AGRICULTURAL
GUIDE
Published by the University of Missouri-Columbia Extension Division

Estate taxes

Delayed payment of federal estate taxes

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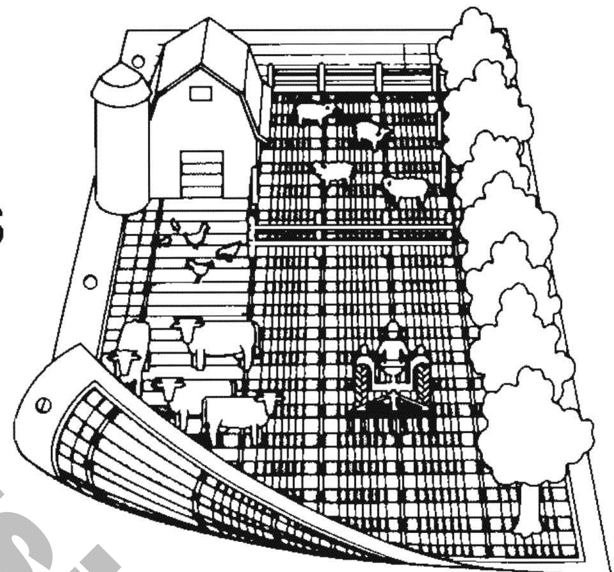

Farmers and small-business owners often fear that their loved ones might have to sell the family business to pay death taxes. In reality, the probability of a forced sale solely to pay estate taxes is small for three reasons.

First, you can leave a substantial amount of property to your heirs free of estate taxes. (See Extension Manual 68, "Estate Planning for Missouri Families.") All property left to your spouse is exempt from any estate taxes. In addition, the 1986 estate tax "unified credit" allows $500,000 in property to pass to other heirs tax-free. This "tax-free" amount will increase to $600,000 after 1986.

Second, the Internal Revenue Service allows a closely held family business to value land on the basis of its "current use" rather than on the standard "fair market value." (See UMC Guide G505, "Farmland Valuation for Estate Tax Purposes.") Current use valuation of farmland can usually reduce the land value by 20 to 50 percent. This will, in turn, sharply reduce potential estate taxes.

Third, tax laws allow for delayed payment of federal estate taxes. These provisions can be useful for estates that experience shortages of liquid assets upon the death of the estate owner.

This guide will explain conditions under which you can delay payment of estate taxes. This guide is not intended to be a substitute for professional advice. Consult your attorney or accountant for assistance with specific estate tax questions.

When are estate taxes due?

Normally, estate taxes are due nine months after the death of the estate owner. However, you may be granted up to a 10-year extension if you can show reasonable cause explaining why payment is impossible or impractical at that time. This extension is not automatic. The estate must pay interest on the balance due for the extension period. The interest rate is based on the prime rate charged by banks during the six-month periods ending March 31 and Sept. 30 each year. To apply for an extension, you must file IRS Form 4768 early enough to allow the IRS time to consider the application and reply before the initial nine-month period expires. Include with Form 4768 a detailed written statement explaining why you cannot pay the estate tax when originally due.

Examples of "reasonable cause" are:

- Assets are located in several legal jurisdictions outside your immediate control.
- Assets consist of rights to receive payments in the future, such as royalties, annuities and accounts receivable.
- The value of the estate cannot be determined by the date due or assets cannot be collected without a lawsuit.
- You have made a reasonable effort and are unable to convert assets into cash. To borrow to pay the tax, you will have to pay an unusually high interest rate.

A separate provision, IRS Code Section 6166, allows you to pay the estate taxes due on a closely held family business in installments over a 15-year period if the business remains in the family.

When can Section 6166 be used?

You can only use Section 6166 to delay the payment of taxes on closely held business property. The business must be engaged in productive activities. It cannot simply manage assets. The value of the deceased's share of the closely held business must be at least 35 percent of the adjusted gross estate (gross estate less expenses, debts and taxes) plus the value of gifts made within three years of death. The interest in a closely held farm business includes land, livestock, buildings and equipment used in farming, plus the value of the farm house and other improvements regularly occupied by the operators of the farm.

The deceased must have been a U.S. citizen or resident at the time of death to use 6166.

You may defer only the federal estate taxes due on the portion of the estate that consists of closely held business property. For example, if 50 percent of the estate consists of closely held business property, then only 50 percent of the estate taxes may be deferred by electing 6166. The remaining estate taxes are due within nine months of the estate holder's death and are subject to interest and penalty for late payment.

Section 6166 is a voluntary election. Should the heirs desire to delay the payment of estate taxes, the executor can elect 6166 on part or all of the property eligible.

What is a closely held business?

A closely held business is one in which a substantial portion of the *ownership and management* was under the control of the deceased.

To elect Section 6166, the deceased must have been actively involved in management of the business *and*

1. The owner of a trade or business carried on as a proprietorship (most farms are proprietorships); or
2. The owner of at least 20 percent of the capital in a partnership with not more than 15 partners; or
3. The owner of at least 20 percent of the voting stock in a corporation with not more than 15 shareholders.

Exercise caution when using cash rental agreements. A farm that is cash rented (even to a family member) probably will not qualify as a closely held business. Make crop-share arrangements to avoid this problem.

If the deceased owned more than one closely held business, only those businesses in which the deceased had an interest of 20 percent or more may be combined and treated as a single business.

How long can estate taxes be delayed?

The timely election of Section 6166 can result in the installment payment of estate taxes over a period of nearly 15 years. For the first nine months after death, no payments are due and no interest accumulates. For the next four years, you make only annual interest payments. During the following 10 years, both principal and interest are due.

No penalty is made for early payment of installments.

The estate executor is personally liable for deferred taxes unless the IRS files a lien on the property as security for taxes postponed.

Section 6166 interest rates

For the first $1 million in closely held business property, interest is charged on the balance of the estate taxes due at the rate of 4 percent per annum. For estates valued at more than $1 million, interest on the excess is calculated at the prime rate charged by banks during the six month period ending March 31 and Sept. 30 each year.

The interest rate will increase from 4 percent to the prime rate for the delinquent period if you make any payments late. In addition, a penalty of 5 percent of the payment will be charged for each month the payment is late.

Any payment not made within six months of the due date will cause the remaining balance to become due in full.

Restrictions on the heirs

Heirs or their family members must retain ownership of the property until the balance of the estate taxes is paid. Should the heirs terminate the business, liquidate a majority of the business assets or sell 50 percent or more of the eligible closely held business property to a non-family member, remaining unpaid taxes become due immediately. The heirs can choose to incorporate the business, provided stock ownership remains in the family.

Filing deadlines

You should file estate tax returns on IRS Form 706 within nine months of the estate owner's death unless an extension is granted. By filing Form 4768, you can request an extension of up to six months if it is impossible or impractical to complete the return by the due date.

To make delayed payment under Section 6166, attach a letter to the estate tax return. The letter must include the reason the estate qualifies for 6166 and a payment schedule.

The election to use Section 6166 *must* be made on a timely filed estate tax return. No extensions are allowed. If you are uncertain about whether you want to use Section 6166, consider filing for it anyway. This is called a "protective election." You can always decide later not to use it, but once the initial filing deadline has past, you cannot elect 6166.

A protective election is often made when the exact amount of the tax due is uncertain, as might be the case when current use valuation of farmland (Section 2032A) is used. If the IRS later disallows the current use valuation and if you then owe additional estate taxes, you will still be able to use the 6166 delayed payment method because you made the protective election.

Example

Widow Wilson dies in 1987 and leaves her children an estate valued at $1.25 million. Part of the estate consists of cash, bonds and household property, but most of the estate ($1 million) is the value of the family farm. The children elect to use 6166 to delay payment of estate taxes on the value of the farm.

Adjusted gross estate	$1,250,000
Estate tax due	255,500
Percent closely held business	80%
Tax eligible for deferral	204,400
Tax due 9 months after death	$ 51,100

Had the value of the farm business exceeded $1 million, only the deferred estate taxes on the first $1 million in closely held business property would have been eligible for 4 percent interest. The prime rate would be used to calculate interest on the excess.

As you can see from this example, electing Section 6166 does not reduce estate taxes. You pay the entire amount due ($255,500) but you pay it over an extended period. If you hadn't made the 6166 election, the $255,500 would have been due nine months after the death of the estate owner.

Date of death plus	Principal	Interest
9 months	$ 51,100	—
1 year & 9 months	—	$ 8,176
2 years & 9 months	—	8,176
3 years & 9 months	—	8,176
4 years & 9 months	—	8,176
5 years & 9 months	20,440	8,176
6 years & 9 months	20,440	7,358
7 years & 9 months	20,440	6,541
8 years & 9 months	20,440	5,723
9 years & 9 months	20,440	4,906
10 years & 9 months	20,440	4,088
11 years & 9 months	20,440	3,270
12 years & 9 months	20,440	2,453
13 years & 9 months	20,440	1,635
14 years & 9 months	20,440	818
TOTAL	$255,500	$77,672

Table 1. 6166 Estate tax payment schedule

The use of 6166 results in payment of a substantial amount of interest—$77,672 in this example. At 4 percent, it will probably be the lowest rate of interest you can get.

More information

For additional information on estate planning ask your local University of Missouri Extension Center for Manual 68, "Estate Planning for Missouri Families;" UMC Guide G503, "Gifts and Gift Taxation;" Guide G504, "Marital Trusts;" Guide G505, "Farmland Valuation for Estate Tax Purposes;" or Extension Circular 863, "A Will Of Your Own."

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