Overview of the Estate Tax

The estate tax is due and payable at the same time the estate tax return is due, that is nine months after the decedent’s date of death. It must be paid within the time prescribed to avoid assessment of interest and penalties. Extensions of time for payment may be granted, but such extensions—although preventing the application of certain penalties—do not entirely negate the assessment of interest.

Due Date

The payment due date is the same numbered day of the ninth month after the date of death as that date was of the month in which death occurred. If there is no similarly numbered day in the ninth month, the tax is deemed to be due on the last day of that month. For example, if the date of death were July 31, the due date would be April 30 of the following year.

Place of Payment

The law requires that the tax be paid, without any assessment or notice by the Internal Revenue Service (IRS), to the IRS office where the estate tax return is filed. Unless the return is hand carried to the office of the IRS District Director, it should be mailed to the IRS Service Center for the State in which the decedent was domiciled on the date of death.

Method of Payment

The tax may be paid by check or money order payable to the U.S. Department of Treasury. If the amount of tax paid with the return is different from the amount of the net estate tax payable as computed on the return, the executor should explain the difference in an attached statement.

Flower Bonds

Treasury bonds of certain issues known as “flower” bonds are redeemable at par (plus accrued interest from the last preceding date to the date of redemption) upon the death of the owner, at the option of the estate representative. No treasury obligations issued after March 3, 1971 will be redeemable at par value for this purpose.

Estate Tax Option for Closely Held Business Interests

The estate of an individual who dies owning a closely held business interest (discussed below)—including an interest in forest land—may, by meeting certain requirements, qualify for a special elective method of paying the estate tax attributable to that interest. Under section 6166 of the Internal Revenue Code (IRC), payment of the tax may be totally deferred for the first 5 years, with the estate making 4 annual payments of interest only, followed by payment of the balance in up to 10 annual installments of principal and interest. The maximum payment period, however, is 14 rather than 15 years because the due date of the last payment of interest only coincides with the due date for the first installment of tax. Election of special use valuation as discussed in chapter 12 does not prevent an election under section 6166.

Percentage Test

The closely held business interest(s) must comprise more than 35 percent of the decedent’s adjusted gross estate. The interest(s) can be composed entirely of forested property or partially include forest land, but must be active businesses. Investment property will not qualify. If special use valuation has been elected by the estate (see chapter 12), that value is used for purposes of determining whether the 35-percent test has been met.

Mortgage effects—Insofar as the eligibility of a business ownership interest as a percentage of the decedent’s adjusted gross estate is concerned, mortgages secured by real property used in the business must be deducted. Eligibility is measured in terms of the net value of the property in question and whether that value meets the 35-percent threshold requirement. Private Letter Ruling 8515010 (January 8, 1985) discusses the effect of a mortgage that encumbers both property used in the closely held business and other property. The IRS here ruled that the gross value of the decedent’s closely held timber growing business had to be reduced by that portion of the outstanding mortgage attributable to it for purposes of valuation under the section 6166 installment provisions. The mortgage in question encumbered both timberland and pasture. The rental of the pasture by the decedent was determined to be a passive activity, not the conduct of an active business. The
timberland was held to be an active business, however, and an allocation of the mortgage between it and the pasture on the basis of acreage was therefore necessary.

**Combining interests**—Interests in two or more closely held businesses may be combined for purposes of meeting the 35-percent test if more than 20 percent of the value of each is included in the gross estate. The value of a surviving spouse’s interest in property held as tenancy in common, tenancy by the entirety, joint tenancy, or community property will be counted in determining whether more than 20 percent of the business was owned by the decedent.

**Interest Payable on Deferred Tax**

Interest on deferred tax is payable at a special 2-percent rate, compounded daily, on the portion attributable to the first $1 million of taxable value (the first $1 million in excess of the effective exclusion amount provided by the unified credit) of the closely held business. Since 1999, the first $1 million has been indexed for inflation. The taxable value in 2008 subject to the 2-percent interest rate is $1,280,000. That means that for 2008, the maximum amount of tax eligible for the 2-percent rate is $576,000 ($1,356,800 tentative tax on $3,280,000, less the applicable unified credit of $780,800). On the excess, the rate is 45 percent of the rate charged by the IRS for late tax payments. The interest paid is not deductible for either income or estate tax purposes.

**Making the Election**

The section 6166 election must be made on a timely filed estate tax return containing the following information: (1) the decedent’s name and taxpayer identification number; (2) the amount of the tax to be paid in installments; (3) the date elected for payment of the first installment; (4) the number of annual installments, including the first installment, in which the tax is to be paid; (5) the properties shown on the estate tax return that constitute the closely held business interest; and (6) the facts supporting the conclusion that the estate qualifies for the deferral and installment election.

**Subsequent deficiencies**—If the election is made at the time the estate tax return is filed, it will also cover subsequent estate tax deficiencies determined by the IRS that are attributable to the closely held business. This is in addition to the estate tax originally due with the return as filed.

**Protective election**—If it is uncertain at the time of filing the return whether the estate qualifies for the election, a protective election can be made. It will allow subsequent deferral of any portion of the tax attributable to the closely held business that is shown on the return, or deferral of deficiencies remaining unpaid at the time values are finally determined. The protective election must be made on a timely filed return. A final election notice then must be filed within 60 days after it has been determined that the estate qualifies for the election [Treasury Regulation 20.6166-1(d)].

**Another alternative**—Even if a regular or protective election was not filed, the executor of an estate can obtain a general extension of time for payment of the estate tax for a period not to exceed 12 months from the date fixed for payment of the tax, if it can be shown that “reasonable cause” exists for granting the extension [IRC section 6161(a)]. An additional discretionary extension of time to pay also may be allowed for reasonable cause; the time for payment under such an extension may be deferred for a period not to exceed 10 years [IRC section 6161(a) (2)]. Reasonable cause [Treasury Regulation 20.6161-1(a) (1) and Instructions for IRS Form 4768 (Revised January 2007), Part III, p. 3] will exist under any of the following circumstances: (1) the estate consists largely of a closely held business or farm and does not have sufficient funds to pay the tax on time; (2) the estate is unable to gather sufficient liquid assets because of legal difficulties; (3) the assets consist of annuities, royalties, contingent fees, or accounts receivable that are not collectible by the due date; (4) litigation is required to collect assets in the decedent’s estate; (5) the estate must sell assets to pay the tax at a sacrifice price or in a depressed market; (6) the estate does not—without borrowing at a rate of interest higher than that generally available—have sufficient funds to pay the entire tax and at the same time also provide for the surviving spouse’s and children’s allowances and outstanding claims against the estate; or (7) the estate’s liquid assets are located in several jurisdictions and are not immediately subject to the executor’s control.

**Acceleration of Unpaid Taxes**

Deferred tax payments are accelerated if more than one-half of the value of the qualified business interest(s) is withdrawn or disposed of during the deferral period. See below for a discussion of what constitutes a withdrawal or disposal. The same rule applies if funds or assets are withdrawn that represent 50 percent or more of such value. For this purpose, values are measured as of the date of the withdrawal(s), not the date of death.

**Death of original heir**—The transfer of the decedent’s interest upon the death of the original heir, or upon the death of any subsequent transferee who has received the interest as a result of the prior transferor’s death, will not cause acceleration of taxes if each subsequent transferee is a member of the transferor’s family. IRC section 267(c)(4) defines family members as brothers and sisters (whole or half blood), spouses, ancestors, and lineal descendants.
**Delinquent payments**—A delinquent payment of either interest or tax will accelerate the due date of the unpaid tax balance if the full delinquent amount is not paid within six months of its original due date. The late payment, however, will not be eligible for the special 2-percent interest rate. Additionally, a penalty of 5 percent per month of the amount of the payment will be imposed.

**Liability for Payment of the Tax**

With a section 6166 election, the estate representative basically is liable for payment of the tax. However, an executor or administrator seeking discharge of liability may file an agreement that gives rise to a special estate tax lien. The lien is against “real and other property” expected to survive the deferral period. The maximum amount subject to the lien is the amount of deferred tax, plus the first 4 years of interest. All parties having an interest in the property to which the lien is to attach must sign an agreement to its creation.

Once filed, the lien is a priority claim against the property, with some exceptions: (1) real property tax and special assessment liens; (2) mechanics’ liens for repair or improvement of real property; (3) real estate construction or improvement financing agreements; and (4) financing for the raising or harvesting of a farm crop, or for the raising of livestock or other animals.

**What Constitutes a Closely Held Business Interest?**

**Sole proprietorship**—A sole proprietorship (see chapter 14) may qualify as a closely held business. Assets, including cash, must actually be involved in the trade or business of the sole proprietorship before their value can be included. Passive assets held by a sole proprietorship are not considered in determining value.

**Partnership**—If certain rules are met, a partnership interest (see chapter 15) may qualify. Either 20 percent or more of the partnership’s total capital interest at the time of the decedent’s death must be included in the decedent’s gross estate or the total number of partners must not exceed 45. Inclusion of the value of passive assets held by a partnership is disallowed for purposes of the 35-percent test. Partnership interests held by members of a decedent’s family (as defined above) are treated as if owned by the decedent for purposes of the 35-percent test. A husband and wife are considered as one partner if the property is held as community property, tenancy in common, joint tenancy, or tenancy by the entirety (see chapter 14).

**Corporation**—A corporate interest (see chapter 16) also may qualify as an interest in a closely held businesses. For a corporate interest to qualify, however, 20 percent or more of the corporate voting stock must be included in the decedent’s gross estate or the total number of shareholders must not exceed 45. Only stock constitutes an interest in a corporate closely held business; corporate debt securities are not interests. It is not necessary that the shareholder decedent have been personally involved in the business in order for his (her) stock ownership to qualify under section 6166. As with a partnership, corporate interests held by a decedent’s family, as defined above, are treated as if owned by the decedent for purposes of the 35-percent test. A husband and wife are treated as one shareholder if the stock is held as community property, tenancy in common, joint tenancy, or tenancy by the entirety.

**Special attribution election**—A special attribution-of-ownership rule applies if the executor of the estate so elects. This rule provides that all non-readily tradable stock and all partnership capital interests of a decedent and the decedent’s family will be considered owned by the decedent for purposes of determining whether 20 percent of the corporation or partnership is includible in the decedent’s gross estate [IRC section 6166(b)]. Family members whose interests will be considered as held by the decedent are the same as defined above.

If the benefits of this rule are elected, the estate is deemed to have elected to pay the tax attributable to the business interest in 10 installments beginning on the due date for payment of the decedent’s estate tax; there is no deferral period. Additionally, the special interest rate applied under the regular deferral and installment election is not available [IRC section 6166(b)(7)(A)(iii)].

It should be noted that the stock or partnership interests attributed to a decedent under this rule are attributed only for the purposes of the 20-percent requirements. Thus, the value of the attributed stock or partnership interest is not included in the decedent’s gross estate for purposes of the 35-percent rule.

**Trusts**—The IRC installment payment provisions and IRS regulations do not refer specifically to trust ownership of an interest in a closely held business. The IRS, however, does recognize business interests in trust as qualifying under section 6166. For example, in Private Letter Ruling 9015003 (December 22, 1989) and supplementing Private Letter Ruling 9001062 (October 13, 1989), the IRS concluded that a decedent’s one-third interest in a timber business held in trust qualified as an interest in an active, closely held business for section 6166 purposes. The property was under active forest management, with daily operations and timber sales carried out by an independent forest management company. The decedent, individually and through her agents, participated in the decision-making process in running
the business. She and other grantors met annually with the trustee and a representative of the forest management company to review the prior year’s forest management activities, to discuss plans for the coming year, and to make long-term plans. The decedent also shared equally with the other grantors the income from and the expenses of the business, and thus also shared in the risks involved. For purposes of IRC section 6166(a), activities of an agent may be attributed to a decedent. In this case, the trustee was the decedent’s agent.

Conservation reserve program enrollment—The IRS has ruled that land entered into the Federal Conservation Reserve Program (CRP) was part of the decedent’s farming business in determining whether the executor could elect deferral of estate tax under section 6166 (Private Letter Ruling 9212001, June 20, 1991). Although the decedent was engaged in the business of farming and cattle raising on other lands that she owned, she never had used the CRP land for commercial purposes—having purchased it after it already had been entered into the CRP. The IRS determined that participation in programs such as CRP does not disqualify the lands in question from section 6166 eligibility.

What Constitutes Withdrawal or Disposition?

Changes in organizational form do not terminate the installment payment right if they do not materially affect the business. Thus, incorporation of a sole proprietorship, a shift from sole proprietorship status to partnership, liquidation of a corporation, and transfer of a sole proprietorship to a limited partnership all have been held not to accelerate payment. Incorporation of a sole proprietorship with issuance of corporate debentures, however, is a disposition as to the debt securities issued. An installment sale of property also will terminate section 6166 status if the 50-percent limit is reached.

Converting cropland for which a section 6166 election is in force to grass or tree cover under CRP is not a withdrawal or disposition (Private Letter Ruling 9212001, June 20, 1991). The tax attributable to the property will continue to be eligible for deferral and payment in installments.

Like-kind exchange—The transfer of assets in a tax-free exchange does not accelerate payment of tax that has been deferred. In Private Letter Ruling 8722075 (March 3, 1987), the IRS ruled that an estate’s partition of an undivided interest in forest land, followed by a like-kind exchange, did not affect the section 6166 election that was in force. Although more than 50 percent of the property may have been transferred—depending on whose values were accepted—the exchange did not materially alter the timber business or the estate’s interest in the timber business. The partition and exchange was, therefore, not a disposition for acceleration purposes.

Private letter ruling 8437043 (June 8, 1984)—The IRS, here, held that a proposed sale of timber comprising 51 percent of the closely held business interests and a proposed 29-year lease of the land (comprising 35 percent of the closely held business interests) to a forest products company would constitute a disposition under IRC section 6166(g)(1) (A). The estate, according to the ruling, would be liquidating its active business enterprise of timber production in exchange for an arrangement in which it would merely hold the land as an investment asset from which income would be derived solely on the basis of ownership.

Planning Opportunities

Because the value of the closely held business must exceed 35 percent of the adjusted gross estate, forest landowners seeking to qualify under section 6166 should be familiar with the various elements that constitute the adjusted gross estate. If the value of the tree farm is very close to 35 percent, consideration should be given to increasing its value or decreasing the adjusted gross estate during the decedent’s lifetime. The types of expenses which may be deducted in order to reduce the adjusted gross estate are discussed in chapter 3.

Great care should be taken in deciding whether to make gifts of non-qualifying assets in order to qualify for section 6166 treatment. Gifts of such assets made within 3 years of death that normally would not be included in the gross estate will be considered in determining whether the 35-percent test is met. This provision was specifically designed to prevent deathbed transfers for the purpose of section 6166 qualification.

Special use valuation (see chapter 12) also should be carefully evaluated. While its use will decrease estate tax liability, it may preclude qualifying for installment treatment by lowering the qualified property’s value below 35 percent of that of the adjusted gross estate. Under these circumstances, if only one or the other can be elected, the value of deferring the estate tax payments should be compared to the value of the estate tax reduction.