

December 1986

Liquidity Problems of Owners of Closely Held Corporations: Relief Provided by Sections 303 and 6166

J. Howard Sheffield

Follow this and additional works at: <https://scholarship.law.ufl.edu/flr>



Part of the [Law Commons](#)

Recommended Citation

J. Howard Sheffield, *Liquidity Problems of Owners of Closely Held Corporations: Relief Provided by Sections 303 and 6166*, 38 Fla. L. Rev. 787 (1986).

Available at: <https://scholarship.law.ufl.edu/flr/vol38/iss5/4>

This Article is brought to you for free and open access by UF Law Scholarship Repository. It has been accepted for inclusion in Florida Law Review by an authorized editor of UF Law Scholarship Repository. For more information, please contact kaleita@law.ufl.edu.

LIQUIDITY PROBLEMS OF OWNERS OF CLOSELY
HELD CORPORATIONS: RELIEF PROVIDED BY
SECTIONS 303 AND 6166

J. HOWARD SHEFFIELD*

I. INTRODUCTION.....	787
II. SECTION 303 STOCK REDEMPTIONS	789
A. <i>In General</i>	789
B. <i>Percentage Limitations</i>	790
C. <i>Amount Redeemable</i>	791
D. <i>Qualifying Transactions</i>	792
E. <i>Time Limitations</i>	794
III. SECTION 6166 ESTATE TAX DEFERRAL.....	794
A. <i>In General</i>	794
B. <i>Closely Held Business</i>	796
C. <i>Qualification Under Section 6166</i>	798
D. <i>Installment Payments Under Section 6166</i>	799
E. <i>Special Lien Under Section 6324A</i>	799
F. <i>Acceleration of Payment</i>	800
IV. COORDINATION OF SECTION 6166 WITH SECTION 303.....	802
A. <i>In General</i>	802
B. <i>Effect of Section 303 Redemptions on Section 6166</i>	803
V. PLANNING CONSIDERATIONS	805
A. <i>Valuation</i>	805
B. <i>The Estate</i>	807
C. <i>The Corporation</i>	807
D. <i>Inter Vivos Planning</i>	808
VI. CONCLUSION	809

I. INTRODUCTION**

The estate of a deceased stockholder of a closely held corporation may face unique problems during administration. Often the principal estate asset is shares of stock in the corporation. The estate may lack other liquid assets to meet

* Attorney, Newton & Morehead, Jacksonville, Florida. B.S., 1982, Florida State University; J.D., 1985, Cumberland School of Law of Samford University; LL.M. (Taxation), 1986, University of Florida. This paper was prepared as part of the requirements of the University of Florida Graduate Tax Program.

** Unless otherwise provided, all Code references herein are to the Internal Revenue Code of 1954, as amended.

substantial federal estate taxes, state death taxes, and funeral and administrative expenses incurred. To generate cash to pay these taxes and expenses, the estate may be forced to dispose of stock. Often there is no readily available market to sell the stock in a closely held corporation.¹ The personal representative may have to sell at a depressed price to create liquidity. Consequently, the corporation frequently purchases the stock. General tax law principles may, however, result in detrimental income tax effects. The possibility that distributions of property by a corporation in redemption of its stock would be treated as a dividend² prompted Congress to provide partial relief from adverse dividend treatment in 1950.³ Such relief was codified in section 303 of the Internal Revenue Code (the Code).

Section 303 eases the income tax problems of a closely held corporation when funds are withdrawn to pay the deceased shareholder's death taxes and administration expenses. This paper focuses on section 303 and the estate tax deferral provisions provided by Congress.⁴ Section 6166 allows installment pay-

1. Kurzman, *Estate Planning Considerations on the Organization of Business: Proprietorships, Partnerships, Corporations*, N.Y.U. 34TH INST. ON FED. TAX'N 1433, 1455 (1976).

2. Int. Rev. Code of 1939, ch. 1, § 115(9), 53 Stat. 48 (now I.R.C. § 302(4) (West 1986)). Under the Internal Revenue Code, a distribution of property by a corporation is includable in a shareholder's gross income to the extent it is a "dividend." I.R.C. § 301(c)(1) (West 1986). The Code defines "dividend" as a distribution by a corporation to its shareholders (1) out of earnings and profits accumulated after February 28, 1913, or (2) out of earnings and profits of the taxable year. I.R.C. § 316(a) (1982). Redemptions occur when a corporation acquires its stock from a shareholder in exchange for property. I.R.C. § 317(b) (West 1986).

A redemption constitutes an "exchange," and not a dividend, if it satisfies one of four conditions of § 302(b). I.R.C. § 302(a) (West 1986). First, a redemption qualifies as an exchange if it is "not essentially equivalent to a dividend." I.R.C. § 302(b)(1) (West 1986); *see also* United States v. Davis, 397 U.S. 301, 313 (1970) ("a redemption must result in a meaningful reduction in the shareholder's proportionate interest in the corporation"). Second, § 302(b) is satisfied if a redemption is "substantially disproportionate" with respect to the shareholder. I.R.C. § 302(b)(2) (West 1986). To qualify as "substantially disproportionate," the redemption must satisfy three tests; immediately after redemption, the shareholder must own less than (a) 50% of the combined voting power of all classes of stock (indicating a loss of control by the family), (b) 80% of the voting stock the shareholder owned immediately before redemption, and (c) 80% of the common stock that the shareholder owned immediately before redemption. I.R.C. § 302(b)(2)(B), (C) (West 1986). Third, exchange treatment is accorded a redemption of all the shareholder's stock. I.R.C. § 302(b)(3) (West 1986). Finally, a redemption will qualify if it is a redemption from a noncorporate shareholder in partial liquidation of the distributing corporation. I.R.C. § 302(b)(4) (West 1986). Termination of a qualified trade or business constitutes a "partial liquidation." I.R.C. § 302(e)(2) (West 1986); *see also* Imler v. Commissioner, 11 T.C. 836 (1948) (bona fide contraction of business operations as a result of casualty losses exempted redemption from dividend treatment).

Family-owned corporations frequently fail to meet the requirements of § 302(b) because of attribution rules. *See* I.R.C. §§ 302(e)(1), 318 (West 1986); Cavitch, *Problems Arising from the Attribution Rules*, N.Y.U. 35TH INST. ON FED. TAX'N 801, 822 (1977). *But see id.* at 822-35.

3. Rev. Act of 1950, ch. 994, § 209(a), 64 Stat. 932 (amending Int. Rev. Code of 1939, ch. 1, § 115(g), 53 Stat. 47). This law exempted the proceeds of a stock redemption from being taxed as a dividend only if the value of the stock included in the decedent's estate comprised more than 50% of the value of the net estate. The ceiling for this exemption was an amount equal to the total amount of estate, inheritance, legacy or succession taxes. *Id.*

4. I.R.C. §§ 6161, 6166 (West 1986).

ment of estate taxes to reduce the immediate tax burden. This deferral prevents forced liquidation and allows the closely held business to continue operation.⁵

This paper first discusses section 303. Operation of section 6166 and the coordination of sections 6166 and 303 are then examined. Valuation problems of closely held corporation stock are also addressed. Finally, the paper explores lifetime and post-mortem planning opportunities.

II. SECTION 303 STOCK REDEMPTIONS

A. *In General*

In 1950, Congress amended section 115(G) of the 1939 Code (the forerunner to section 303 of the 1954 Code) to provide that corporate distributions in redemption of stock would be treated as a sale of the stock if certain conditions were met.⁶ The House Committee on Ways and Means stated the amendment's purpose as follows:

It has been brought to the attention of your committee that the problem of financing the estate tax is acute in the case of estates consisting largely of shares in a family corporation. The market for such shares is usually very limited, and it is frequently difficult, if not impossible, to dispose of a minority interest. If, therefore, the estate tax cannot be financed through the sale of the other assets in the estate, the executors will be forced to dispose of the family business. In many cases the result will be the absorption of a family enterprise by larger competitors, thus tending to accentuate the degree of concentration of industry in this country.⁷

Section 303 currently permits redemptions of a shareholder's stock up to an amount needed to pay the deceased shareholder's estate taxes and funeral and administration expenses.⁸ The distribution escapes taxation as a dividend under section 301⁹ because the distribution is treated as made in full payment in exchange for the stock redeemed.¹⁰ In general, the estate recognizes little or no gain on the redemption because the estate's basis in the stock equals the stock's fair market value on the date of the decedent's death or on the alternate valuation date.¹¹ If the stock has increased in value between the date of death and the date of redemption, the gain is normally treated as long-term capital gain.¹²

5. See H.R. REP. No. 1380, 94th Cong., 2d Sess. 28-36 (1976).

6. See *supra* note 2 and accompanying text.

7. H.R. REP. No. 2319, 81st Cong., 2d Sess. (1950), 1950-2 C.B. 380, 427.

8. I.R.C. § 303(a) (1982).

9. See *supra* note 2.

10. I.R.C. § 303(a) (1982).

11. I.R.C. § 1014(a) (West 1986).

12. See I.R.C. §§ 1221, 1223(11), 1222(3) (West 1986). The Tax Reform Act of 1986 repeals the capital gains deduction of § 1202 for taxable years beginning after December 31, 1986. H.R. 3838, 99th Cong., 2d Sess. § 301(a), (c), 132 CONG. REC. H7389 (daily ed. Sept. 18, 1986). The maximum rate on long-term capital gains for 1987 and thereafter is 28%. *Id.* § 302(a), 132 CONG. REC. at H7389-90.

B. Percentage Limitations

Stock included in a decedent's gross estate qualifies for redemption under section 303 only if its value for federal estate tax purposes exceeds thirty-five percent of the value of the decedent's gross estate, reduced by amounts deductible under sections 2053 and 2054.¹³ Since the thirty-five percent requirement applies to the gross estate less "allowable" (rather than allowed) deductions under sections 2053 and 2054, the personal representative must analyze the estate's income tax return. The personal representative may waive the sections 2053 and 2054 deductions in computing the taxable estate of a decedent. If so, the expenses may be deducted in computing taxable income of the estate.¹⁴ This allows an estate to take such deductions on its fiduciary income tax returns without jeopardizing its ability to qualify for section 303 treatment.

The proposed regulation states the amount of allowable section 2053 and section 2054 deductions shall be determined on the basis of facts and circumstances in existence on the date (including extensions) for filing the estate tax return.¹⁵ An item may constitute an allowable deduction although its exact amount is not known, provided an amount is ascertainable with reasonable certainty and the item will be paid.¹⁶ The proposed regulation concludes that interest payments on estate taxes deferred under section 6166 will not qualify as an allowable section 2053 expense because such payments could not be properly claimed as a deduction when the original estate tax return was due.¹⁷ If an estate is close to meeting the thirty-five percent test of section 303, it may be beneficial to obtain as many extensions of the estate tax due date as possible. Any deductions becoming ascertainable with reasonable certainty by

13. I.R.C. § 303(b)(2)(A) (1982). Deductions allowable under §§ 2053 and 2054 include funeral and administration expenses, claims against the estate, debts, and casualty losses. I.R.C. §§ 2053(a), 2054 (West 1986).

14. I.R.C. § 642(g) (West 1986); see Prop. Reg. 1.303-1(a)(5), reprinted in II FED. TAXES (P-H) ¶ 70,463 (1987) (determination of "allowable" §§ 2053 and 2054 deductions made without regard to deductions claimed on federal estate tax return).

15. Prop. Reg. § 1.303(a)(5), reprinted in II FED. TAXES (P-H) ¶ 70,463 (1987). Before the Tax Reform Act of 1976, the percentage threshold for § 303 qualification was either 35% of the decedent's gross estate or 50% of the decedent's taxable estate. See 49 Fed. Reg. 33,277 (1984) (Supplementary Information). Both computations were based on the estate tax return, thus only allowed deductions under §§ 2053 and 2054 were relevant. Current regulations do not reflect changes made in 1976 and 1981. *Id.*

16. Prop. Reg. § 1.303-1(a)(5), reprinted in II FED. TAXES (P-H) 70,463 (1987).

17. *Id.* In 1977, the Tax Court held interest paid on deferred tax constitutes an expense of administering the estate and is deductible from the gross estate under § 2053. *Estate of Bahr v. Commissioner*, 68 T.C. 74, 83 (1977). *But see* *Estate of Bailly v. Commissioner*, 81 T.C. 246, 251 (1983) (estimated amount of interest to be accrued over § 6166 deferral period not deductible on initial federal estate tax return; distinguishing *Estate of Bahr*).

After 1986, the Tax Reform Act of 1986 will not disallow deductions for interest paid because of an extension under § 6166. The interest is excepted from the definition of non-deductible personal interest. H.R. 3838, 99th Cong., 2d Sess. § 511(b), 132 CONG. REC. H7397-98 (daily ed. Sept. 18, 1986).

the end of the extension period will be allowable, and the estate may then meet the thirty-five percent test.

When stock of two or more corporations is included in the gross estate, the value of all shares owned can be combined in determining whether the thirty-five percent test is met. This applies, however, only if twenty percent or more of the value of the outstanding stock of each such corporation is included in the gross estate.¹⁸ For purposes of the twenty percent test, the surviving spouse's interest in stock held by the decedent and the surviving spouse as community property, joint tenants, tenants by the entirety, or tenants in common is considered to be included in the decedent's gross estate.¹⁹

To determine whether the twenty and thirty-five percent requirements of section 303(b), properties gratuitously transferred by a decedent within three years of death are included in his gross estate.²⁰ Thus, if the gift is an asset other than stock, the value of the estate will be increased and the thirty-five percent test will be more difficult to achieve. If closely held stock is pulled back into the gross estate it will become easier to meet the thirty-five percent test. This stock could only be used for purposes of meeting the percentage qualification test and would not qualify for a section 303 redemption unless the value of the stock is included in the gross estate under subsections 2035(a) and (d)(2).²¹

C. Amount Redeemable

The maximum amount of corporate distributions qualifying for exchange treatment under section 303 equals the sum of federal and state death taxes (including any interest collected as part of such taxes) and funeral and administration expenses allowable under section 2053.²² Proposed regulations state the term "taxes" includes additional recapture tax imposed under section 2032A²³ and interest on the recapture tax payable under section 1016(c).²⁴

18. I.R.C. § 303(b)(2)(B) (1982); see Prop. Reg. § 1.303-1(a)(2), reprinted in II FED. TAXES (P-H) ¶ 70,463 (1987).

19. *Id.* But see Rev. Rul. 61-91, 1961-1 C.B. 714 (community interest of surviving spouse not combined with deceased spouse's interest for purposes of § 6166 percentage threshold tests).

20. I.R.C. § 2035(d)(3)(A) (West 1986).

21. Prop. Reg. § 301-1(a)(3), reprinted in II FED. TAXES (P-H) ¶ 70,463 (1987). Under § 2035, stock given away within three years of death and which would otherwise be included in the decedent's gross estate under § 2036, 2037, 2038 or 2042 is included in the gross estate. I.R.C. § 2035(d)(2) (West 1986). This stock qualifies for § 303 treatment.

22. I.R.C. § 303(a) (1982); see Treas. Reg. § 1.303-2(g)(1) (West 1986).

23. Prop. Reg. § 1.303-1(a)(1), reprinted in II FED. TAXES (P-H) ¶ 70,463 (1987). An additional tax on property valued under § 2032A current use value, instead of fair market value, is imposed if property is disposed of within ten years of the date of the decedent's death. I.R.C. § 2032A(c)(1)(A) (West 1986). An additional tax is also imposed if the qualified heir ceases to use the property for a qualified use or ceases to materially participate in the use of the property. I.R.C. § 2032(c)(1)(B) (West 1986).

24. Prop. Reg. § 1.303-1(a)(1), reprinted in II FED. TAXES (P-H) ¶ 70,463 (1987); see I.R.C. § 1016(c)(5)(B) (West 1986).

The proposed regulations also state "additions to the tax, additional amounts, and penalties under chapter 68 of the Code will not be treated as part of the tax for purposes of section 303(a)(1)."²⁵ However, section 6662(a)(2) says any reference in the Code to "tax" shall be deemed to refer to additions to the tax, additional amounts, and penalties provided in chapter 68.²⁶ Under section 6660, an addition to the tax is imposed for underpayments of estate taxes attributable to a valuation understatement, which is defined as a valuation claimed on an estate tax return 66 2/3 percent or less than the amount determined to be the correct value.²⁷ This becomes an important issue if the Internal Revenue Service (the Service) increases the estate tax valuation of stock after a section 303 redemption.

Stock subject to the generation-skipping transfer, occurring at the same time as and as a result of the death of an individual, within the meaning of section 2611(a),²⁸ may qualify for redemption under section 303.²⁹ The purpose of section 303(d) is to provide liquidity for the generation-skipping transfer, since the person primarily responsible for the payment of the tax may find it necessary to sell stock of a closely held corporation in order to meet the tax liability.³⁰

D. Qualifying Transactions

To qualify for exchange treatment under section 303 there must be a "redemption."³¹ A redemption is an acquisition of stock by a corporation for money, securities and any other property other than stock in the redeeming corporation.³² Any stock included in determining the decedent's gross estate can be redeemed without regard to the class of stock.³³ If it is exchanged for new stock, the basis of which is determined by reference to the basis of the old stock, the redemption of the new stock will be treated the same under section 303 as the redemption of the old stock would have been.³⁴ This substitute basis provision applies to a section 368 reorganization, a spin-off under section 355, a section 1036 exchange, or a stock distribution under section 305(a).³⁵ A redemption of stock will qualify under section 303 even if the stock redeemed is "section 306 stock" and, to the extent that conditions of section 303 are met,

25. Prop. Reg. § 1.303-1(g), *reprinted in* II FED. TAXES (P-H) ¶ 70,463 (1987).

26. I.R.C. § 6662(a)(2) (West 1986).

27. *Id.* § 6660(a)(c).

28. *Id.* § 2611(a).

29. *Id.* § 303(d) (1982). *See generally id.* §§ 2601-2663 (tax on certain generation-skipping transfers).

30. *See* H.R. REP. No. 94-1515, 94th Cong., 2d Sess. 616 (1976).

31. I.R.C. § 303(a) (West 1986).

32. *See id.* § 317 (1982).

33. Treas. Reg. § 1.303-2(c)(1) (West 1986).

34. *Id.* § 1.303-2(d); *see* I.R.C. § 303(c) (1982); Prop. Reg. § 1.303-1(f), *reprinted in* II FED. TAXES (P-H) ¶ 70,463 (1987).

35. Treas. Reg. § 1.303-2(d) (West 1986); Prop. Reg. § 1.303-1(f), *reprinted in* II FED. TAXES (P-H) ¶ 70,463 (1987).

the redemption will not be treated as a dividend.³⁶ This enables a corporation to issue non-voting preferred stock post-death as a tax-free dividend. The estate can use this section 306 stock for a section 303 redemption without being doused with ordinary income or losing voting control of the corporation.

Section 303(b)(3) requires that the interest of the redeeming shareholder be reduced directly (or indirectly through a binding obligation to contribute) by any payment of death taxes or funeral and administration expenses.³⁷ This requirement is designed to allow preferential section 303 treatment only to redemptions directly related to legitimate liquidity needs of the estate.³⁸ Section 303 is not available if the decedent's stock is devised to a specific beneficiary and the will provides that estate taxes and expenses shall be paid out of the residue. Section 303 qualification is lost if property passes from the decedent to the surviving spouse, or to a trust for the spouse's benefit, if the marital share does not bear the burden of taxes and expenses.³⁹ However, if the will requires the personal representative to pay taxes and expenses, it is possible for a redemption from the personal representative to qualify for section 303 treatment. Proceeds can be distributed to the surviving spouse or to a marital trust.⁴⁰ If the personal representative is not required to pay taxes or expenses but has discretion to determine who receives the stock, then a redemption from the personal representative will qualify for section 303 treatment to the extent payment of taxes or expenses reduces the liability of the ultimate taker of the proceeds of the redemption.⁴¹

Section 303 treatment is available for stock included in the decedent's gross estate and passed to any person by reason of the decedent's death. This includes an heir, legatee, or donee of the decedent; a surviving joint tenant, surviving spouse, appointee, or taker in default of appointment; or a trustee of a trust created by the decedent.⁴² However, the regulations take the position that section 303 does not apply to redemptions of stock from persons who acquired the decedent's stock by gift or purchase from any person to whom such stock has

36. Treas. Reg. § 1.303-2(d) (West 1986); Prop. Reg. § 1.303-1(f), *reprinted in II FED. TAXES (P-H) ¶ 70,463 (1987)*. See generally Rev. Rul. 82-72, 1982-1 C.B. 57, 58, *modifying* Rev. Rul. 74-266, 1974-1 C.B. 73. Section 306 stock is generally preferred stock received as a nontaxable stock dividend under § 305(a) or in a nontaxable corporate reorganization or separation. I.R.C. § 306(c)(1)(A), (B) (West 1986). Section 306 taints stock so received and on its subsequent sale, any gain recognized will be taxed as ordinary income. *Id.* § 306(a)(1)(A), (a)(2). Death removes the § 306 taint because the stock's basis in the hands of the estate or beneficiary is determined under § 1014, rather than by reference to the decedent's basis in the stock. Treas. Reg. § 1.306-3(e) (West 1986).

37. I.R.C. § 303(b)(3) (1982).

38. See H.R. REP. No. 1380, 94th Cong., 2d Sess. 35 (1976).

39. See Prop. Reg. § 1.303-1(d)(4) example 4, *reprinted in II FED. TAXES (P-H) ¶ 70,463 (1987)*.

40. Prop. Reg. § 1.303-1(d)(2), *reprinted in II FED. TAXES (P-H) 70,463 (1987)*.

41. *Id.*; see Prop. Reg. § 1.303-1(d)(4) examples 1 & 2, *reprinted in II FED. TAXES (P-H) ¶ 70,463 (1987)*.

42. Treas. Reg. § 1.303-2(f) (West 1986); Prop. Reg. 1.303-1(d)(1).

passed from the decedent.⁴³ The regulations also state section 303 does not apply to redemptions of stock from shareholders who received the stock in satisfaction of specific monetary bequests, because they are deemed to have acquired the stock by purchase rather than by bequest.⁴⁴

E. *Time Limitations*

Distributions in redemption of stock under section 303 must be made within three years and ninety days after the federal estate tax return is due.⁴⁵ If the estate tax return was filed before its due date, the due date rather than the earlier filing date will control for section 303 purposes.⁴⁶ Since an estate tax return is due within nine months of the decedent's death,⁴⁷ the corporation has approximately four years to make a section 303 distribution. A deficiency determination filed with the Tax Court tolls the statute and section 303 redemption can be made within sixty days after the decision of the court becomes final.⁴⁸ If an election has been made to pay estate taxes on a deferred basis, under section 6166, the redemption can take place at any time within the deferral period.⁴⁹

III. SECTION 6166 ESTATE TAX DEFERRAL

A. *In General*

The estate tax is due nine months after the decedent's death.⁵⁰ The Service has discretionary authority under section 6166(a) to grant an extension for payment for a reasonable time not to exceed twelve months.⁵¹ However, the regulations require a finding of "reasonable cause" based on the facts and circumstances.⁵² If an extension is granted, it may enable the corporation to

43. Treas. Reg. § 1.303-2(f) (West 1986).

44. *Id.* In *Lake v. United States*, 68-1 U.S. TAX CAS. (CCH) ¶ 9305 (E.D. Tex. 1968) the regulation was held invalid. On appeal, the Fifth Circuit held the regulation did not apply under the facts of the case, and did not rule on the regulation's validity. *United States v. Lake*, 406 F.2d 941, 950 (5th Cir. 1969).

45. I.R.C. § 303(b)(1)(A) (1982); *see id.* § 6501(a) (West 1986). Section 303(b)(1)(A) states that redemption must occur within 90 days after the time period provided in § 6501(a), three years after the filing of the estate tax return.

46. Rev. Rul. 69-47, 1969-1 C.B. 94.

47. I.R.C. § 6075(a) (1982).

48. *Id.* § 303(b)(1)(B).

49. *Id.* § 303(b)(1)(C).

50. *Id.* § 6151. Payment is due when the estate tax return is required to be filed, without regard to extensions for the time of filing the return. The estate tax return is due nine months after the decedent's death. *Id.* § 6075.

51. *Id.* § 6161(a1).

52. Treas. Reg. § 20.6161-1(a)(1) (West 1986). Examples of reasonable cause are (1) delay in marshalling assets located in several jurisdictions; (2) substantial assets consisting of rights to receive money in the future (i.e., annuities, copyright royalties, contingent fees, or accounts re-

complete a section 303 redemption and provide the estate with cash to pay the estate tax. If the corporation does not have adequate funds to redeem a sufficient amount of stock within the first year, a longer extension would be required.

Section 6161(a)(2) authorizes the Service, for "reasonable cause," to extend the time for payment of any part of the estate tax, or any part of any installment due under section 6166, for a reasonable period not to exceed ten years from the date otherwise required for payment of the tax (or, in the case of an installment payment owed pursuant to section 6166, not beyond a date which is twelve months after the due date for the last installment).⁵³ In contrast to section 6161, when a business is the principal asset of the estate, Congress has provided in section 6166 an automatic deferral provision not subject to the discretion of the Secretary.⁵⁴ Section 6166 was originally enacted in 1958.⁵⁵ Congress' primary objective was to reverse the trend of many small businesses and farms being forced to sell their assets to larger conglomerates to generate funds to pay estate taxes.⁵⁶ The House Committee on Ways and Means expressed the following goal for section 6166:

Therefore, although not removing any [f]ederal 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 out of earnings of the business, or at least that it will provide the heirs with time to obtain funds to pay the [f]ederal 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.⁵⁷

Under section 6166, if the decedent dies after December 31, 1981, estate taxes attributable to a closely held business interest can be paid in ten installments, the first of which is due five years after the federal estate tax return is due.⁵⁸ Interest must be paid each year on the unpaid amount of the tax.⁵⁹

ceivable) which the estate cannot borrow against except on terms which would inflict loss upon the estate; (3) substantial assets which cannot be collected without litigation; or (4) lack of sufficient funds in the estate, and inability to borrow except at a rate which imposes a hardship upon the estate. Treas. Reg. § 20.6161-1(a)(1) examples 1-4.

53. I.R.C. § 6161(a)(2) (1982); see H.R. REP. NO. 1515, 94TH CONG., 2D SESS. 611 (1976) ("reasonable cause" to have same meaning as under § 6161(a)(1) of the regulations).

54. See STAFF OF JOINT COMM. ON TAX'N, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 546 (Comm. Print 1976), reprinted in 1976-3 C.B. 558 (additional relief needed for estates with liquidity problems because Service too restrictive in granting § 6161 extensions). Compare Treas. Reg. § 20.6161-1(b) (West 1986) (application for extension) with Treas. Reg. § 20.6166-1(b) (1980) (time and manner of election of extension).

55. Technical Amendments Act of 1958, Pub. L. No. 85-866, tit. II, § 206(a), 72 Stat. 1606, 1681 (1958) (renumbered § 6166A 1976, repealed 1981) (current version at I.R.C. § 6166 (West 1986)).

56. H.R. REP. NO. 2198, 85TH CONG., 1ST SESS. (1958), reprinted in 1959-2 C.B. 713.

57. *Id.*

58. I.R.C. § 6166(a)(1), (3) (West 1986). The decedent must have been a citizen or resident of the United States at the time of his death. *Id.* § 6166(a)(1).

59. *Id.* § 6166(f).

However, the rate is reduced to only four percent on taxes attributable to the first \$1,000,000 in value of the business.⁶⁰

B. *Closely Held Business*

Before an estate can qualify for deferral, the "interest in a closely held business" must be included in determining the gross estate.⁶¹ Section 6166(b)(1)(C) provides "interest in a closely held business" means stock in a corporation carrying on a trade or business if twenty percent or more in value of the voting stock of the corporation is included in determining the gross estate or the corporation had fifteen or fewer shareholders.⁶² These determinations relate to valuation and number of shareholders immediately before the decedent's death.⁶³ Consequently, the number of shareholders and the value of the voting stock held by each shareholder when forming or reorganizing a corporation must be considered. If it is not possible to meet the fifteen shareholder test, an effort should be made to acquire twenty percent of the value of voting stock to remain eligible to use section 6166.

Three attribution rules in section 6166(b)(2) impact on qualification under the fifteen shareholder or twenty percent test.⁶⁴ Under the spousal attribution rule, stock held by a husband and wife as community property, joint tenants, tenants by the entirety, or tenants in common is treated as owned by one shareholder for purposes of the fifteen shareholder test.⁶⁵ The entity attribution rule of section 6166(b)(2) provides stock owned, directly or indirectly, by or for a corporation, partnership, estate or trust is considered as owned proportionately by or for its shareholders, partners, or current beneficiaries.⁶⁶ The entity attribution rule was enacted to prevent the use of entities as shareholders to abrogate the fifteen shareholder test.⁶⁷ The family attribution rule of section 6166(b)(2)(D) attributes stock owned by the decedent's family to the decedent for purposes of the fifteen shareholder test.⁶⁸ Family includes the decedent's brothers and sisters, spouse, ancestors and lineal descendants.⁶⁹

It is possible for the entity attribution rule to attribute stock to a relative, and the family attribution rule to reattribute stock to the decedent for purposes of the fifteen shareholder test. In addition, the personal representative can elect to have any "non-readily tradable stock" treated as owned by the decedent,

60. *Id.* § 6601(j)(2). The remainder of interest is determined under floating rates of § 6621. *Id.* § 6621.

61. *Id.* § 6166(a)(1).

62. *Id.* § 6166(b)(1)(C).

63. *Id.* § 6166(b)(2)(A).

64. *Id.* § 6166(b)(2)(B), (C), (D).

65. *Id.* § 6166(b)(2)(B).

66. *Id.* § 6166(b)(2)(C).

67. STAFF OF JOINT COMM. ON TAX'N, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 548 (Comm. print 1976), reprinted in 1976-3 C.B. 560.

68. I.R.C. § 6166(b)(2)(D) (West 1986).

69. *Id.* § 267(c)(4).

because of the family attribution rule, included in determining the value of the decedent's gross estate for purposes of the twenty percent test.⁷⁰ "Non-readily tradable stock" means stock for which there was no market on a stock exchange or an over-the-counter market at the time of decedent's death.⁷¹ If a section 6166(b)(7) election is made, the special four percent interest rate and ability to defer the estate tax for five years are not available.⁷²

A holding company not carrying on a trade or business may qualify as a closely held business.⁷³ If stock owned by the holding company is in a business company (a corporation carrying on a trade or business), a look-through is allowed and the holding company stock will constitute stock of a business company.⁷⁴ But the stock of the holding company and the business company must be non-readily tradable stock⁷⁵ and the voting stock owned by the holding company must meet the twenty percent test.⁷⁶ If this treatment is elected, the special four percent interest rate and the ability to defer the estate tax for five years are not available.⁷⁷

The Service takes the position that the corporation must be engaged in an "active," as opposed to "passive," trade or business. "Section 6166 was intended to apply only with regard to a business such as a manufacturing, mercantile, or service enterprise, as distinguished from management of investment assets."⁷⁸ In Revenue Ruling 75-365, the taxpayer owned rental commercial property, rental farm property, and notes receivable.⁷⁹ A fully-equipped business office was maintained to collect rents, negotiate loans, receive note payments, and maintain records. The Service held the decedent was merely an owner, managing investment assets to obtain income ordinarily expected from them, and not engaged in a "closely held business." In a Private Letter Ruling, the Service explained that for rental property to constitute an active trade or business, the personal representative must demonstrate the decedent's employee or agent normally performed substantial personal services in managing, maintaining and leasing the property.⁸⁰

In Revenue Ruling 75-366, the decedent owned farm real estate operated with tenant farmers on a basis where the decedent paid forty percent of expenses and received forty percent of income.⁸¹ The decedent participated in manage-

70. *Id.* § 6166(b)(7)(A)(i).

71. *Id.* § 6166(b)(7)(B).

72. *Id.* § 6166(b)(7)(A)(ii), (iii).

73. The term "holding company" means any corporation holding stock in another corporation. *Id.* § 6166(b)(8)(D)(i).

74. *Id.* § 6166(b)(8)(A)(i).

75. *Id.* § 6166(b)(8)(B).

76. *Id.* § 6166(b)(8)(C).

77. *Id.* § 6166(b)(8)(A)(ii), (iii).

78. Rev. Rul. 75-365, 1975-2 C.B. 471; see Cummins, Weinberg & Roth, *The Active Business Requirement For Estate Tax Deferral: How Little Activity Qualifies?*, 59 TAXES 647, 650 (1981).

79. Rev. Rul. 75-365, 1975-2 C.B. 471.

80. Priv. Ltr. Rul. 8,134,009 (Apr. 28, 1981), IRS — LTR. RULINGS REP. (CCH) No. 235 (Sept. 3, 1981).

81. Rev. Rul. 75-366, 1975-2 C.B. 472.

ment decisions such as what crops to plant, what fields to plant or pasture, weed control, and how to use subsidy programs. Since the decedent participated in farm management, and his income was tied to farm production instead of fixed rentals, the Service ruled the decedent was involved in a trade or business.⁸²

Even if a corporation is conducting an active trade or business, the corporate assets must be looked at to determine their use. For purposes of section 6166, passive assets will not be considered in determining the value of the corporation.⁸³ Thus, the extent of a corporation's holdings of passive assets will impact on whether the corporation qualifies for section 6166, and on the amount of estate tax deferral available.

C. Qualification Under Section 6166

To qualify under section 6166, the value of the closely held business must exceed thirty-five percent of the decedent's adjusted gross estate.⁸⁴ "Adjusted gross estate" is the value of the decedent's gross estate reduced by deductions allowable under sections 2053 and 2054.⁸⁵ To determine the gross estate, section 2035 requires all gifts made within three years of death be included in determining whether the thirty-five percent requirement is met.⁸⁶ This prevents deathbed transfers which might increase the percentage of estate assets represented by closely held corporate stock.

Since "allowable deductions" reduce the gross estate, deductions taken on the estate's income tax return may still be considered in arriving at the adjusted gross estate. The amount of allowable deductions is determined by the facts and circumstances in existence on the estate tax return filing date (including extensions).⁸⁷ However, the Service has consistently taken the position that interest under section 6166 is not deductible until it accrues, and thus cannot be estimated and deducted on the first estate tax return filed.⁸⁸

Section 6166(c) allows interests in more than one closely held business to be aggregated to determine if the thirty-five percent requirement is met, as long as the decedent owned twenty percent or more of the total value of each business.⁸⁹ For purposes of this twenty percent requirement, any interest in the

82. *Id.*

83. I.R.C. § 6166(b)(9)(A) (West 1986). The term "passive assets" refers to assets not used in carrying on a trade or business, including any stock in another corporation, unless such stock is treated as held by the decedent by reason of the holding company election, or if the other corporation meets the 15 shareholder or 20% test, and 80% of the assets of both corporations are used to carry on a trade or business. *Id.* § 6166(b)(9)(B).

84. *Id.* § 6166(a)(1). For § 6166 purposes, all value determinations are the same as final determinations made for estate tax purposes. *Id.* § 6166(b)(4).

85. *Id.* § 6166(b)(6); see *supra* text accompanying note 15.

86. I.R.C. § 2035(a), (d)(4) (West 1986).

87. *Id.* § 6166(b)(6).

88. See, e.g., Rev. Rul. 84-75, 1984-1 C.B. 193; Rev. Rul. 80-250, 1980-2 C.B. 278; see also cases cited *supra* note 19.

89. I.R.C. § 6166(c) (West 1986).

business owned by the decedent's spouse will be deemed owned by the decedent if such interest was owned as community property, joint tenants, tenants by the entirety, or tenants in common.⁹⁰ The section 6166(b)(7) election, relating to use of family attribution rules for the twenty percent test, applies to section 6166(c) to permit aggregation of interests not owned by the decedent in qualifying his estate for deferral under section 6166.⁹¹

D. *Installment Payments Under Section 6166*

The maximum deferral under section 6166 is an amount bearing the same ratio to total federal estate taxes imposed as the value of the interest in the closely held business bears to the value of the adjusted gross estate.⁹² For example, a one hundred percent owned corporation with an estate tax value of \$1,000,000 and an adjusted gross estate of \$2,000,000 allows for a deferral of fifty percent of the estate tax.

The first installment of the estate tax payments can be deferred up to five years and nine months after the decedent's death.⁹³ Remaining tax is due in nine additional annual installments.⁹⁴ However, even though estate tax is deferred, interest is still due annually beginning one year after the original due date for payment.⁹⁵ One of the advantages of section 6166 is the reduced four percent interest rate.⁹⁶ For the first \$345,800 of tax deferred, reduced by the unified credit under section 2010(a), the interest rate is only four percent.⁹⁷ With a unified credit in 1986 of \$155,800, the four percent interest rate will apply to the first \$190,000 of estate tax deferred.⁹⁸ If the deferred tax exceeds \$190,000, interest on the excess will be determined under section 6621.⁹⁹ Each interest payment is allocated between the portion qualifying for the four percent rate and the part that does not.¹⁰⁰

E. *Special Lien Under Section 6324A*

When the time for paying the estate tax is extended, the district director has authority to require a bond in an amount not to exceed double the amount

90. *Id.*

91. *Id.* § 6166(b)(7); see *supra* text accompanying note 74.

92. I.R.C. § 6166(a)(2) (West 1986). Under the Tax Reform Act of 1986, any tax imposed by § 2601, because of a generation-skipping transfer, will be treated as an additional estate tax when the closely held stock is the subject of a direct skip, within the meaning of § 2612(c), occurring at the same time and as a result of the decedent's death. Int. Rev. Code of 1986 § 6166(i) (P-H 1986); see also *id.* § 2612(c) (defining "direct skip").

93. I.R.C. § 6166(a)(3) (West 1986). The first installment is due not more than five years after the date prescribed by § 6151(a) for payment of the tax. See *id.* § 6075(a) (1982) (estate tax return due within nine months after decedent's death).

94. *Id.* § 6166(a)(1) (West 1986). The executor can elect a shorter time to defer the tax, paying it in two to ten equal, annual installments. *Id.*

95. *Id.* § 6166(f)(1).

96. *Id.* § 6601(j)(1).

97. *Id.* § 6601(j)(2).

98. *Id.* § 2010(b) (1982).

99. *Id.* § 6621.

100. *Id.* § 6601(j)(3) (West 1986); Treas. Reg. § 20.6166-1(f), (i) example 3 (1980).

for which the extension was obtained.¹⁰¹ Under section 6324A the personal representative may elect to grant the Service a special lien on section 6166 lien property as security for payment of taxes deferred under section 6166.¹⁰² This lien is treated as the bond required under section 2204 necessary to discharge the personal representative from personal liability.¹⁰³ The special lien also serves in lieu of any section 6155 bond¹⁰⁴ or section 6324 lien on the same property.¹⁰⁵ However, an agreement signed by each person having an interest in the property subject to the lien must accompany the election.¹⁰⁶ The agreement must include consent to creation of the lien and designate a responsible person to deal with the Service as agent for the beneficiaries of the estate.¹⁰⁷ A problem arises if some of the beneficiaries refuse to give their required consent.

To constitute "section 6166 lien property" the designated property must be expected to survive the deferral period.¹⁰⁸ The property must be worth the amount of deferred tax and the aggregate amount of interest for the first four years of deferral.¹⁰⁹ Additional lien property may be required by the Service if at any time property covered by the agreement is valued at less than the unpaid portion of deferred taxes and interest.¹¹⁰ If proper security is not presented within ninety days after notice and demand by the Secretary, the unpaid portion of the tax will be accelerated.¹¹¹

Valuation of property falling under this lien must take into account all encumbrances, such as a lien under section 6324B.¹¹² The section 6324B lien automatically applies to all property to which section 2032A special use valuation applies.¹¹³ If section 2032A is elected, there may not be enough property left in the estate to grant a section 6324A lien.

F. Acceleration of Payment

To ensure section 6166 is used for its intended purpose, section 6166(g) identifies three rules triggering an immediate acceleration of the deferred tax under certain circumstances. The first of these acceleration rules deals with dispositions of stock of the closely held corporation and withdrawals from the

101. I.R.C. § 6165 (1982); Treas. Reg. § 20.6165-1(a) (West 1986).

102. I.R.C. § 6324A(a) (1982).

103. *Id.* § 2204(c).

104. *Id.* § 6165.

105. *Id.* § 6324A(d)(4), (6). Under § 6324, a lien attaches to property of the gross estate for ten years, unless the estate tax is paid in full or becomes unenforceable. *Id.* § 6324(a)(1).

106. *Id.* § 6324A(c).

107. *Id.* § 6324A(c)(1), (2).

108. *Id.* § 6324A(b)(1).

109. *Id.* § 6324A(b)(2); *see id.* § 6324A(e)(1), (2) (defining "deferred amount" and "required interest amount").

110. *Id.* § 6324A(d)(5).

111. *Id.*

112. *Id.* § 6324A(b)(2).

113. *Id.* § 6324B(a); *see* note 25 and accompanying text.

corporation.¹¹⁴ If such dispositions and withdrawals, in the aggregate, equal or exceed fifty percent in value of the decedent's interest in the corporation, the entire balance of unpaid estate taxes becomes payable upon notice and demand.¹¹⁵ For example, stock with an estate tax value of \$1,000,000 would result in acceleration if shares worth \$200,000 were sold and a \$300,000 dividend were distributed to the estate.

A "disposition" comprehends many possible ways by which an interest in a closely held corporation ceases to form part of the gross estate.¹¹⁶ However, the term does not extend to transactions which are mere changes in form such as a section 351 incorporation.¹¹⁷ Private Letter Rulings allow liquidations to occur pursuant to section 331 or section 333 if the closely held business remains intact.¹¹⁸ Additionally, the statute specifically allows exchanges made pursuant to a D, E or F reorganization and section 355 to occur without triggering acceleration.¹¹⁹ Under section 6166(g)(1)(D), a transfer of property to a person entitled to receive it by reason of the decedent's will, the law of intestate succession, or a trust created by the decedent will not cause acceleration.¹²⁰ Similarly, the death of a person who received the property from the decedent is exempt if the subsequent transferee is a family member.¹²¹

The second acceleration rule applies to estates with "undistributed net income."¹²² "Undistributed net income" of an estate is the excess of the distributable net income for the year over the sum of (1) distributions deductible under section 661(a), (2) the estate's federal income tax, and (3) the federal estate tax including interest paid for the taxable year.¹²³ If the estate has undistributed net income in a tax year ending on or after the due date for the first installment of principal, this amount must be used to reduce the remaining

114. I.R.C. § 6166(g)(1)(A) (West 1986).

115. *Id.* For § 6166 purposes, value is determined using the estate tax value. *Id.* § 6166(b)(4). Withdrawals from a holding company, dispositions of holding company stock, dispositions by the holding company, or withdrawals from the business company are all treated as dispositions or withdrawals. *Id.* § 6166(g)(1)(E), (F).

116. Treas. Reg. § 20.6166A-3(e)(2) (1980).

117. *Id.* Section 351 is a nonrecognition provision applying to transfers of assets to a corporation in exchange for stock or securities after which the transferors have control over the corporation. *See* I.R.C. § 351 (West 1986).

118. *See* Priv. Ltr. Rul. 8,539,018 (June 26, 1985), IRS — LTR. RULINGS REP. (CCH) No. 449 (Oct. 9, 1985) (liquidation followed by like-kind exchange does not accelerate payment of estate tax); Priv. Ltr. Rul. 8,534,073 (May 29, 1985), IRS — LTR. RULINGS REP. (CCH) No. 444 (Sept. 4, 1985) (formation of limited partnership subsequent to proposed liquidation "mere change in form" for purposes of § 6166); Priv. Ltr. Rul. 8,103,066 (Oct. 22, 1980), IRS — LTR. RULINGS REP. (CCH) No. 204 (Jan. 28, 1981); Priv. Ltr. Rul. 7,926,116 (Mar. 30, 1979), IRS — LTR. RULINGS REP. (CCH Microfiche) No. 122 (June 1979).

119. I.R.C. § 6166(g)(1)(C) (West 1986); *see id.* §§ 355, 356, 368(a)(1)(D), (E), (F).

120. *Id.* § 6166(g)(1)(D).

121. *Id.* The family of a decedent includes his brothers and sisters, his spouse, ancestors and lineal descendants. *Id.* § 267(c)(4).

122. *Id.* § 6166(g)(2).

123. *Id.* § 6166(g)(2)(B); *see id.* § 643(a) (defining "distributable net income").

balance of the deferred tax.¹²⁴ This rule reflects the policy that if the estate has liquid assets the deferral privilege is not needed. Since the first estate tax installment can be deferred for five years and nine months after death, the estate can accumulate income during that period. If, after the deferral period, the personal representative is required to pay part of the deferred tax, because of undistributed net income, payment is due no later than the due date for filing that year's income tax return.¹²⁵

The third acceleration rule applies when a personal representative fails to pay an installment when due, including payments required because of undistributed net income.¹²⁶ Any principal or interest not timely paid (including extensions) accelerates the unpaid portion of the tax upon notice and demand.¹²⁷ If principal and interest are paid within six months of the due date, acceleration will not occur. A penalty of five percent will, however, be imposed for each month the payment is late and the reduced four percent interest rate will not be allowed for that payment.¹²⁸ For reasonable cause, section 6161 allows an extension for payment of any installment under section 6166.¹²⁹ Therefore, if it becomes apparent the estate will not be able to make a payment, an extension for the installment payment should be requested so the entire deferred amount is not accelerated.

IV. COORDINATION OF SECTION 6166 WITH SECTION 303

A. *In General*

Congress enacted sections 6166 and 303 to alleviate liquidity problems when an estate consists largely of closely held business interests. However, large section 303 redemptions eliminate liquidity problems and there is no sound public policy reason to allow for estate tax deferral. Consequently, section 6166(g)(1)(A) accelerates the deferred tax when fifty percent or more of the value of the corporation is withdrawn.¹³⁰ Because corporations may not have sufficient funds to accommodate a single section 303 redemption, redemptions usually occur over a period of years. Even if both the corporation and the estate have sufficient cash to pay taxes and expenses, sound economic reasons exist to maximize use of section 303 and defer taxes under section 6166. There is no requirement in section 303 that a liquidity problem exist. If the requirements of section 303

124. *Id.* § 6166(g)(2)(A). If § 6166(b)(8)(A) treats stock in a holding company as stock in a business corporation, dividends paid by the business corporation to the holding company will be treated as paid to the estate in determining undistributed net income. *Id.* § 6166(g)(2)(C); *see supra* notes 78-81.

125. I.R.C. § 6166(g)(2)(A) (West 1986).

126. *Id.* § 6166(g)(3).

127. *Id.* § 6166(g)(3)(A).

128. *Id.* § 6166(g)(3)(B).

129. *Id.* § 6161(a)(2)(B).

130. *Id.* § 6166(g)(1)(A).

are met, redemptions should be utilized to withdraw corporate earnings and profits at little or no tax cost to the estate.¹³¹ Section 6166 is beneficial because of the special four percent interest rate, and income is split because the estate is a separate taxpayer.¹³²

B. *Effect of Section 303 Redemptions on Section 6166*

Generally, when fifty percent or more of the corporation's value is disposed of or withdrawn, the balance of the estate tax becomes due.¹³³ However, section 6166(g)(1)(B) excepts a section 303 redemption otherwise constituting a disposition from triggering acceleration.¹³⁴ This exception applies if a payment at least equal to the total amount of money and other property distributed¹³⁵ is made by the date the first installment becomes due after the date of the distribution (or, if earlier, one year from the date of the distributions) [hereinafter described as "savings clause"]. Even if the section 303 redemption qualified under the savings clause [hereinafter referred to as a "covered redemption"], it will reduce the value of the corporation and, therefore, impact on whether withdrawals and dispositions exceed the fifty percent test¹³⁶ [hereinafter the value of the corporation will be referred to as "acceleration base"]. To qualify under section 303, funds from a redemption occurring more than four years after the decedent's death must be used within one year to pay death taxes or expenses.¹³⁷ By coordinating the statutes, these redemption proceeds are available to pay the next installment under section 6166.

Section 303 redemptions not used to pay federal estate taxes (e.g., used to pay state estate taxes or administrative expenses) are not sheltered by the savings clause and will be treated as a disposition¹³⁸ [hereinafter referred to as a "non-covered redemption"]. The goal is to maximize benefits of sections 303 and 6166 by redeeming as much stock as permitted for noncovered redemptions without causing acceleration. It would seem this could be achieved by having the noncovered redemptions amount to forty-nine percent of the acceleration base and qualify the remainder as covered redemptions. However, a covered redemption can trigger acceleration. Even though the covered redemption occurs last, the acceleration base reduction "relates back" to the decedent's death when

131. *See id.* § 312(n)(7) (West 1986). When a corporation makes a distribution for a § 303 redemption, the ratable share of earnings and profits of the corporation is reduced. *Id.*

132. However, under the Tax Reform Act of 1986, the rate structure applicable to trusts and estates has been compressed (the maximum marginal rate is reached more quickly than for individuals), thereby minimizing the value of the estate as the separate taxpayer.

133. *Id.* § 6166(g)(1)(A).

134. *Id.* § 6166(g)(1)(B)(i).

135. *Id.* § 6166(g)(1)(B).

136. *Id.* § 6166(g)(1)(B)(ii).

137. *Id.* § 303(b)(4).

138. *Id.* § 6166(g)(1)(B) (West 1986); *see* Rev. Rul. 85-43, 1985-1 C.B. 356 (state estate tax payments are not payment of estate taxes within the meaning of § 6166(g)(1)(B)). *But see* I.R.C. § 6601(e)(1) (West 1986) (payment of interest on deferred estate tax qualifies for § 6166(g)(1)(B) treatment).

determining whether any prior noncovered redemptions will trigger acceleration.¹³⁹ For example, if an estate owns stock with an acceleration base of \$1,000,000 and the personal representative redeems \$300,000 in a noncovered redemption, acceleration would not occur. But a covered redemption of \$400,000 would reduce the acceleration base to \$600,000. Since the acceleration base "relates back," the earlier noncovered redemption would be a fifty percent disposition and the estate tax is accelerated.

To use noncovered redemptions to full advantage, subsequent covered redemptions must be considered. What qualifies as a covered redemption under the savings clause has been unclear. Section 6166 does not defer the entire estate tax; some tax must be paid when due under section 6151(a). The estate may have valuation issues to resolve before section 303 redemptions are contemplated. The question, then, is whether the later section 303 redemption will be considered as covered because of the previous estate tax payment. In Revenue Ruling 72-188, the Service adopted the "cumulative method" requiring a comparison of the cumulative estate payments with the cumulative section 303 redemptions.¹⁴⁰ The section 303 redemptions are covered to the extent they exceed the cumulative estate tax payments. However, estate tax regulations adopt the "redemption-by-redemption" approach.¹⁴¹ This approach allows a section 303 redemption only if payment of the next installment of the estate tax is not less than the amount of the redemption. Congress extended the period for section 303 redemptions to more closely correlate the rules of sections 303 and 6166 allowing corporate earnings generated throughout the installment payment period to be used for stock redemptions needed to pay the deferred federal estate tax.¹⁴² It is only reasonable that redemptions qualifying under this approach are covered.

Commentators speculated on which approach was proper.¹⁴³ Private Letter Rulings gave some insight,¹⁴⁴ but letter rulings may not be used as precedent under section 6110(j)(3).¹⁴⁵ Finally, in Revenue Ruling 86-54, the Service gave much needed guidance.¹⁴⁶ The ruling states neither approach achieves the primary purpose of section 6166 and sole reliance on either approach causes distortions.¹⁴⁷ The Service reconsidered Revenue Ruling 72-188. In light of congressional intent behind sections 303 and 6166, the cumulative approach and

139. Treas. Reg. § 20.6166A-3(e)(5) (1980).

140. Rev. Rul. 86-54, 1986-15, I.R.B. 44, 46, *modifying* Rev. Rul. 72-188, 1972-1 C.B. 383.

141. *Id.*; see Treas. Reg. § 20.6166A-3(d)(2) (1980).

142. H.R. REP. NO. 1380, 94th Cong., 2d Sess. 35-36 (1976).

143. See Blum & Trier, *Planning for Maximum Benefits of 303 Redemptions with Estate Tax Deferral*, 53 J. TAX'N 236 (1980); Fleming, *Funding Estate Tax Installment Payments with Section 303 Redemptions After the 1976 Tax Reform Act*, 4 J. CORP. TAX'N 22 (1977).

144. See Priv. Ltr. Rul. 8,324,107 (Mar. 17, 1983), IRS — LTR. RULINGS REP. (CCH) No. 329 (June 22, 1983); Priv. Ltr. Rul. 8,318,036 (Jan. 31, 1983), IRS — LTR. RULINGS REP. (CCH) No. 323 (May 11, 1983).

145. I.R.C. § 6110(j)(3) (West 1986).

146. Rev. Rul. 86-54, 1986-15 I.R.B. 44.

147. *Id.* at 46.

the redemption-by-redemption approach may now be used interchangeably.¹⁴⁸ The estate planner can now safely plan early redemptions relying on the cumulative approach. After four years, a series of regular annual redemptions are protected by the redemption-by-redemption approach. Now with some certainty that present and future redemptions will be covered, large early noncovered redemptions can be safely planned to avoid acceleration. By using a micro-computer and electronic spreadsheet program, this calculation can be done with ease.¹⁴⁹

V. PLANNING CONSIDERATIONS

A. Valuation

To qualify for both sections 303 and 6166, the value of closely held stock is a major factor.¹⁵⁰ Conflicting considerations occur when valuing stock. In calculating the estate tax liability, stock value should be kept as low as possible, but if sections 303 and 6166 are involved, a higher value may be necessary to qualify and determine the amount of deferral.

Values used for the federal estate tax return may be changed as the result of audit, conference, or litigation. If a section 303 redemption occurs, and later the value of redeemed stock is reduced, excess distributions will probably be treated as a dividend.¹⁵¹ If the stock's value is in doubt, treatment for income tax purposes is also affected. The estate may have to report gains on a section 303 redemption, while the section 1014 basis may not be known until completion of the Federal estate tax audit. In addition, the election under section 6166 must be made not later than the time for filing the return (including extensions) in order for it to be effective.¹⁵² Even if the estate does not appear to qualify for section 6166 deferral at the time the estate tax is filed, a protective election should be considered in case a later valuation change qualifies the estate.¹⁵³

As discussed earlier, the personal representative wants to value assets as low as possible for estate tax purposes. Problems arise if a section 303 redemption occurs for a higher amount. The Service will attempt to adjust the estate tax, claiming the redemption was at the true fair market value. The statute of limitations is usually three years,¹⁵⁴ but is extended to six years if an omission exceeds twenty-five percent of the gross estate.¹⁵⁵ If the statute is still open, not only will the estate be liable for increased estate taxes, but also for interest

148. *Id.*

149. See Anderson, *Letter Rulings Indicate Approval of Serial Redemptions Along with Deferral Under 303*, 59 J. TAX'N 370, 374 & n.11 (1983).

150. Compare I.R.C. § 303(g)(2)(A) (1982) with *id.* § 6166(a)(1) (West 1986)

151. See *supra* notes 2-3 and accompanying text.

152. I.R.C. § 6166(d) (West 1986).

153. See Treas. Reg. § 20.6166-1(d)(1980).

154. I.R.C. § 6501(a) (West 1986).

155. *Id.* § 6501(e)(2).

and possibly a penalty for a valuation understatement.¹⁵⁶ Therefore, any section 303 redemptions occurring soon after death should be close to estate tax values unless there are valid reasons for a difference. Even if the statute of limitations has run, the Service will try to adjust fair market values shown on the federal estate return if section 2032A special use valuation was elected and the additional recapture tax is imposed.¹⁵⁷ In a Private Letter Ruling, the Service held fair market value of property may be adjusted after the statute of limitations has run, but the adjustment must be limited to the amount allowed as the maximum reduction permitted in valuation under section 2032A for the year of the decedent's death.¹⁵⁸

Each item in a decedent's gross estate is reported at its fair market value unless the alternate valuation method is elected. The regulations define fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."¹⁵⁹ Stock in a closely held corporation seldom has an ascertainable market value. If the fair market value of the shares of stock cannot be ascertained from restrictive agreements or market transactions, the financial condition of the company must be evaluated. In Revenue Ruling 59-60, some of the factors to be considered are earning capacity, book value, dividend paying capacity, goodwill, and if the stock represents a minority or controlling interest.¹⁶⁰

A properly drafted buy-sell agreement can establish the value of a deceased shareholder's stock and fix liability for the payment of state and federal death taxes. To fix values for estate tax purposes, the following requirements must be met: (1) the agreement must restrict lifetime dispositions by the owner; (2) the estate must be obligated to sell the decedent's interest in the business; (3) there must be bona fide business reasons for the agreement; and (4) the valuation must be specified or readily ascertainable according to the terms of the agreement and the value must have been reasonable when made.¹⁶¹ Section 6166 is not available if all the decedent's shares are required to be redeemed under a buy-sell agreement. Therefore, the agreement should limit the redemption to the lesser of (1) the maximum amount qualifying for a section 303 redemption, or (2) the maximum redemption that does not accelerate the tax under section 6166.

156. *Id.* §§ 6601(a), 6660.

157. *See* Priv. Ltr. Rul. 8,403,001 (Sept. 9, 1983), IRS — LTR. RULINGS REP. (CCH) No. 360 (Jan. 25, 1984).

158. *Id.*

159. Treas. Reg. § 20.2031-1(b) (West 1986).

160. Rev. Rul. 59-60, 1959-1 C.B. 237.

161. *See* R. STEPHENS, G. MAXFIELD, S. LIND, & D. CALFEE, FEDERAL ESTATE AND GIFT TAXATION ¶ 4.02[3][g] (5th ed. 1983); *cf.* *May v. McGowen*, 194 F.2d 396 (2d Cir. 1952) (*per curiam*) (when two stockholders agreed that neither would dispose of stock without offering it to the other at \$100 per share, and surviving shareholder could buy the deceased's shares at that price, \$100 per share price held controlling).

B. *The Estate*

The qualification of an estate for sections 303 and 6166 will be affected by election of the alternate valuation date under section 2032 or the special use valuation under section 2032A.¹⁶² In considering the elections, the personal representative should examine the value variance of each asset to determine if the estate will still qualify for sections 303 and 6166. Under section 642(g) amounts allowable under section 2053 or 2054 may be used either as a deduction on the estate tax return or the estate's income tax return.¹⁶³ Both sections 303 and 6166 require that the closely held stock constitute thirty-five percent of the gross estate less deductions "allowable" under sections 2053 and 2054.¹⁶⁴ Therefore, taking a deduction from income will not jeopardize qualification under sections 303 and 6166. However, the decision can impact on the amount redeemable under section 303. Administrative expenses will be included in the amount that can be redeemed whether they are deducted from the estate tax or the income tax.¹⁶⁵ However, if items are deducted on the income tax return, the federal estate tax will increase. An increase in the estate tax would then increase the amount redeemable under section 303.

If section 6166 is elected, estate administration will be prolonged.¹⁶⁶ This can be advantageous because the estate is a separate taxpayer and income can be split. Nonetheless, this is not as advantageous after the Tax Reform Act of 1986 and the compression of rate structures.¹⁶⁷ The estate will benefit from the four percent interest rate for a portion of the deferral. However, if a significant amount of tax is deferred, there is a risk the interest rate on the unpaid tax will increase periodically.¹⁶⁸ Administrative costs and other burdens of keeping the estate open must be weighed against the benefits to be derived. However, even if the estate has ample funds to pay taxes and expenses, section 303 should be used because earnings and profits are withdrawn from the corporation for little if any tax cost.¹⁶⁹

C. *The Corporation*

The corporation plays a very important role because it is expected to provide the needed liquidity. Consideration must be given to availability of funds needed to finance the redemption. Usually the corporation owns insurance on the shareholder's life to fund such a redemption. The corporation may not deduct pre-

162. See I.R.C. §§ 2032, 2032A (West 1986); Treas. Reg. § 1.303-2(b) (West 1986).

163. I.R.C. § 642(g) (West 1986); see Prop. Reg. § 1.303-1(a)(5), reprinted in II FED. TAXES (P-H) ¶ 70,463 (1987) (claiming §§ 2053 and 2054 deductions on federal estate tax return immaterial if the expenses are "allowable" when return is filed).

164. I.R.C. §§ 303(b)(2)(A)(ii), 6166(b)(6) (West 1986).

165. *Id.* § 303(a)(2) (1982).

166. After the fifth year the estate must be concerned about undistributed net income. See *id.* § 6166(g)(2).

167. See *supra* note 132.

168. See I.R.C. § 6621(b) (West 1986).

169. See *supra* note 131 and accompanying text.

miums paid on such policies.¹⁷⁰ Accumulating funds for future redemptions might incur an accumulated earnings tax.¹⁷¹ Section 537(a)(2) softens the blow by permitting a corporation to accumulate amounts reasonably anticipated to be needed for a section 303 redemption, but only in the year of the shareholder's death or any year thereafter.¹⁷² The corporation may also accumulate earnings to retire any indebtedness incurred to fund a section 303 redemption.¹⁷³ A good planning technique has the corporation distribute installment notes for the section 303 redemption, coordinated with the section 6166 payments.¹⁷⁴ This allows the redemption to occur in the year of distribution, avoid the four year rule of section 303(b)(4), and still provide time to accumulate needed funds.

The corporation does not have to redeem shares with cash. Before the Tax Reform Act of 1986, a corporation could distribute appreciated property for section 303 redemptions and not be required to recognize lurking gain.¹⁷⁵ Since the distributee would get a section 1012 cost basis in the asset, the gain would escape taxation. However, under new section 311(b)(1), a corporation must recognize gain when appreciated property is distributed.¹⁷⁶

D. *Inter Vivos Planning*

From the moment it becomes apparent that an individual owns a substantial block of closely held corporate stock, sections 303 and 6166 should be considered. The shareholder should avoid making gifts or dispositions of stock if it would reduce holdings below the thirty-five percent level. If gifts are to be made, other property should be conveyed so stock will constitute a greater portion of the gross estate. Gifts must be made more than the three years before the decedent's death to accomplish a savings.¹⁷⁷

To increase the value of the corporation, the shareholder can transfer assets under section 351. However, passive assets add no value to the business interest for purposes of section 6166.¹⁷⁸ If the shareholder owns stock in several corporations, none independently meeting the thirty-five percent test, twenty percent of each could be acquired and aggregated.¹⁷⁹ If the shareholder is unable to meet the twenty percent requirement, stock can be transferred into a holding company. If the original companies conducted active trades or business, and

170. I.R.C. § 264(a) (1982).

171. *See id.* §§ 531-537 (West 1986).

172. *Id.* § 537(a)(2); *see id.* § 537(b)(1).

173. *Id.* § 537(b)(3).

174. Any lurking gain must be recognized on the distribution of the installment notes. *Id.* § 453B(a)(2).

175. *Id.* § 311(d)(2)(C). However, if the property distribution is depreciable, the corporation has recapture income. *See id.* §§ 1245, 1250.

176. The change applies to distributions made after December 31, 1986. H.R. 3838, 99th Cong., 2d Sess. § 633(a)(3), 132 CONG. REC. H7406 (daily ed. Sept. 18, 1986).

177. *See* I.R.C. § 2035(d)(33)(A), (d)(4) (West 1986).

178. *Id.* § 6166(b)(9).

179. *Id.* §§ 303(b)(2)(B), 6166(c).

the stock of the holding company exceeds thirty-five percent of the adjusted gross estate, both sections 303 and 6166 are available.¹⁸⁰

VI. CONCLUSION

Sections 303 and 6166 are a tremendous aid to an estate lacking liquidity. However, they can also be utilized by estates with no liquidity problem. Therefore, they must also be considered as planning tools. The interaction of sections 303 and 6166 is complex. The Service, however, has recently provided some guidance in the area and, with careful planning, the personal representative can maximize the benefits of both sections 303 and 6166.

180. *See id.* § 6166(b)(8).

