Further relaxation of permitted ownership in S corporations created the rush of C corporations to elect S corporation status or to liquidate and reorganize as LLCs. The vast majority of closely held businesses are now taxed as either S corporations or partnerships.

As to real estate, the collapse of the real estate industry and resulting financial failure of many entities caused numerous bankruptcy filings. At the time, many entities filing for bankruptcy owned multiple properties. As a defense tactic, many entities successfully argued in an effort to forestall foreclosures of properties by lenders (and attendant recapture of prior tax benefits) that reorganization in bankruptcy was appropriate because

[63] H.R. REP. NO. 98-861, at 1235–37 (1984) (Conf. Rep).

[64] Pub. L. No. 99-514 (1986).

they held multiple properties (some of which were in default and others were not). Lenders then began requiring that each real estate project be held in a single asset entity as a condition to providing financing. Real estate businesses were then forced into a business structure that required one or more tiers of entities that were not contemplated in 1984 when the "Holding Company" provisions were added to § 6166. Similarly, increasing perceived or real risks of liability from numerous sources encouraged owners of businesses other than real estate to structure their organizations in multiple entities, resulting in many more entities held in multiple brother-sister or tiers of corporations, limited liability partnerships and LLCs to reduce the risk of a failure of one business adversely affecting other businesses.

E. Subsequent Amendments.

Since the DRA of 1984, other changes to § 6166(b) include a change of the reference to the four percent interest rate to two percent to reflect the simplification for the accounting for interest paid in the administration of § 6166.[65]

Further changes were made by the Economic Growth and Taxpayer Relief and Reconciliation Act of 2001 to redefine "Non-Readily Tradable Stock" in the Holding Company rules of § 6166(b)(8)(B), to add a new § 6166(b)(10) applying to banks and similar lending enterprises, and to increase the number of shareholders and partners to 45 from 15.[66] The House Report provides the reason for the change as follows:

> The Committee finds that the present-law 15 partner limitation on partnerships and 15 shareholder limitation on corporations is restrictive and keeps estates of decedents who otherwise held an interest in a closely held business at death from claiming the benefits of installment payment of estate tax. Thus, the Committee wishes to expand the definition of partnerships and corporations to enable more estates of decedents with an interest in a closely held business to claim the benefits of installment payment of estate tax.[67]

The Senate Report similarly provides the following reason for the

[65] *See* I.R.S. Restructuring and Reform Act of 1998, Pub. L. No. 105-206 (1998); Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (1997).

[66] Pub. L. No. 107-16, § 573 (2001).

[67] H.R. REP. NO. 107-37, at 42 (2001).

changes:

> The Committee finds that the present-law installment payment of estate tax provisions are restrictive and prevent estates of decedents who otherwise held an interest in a closely held business at death from claiming the benefits of installment payment of estate tax. Thus, the Committee wishes to expand and modify availability of the provision to enable more estates of decedents with an interest in a closely held business to claim the benefits of installment payment of estate tax.
>
> ***Explanation of Provision***
>
> The bill expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. The bill also provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years.
>
> The bill also clarifies that the installment payment provisions require that only the stock of holding companies, not that of operating subsidiaries, must be non-readily tradable in order to qualify for installment payment of the estate tax. The bill also provides that an estate with a qualifying property interests held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.[68]

[68] STAFF of S. COMM. On Finance, 107th CONG., RESTORING EARNINGS TO LIFT INDIVIDUALS AND EMPOWER FAMILIES (RELIEF) Act of 2001, *available at* http://riacheckpoint.com/checkpoint?usid=20a741dd32e&1kn=mainFS&uqp=659757 (last visited March 21, 2006).