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Deferring the Need for Liquidity

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What is deferring the need for liquidity?

Probably the largest expense your estate may have to pay is estate taxes. Therefore, a solution for an estate facing a problem of lack of liquidity may be to defer all or some of these taxes.

Generally, this may be done in the following ways:

- Requesting an extension of time to pay estate tax
- Qualifying for automatic deferral of taxes attributable to closely held business interests and making the appropriate election
- Qualifying for automatic deferral of taxes attributable to reversionary interests or remainder interests and making the appropriate election

What is requesting an extension of time to pay estate taxes?

Federal estate taxes (federal gift and estate tax and the generation-skipping transfer tax (GSTT)) are normally due within nine months after your death. However, your personal representative may request an extension by filing the appropriate form (Form 4768) on or before the original due date of the estate tax return (within nine months of your death). The IRS may permit such an extension at its discretion.

The IRS will routinely grant an extension of up to 12 months. The IRS may grant a further extension if your personal representative's request is for a reasonable period (up to 10 years) and for a reasonable cause. Reasonable cause is not defined by the IRS. The IRS will review the facts specific to your estate's circumstances. Some of the things the IRS will consider include:

- Whether your assets are not easily controlled by your personal representative (they may be located in many jurisdictions)
- Whether your personal representative is unable to borrow against the assets (e.g., rights to future income)
- Whether there is ongoing litigation tying up the assets
- Whether there are insufficient other liquid funds to provide for your spouse and family
- Whether there are insufficient other liquid assets to pay the estate's other debts and liabilities

If the IRS grants an extension, it may do so on an annual basis only, reviewing your estate's circumstances each year and extending the payment for another year. Additionally, the IRS may require your personal representative to post a bond for the unpaid taxes. This bond can be up to twice the amount of the taxes owed. Finally, your estate must pay interest on the unpaid taxes during the extension period.

What is qualifying for automatic deferral of taxes related to closely held business interests?

The automatic deferral (Section 6166 election) is a method of deferring the payment of the federal generation-skipping transfer tax (GSTT) and/or the federal gift and estate tax (estate tax) attributable to an interest in a closely held business.

If your estate qualifies, Section 6166 requires the IRS, in effect, to act as a lender. Believe it or not, the IRS wants beneficiaries who become owners of a closely held business by reason of death to be able to continue to own and benefit from the business — or to sell the business for a fair price. Section 6166 allows any taxes attributable to the interest in the closely held business to be deferred for 5 years (with interest-only payments for the first 4 years), and then paid in annual installments (consisting of principal and interest) over a period of up to 10 years. This allows more time to raise sufficient funds or obtain more favorable interest rates. The Section 6166 election could very well make the difference between saving and losing a closely held business.

What is a closely held business for Section 6166 election purposes?

A closely held business, for Section 6166 election purposes, includes the following:

Sole proprietorship

If you are the sole owner of the business, it automatically qualifies as a closely held business, as long as you actively participated in the business. However, only the assets that are actually used in carrying on the trade or business will qualify for deferral.

Caution: *The IRS is not clear on this, but if your business is held in a revocable trust, it may qualify if you're a beneficiary of the trust. If you are the sole owner of a business in trust and you are planning on the Section 6166 election, check with a tax attorney to make sure your business will qualify.*

Partnership or corporation

Whether your interest in a partnership or corporation carrying on a trade or business will qualify as a closely held business is determined as follows:

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1. Corporate stock: Stock in a corporation carrying on a trade or business qualifies as an interest in a closely held business if (a) 20 percent or more in value of the voting stock of the corporation is included in your gross estate, or (b) the corporation has 45 or fewer shareholders.
2. Partnership Interest: An interest as a partner in a partnership carrying on a trade or business qualifies as an interest in a closely held business if (a) 20 percent or more of the capital interest in the partnership is included in the gross estate, or (b) the partnership has 45 or fewer partners.

For the purpose of determining how many individuals were involved in the business, the family attribution rule applies. The family attribution rule provides that all stock and all partnership interests held by you or by any member of your immediate family will be treated as if you own it. If you choose to qualify under this test, your personal representative must make the family attribution election on your estate tax return (Form 706).

Technical Note: *Your immediate family includes your spouse, lineal descendants, ancestors, and siblings.*

Tip: *Spouses are considered a single partner or shareholder.*

Technical Note: *Although the term trade or business is not defined by the IRS, it does not mean simply owning income-producing assets. The assets must be used to form some type of enterprise that produces business income. For example, a farm, manufacturing, or service enterprise is a trade or business although a collection of investment assets is not.*

Holding companies

A holding company means any corporation (holding corporation) holding shares of stock in another corporation (business corporation). For Section 6166 election purposes, you may elect to treat shares of stock in a holding corporation as shares of stock in the business corporation. Therefore, your interest in a holding company may qualify if it passes the size of your holdings test (i.e., 20 percent of the shares of stock in the business corporation). In order to treat holding company shares as business corporation shares, all of the following requirements must be satisfied:

- The holding company must own business company stock
- Your personal representative must file an election treating the holding company stock as stock in the business company
- The holding company stock must not be readily tradable (i.e., not traded on any stock market or over-the-counter exchange) at your death
- The value of the holding company must exceed 35 percent of the value of your gross estate

Caution: *If an election is made for holding-company interests, the special 2 percent interest rate and the initial five-year interest-only deferral are not available.*

Does your estate qualify?

To make the Section 6166 election, your personal representative must first determine whether your estate qualifies. Your estate qualifies if the following requirements are satisfied:

You, the decedent, are a U.S. citizen or resident at the time of your death

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Your estate passes a 35 percent test

The value of the interest in the closely held business that is included in your gross estate must exceed 35 percent of your adjusted gross estate. For the purposes of Section 6166, your gross estate is defined as the gross taxable estate plus taxable gifts. Your adjusted gross estate is defined as your gross estate reduced by the sum of certain expenses and losses. Those expenses and losses include: (1) your funeral expenses, (2) certain administration expenses such as the personal representative and the appraiser's fees, (3) claims against your estate, (4) unpaid mortgages and other debts, (5) certain state and foreign death taxes, and (6) losses suffered during the settlement of your estate due to fire, storm, shipwreck, or other casualty. No other deductions are allowed for the purposes of the 35 percent test.

Tip: *A charitable deduction is also not allowed for the purposes of the 35 percent test. However, converting a planned bequest to charity into a legally enforceable lifetime pledge will enable you to deduct this gift, reduce your adjusted gross estate, and perhaps enable your estate to meet the 35 percent test.*

- Interests in more than one closely held business — If you own interests in two or more closely held businesses, they will be added together and treated as one business for purposes of the 35 percent test as long as your gross estate includes 20 percent or more of the value of each business. If you hold the businesses jointly as either joint tenants, tenants-in-common or as community property with your spouse, your spouse's interest will be treated as if you own it for purposes of the 20 percent test.

Example(s): *Ken and Sue are married and jointly own 20 percent of the stock in Corporation A (valued at $6,400,000) and 30* *percent of the stock in Corporation B (valued at $5,600,000). Ken dies, and his adjusted gross estate is valued at $20 million. The entire percentage of interests owned by Ken and Sue is considered owned by Ken's estate for purposes of determining eligibility for the 6166 election. Ken's estate satisfies the 20 percent threshold necessary to allow the interests to be considered one business (20 percent of A and 30 percent of B). The interests in Corporations A and B may be aggregated for purposes of the 35 percent test. Because their total value ($12 million) exceeds 35 percent of Ken's adjusted gross estate ($12 million of $20 million =.60 or 60 percent), the tax attributable to Ken's interests may be deferred.*

Caution: *Your personal representative should carefully consider decisions affecting the valuation of assets in the estate (e.g., the alternate valuation date or special use valuation method). Ideally, your personal representative should not make either of these elections without first determining whether it will prevent the estate from satisfying the 35 percent test.*

- Passive assets are not counted — Passive assets are not counted in the value of a closely held business for the purposes of meeting the 35 percent test. Passive assets are those that are not actually used in the business. They generally include:

1. Cash and other liquid assets
2. Real estate, except certain rental real estate
3. Insurance on the life of the sole proprietor
4. Rental business, unless the business involves more than the mere management of investments
5. Generally, stock in another company, unless the corporations are active corporations

Caution: *Special rules apply to farms (e.g., residential buildings may be considered not to be passive assets). If your closely held business is a farm, seek the advice of a tax attorney about what is includable in your gross estate for purposes of the 35 percent test.*

How does your personal representative make the election?

Satisfy the technical requirements

To make the election, your personal representative must do all of the following:

- Check the appropriate box on your estate tax return — Use Form 706, check the box in Part 3, line 3, and complete and attach items in Part 5
- Attach a completed statement to your estate tax return that must include all of the following information:

1. Your (the decedent's) name and Social Security number
2. Your closely held business interests, identified by schedule and item number
3. Specific, factual reasons why your estate qualifies for the election
4. The calculation of the amount of the tax to be paid in installments
5. The date the first installment is due
6. The number of annual installments in which the tax is to be paid

- Timely file your estate tax return — Your estate tax return and attached completed statement must be filed in a timely manner (nine months after your death unless an extension has been granted).

Caution: *The Section 6166 election must be made no later than the time your estate tax return is required to be filed. An untimely made election will be denied.*

Tip: *If your estate doesn't appear to satisfy the requirements of Section 6166, your personal representative should make a protective election anyway. This way, if it is later determined that the requirements are satisfied after all, the subsequent election will not be denied because it is untimely, and the portion of tax remaining unpaid can be deferred. A protective election is made by filing a notice of election on Schedule A-1 with your estate tax return.*

Acceptance or rejection of the election

The election is deemed to be accepted unless the IRS notifies your personal representative to the contrary. An appellate conference will review a negative determination if your personal representative requests it.

How much estate taxes can be deferred?

Estate taxes attributable to your closely held business interest

The amount of taxes that can be deferred is the total of or any portion of the taxes that are attributable to your closely held business interest.

Example(s): *Pat is the sole owner of a sports shop that sells skis and other outdoor sports equipment. Pat dies in 2022. His adjusted gross estate amounts to $20 million, including the value of his closely held business, valued at $8,000,000. The federal* *estate tax due on Pat's estate is $3,176,000 (assuming no other variables). However, since the value of Pat's business is more than 35 percent of his adjusted gross estate ($8 million of $20 million =.40 or 40 percent), Pat's personal representative makes the Section 6166 election. The personal representative defers $1,270,400 of the total federal estate tax due (40 percent of $3,176,000, or the amount attributable to the closely held business).*

Interest on the deferred tax balance

The taxes must be paid in annual installments for a period of up to 15 years. For the first five years following the date on which the estate taxes are due, your personal representative is only required to pay the interest that is due. From the fifth year on, the annual installments must include payments of principal as well as interest. The balance may be paid in up to 10 annual installments after the interest-only period is over.

An interest rate of 2 percent, compounded daily, is charged on the first $1,640,000 (for estates of persons who die in 2022) of the closely held business interest in excess of the applicable exclusion amount and any other exclusions. The balance of the deferred taxes is subject to interest payable at 45 percent of the rate applicable to underpayments of tax (which is the federal short-term rate plus 3 percent).

Deductibility of interest paid

Interest paid on deferred estate taxes is no longer deductible for either income tax or estate tax purposes.

Tip: *Installment payments being made on estates of decedents dying before 1998 are still deductible, unless the new lower interest rate has been assumed.*

Overpayments

An overpayment of an installment will reduce future installments. No refund of an overpayment will be made until the entire tax is paid.

Can your estate lose its deferral election?

The deferral election ends and the date for payment is accelerated under different circumstances. Acceleration means that the entire unpaid balance may be due on notice or demand.

Failure to pay interest or principal when due

Acceleration occurs if your personal representative fails to make a timely payment of either interest or principal (unless the late payment is made within six months of the time it was due). Even if the late payment is made within the six-month grace period, the special 2 percent rate will be lost, and a penalty of 5 percent of the amount of the payment will be imposed for each month the payment is late.

Disposal of the business assets

Acceleration occurs if one-half or more of the value of your interest in the business is withdrawn, sold, redeemed, exchanged, or otherwise disposed of. For example, acceleration will result if your interest is sold pursuant to a buy-sell agreement or because of Section 303 redemptions of corporate stock. However, acceleration does not occur as a result of corporate reorganizations.

Your personal representative must notify the IRS in writing within 30 days after becoming aware of any disposition of assets that represents more than 50 percent of the business interest that is the subject of the deferred taxes.

Tip: *Your successor should be aware of the consequences of disposing of the business assets. Advise your successor to consult a tax attorney in the event that any type of disposal is contemplated to avoid the loss of the deferral election.*

Undistributed net income

Acceleration occurs if your estate has undistributed net income for any fiscal year ending on or after the first installment date and does not use it to pay down the deferred taxes.

Who is responsible to make the installments?

Your personal representative is personally responsible for paying your estate taxes. However, if payments are spread out over as much as 15 years, this may be impractical, especially if your personal representative is not involved in the business. Your personal representative can apply for a discharge, which the IRS may grant if the personal representative posts a bond for payment of the deferred taxes. However, even posting a bond can be a burden on your personal representative. Therefore, it may be prudent to choose someone who is going to be the successor owner of your closely held business.

What is qualifying for automatic deferral of taxes related to reversionary interests or remainder interests?

Your personal representative can elect to defer paying estate taxes related to a reversionary or remainder interest for up to six months after such interest is terminated. If there is reasonable cause for extending the due date further, the Service may allow up to an additional three years for payment. The IRS allows this deferral because, generally, reversionary and remainder interests are difficult to convert into cash.

Your personal representative must make such an election before the normal due date by checking the appropriate box of the estate tax return, and by filing a notice of election with the IRS District Director. Your personal representative must also include a certified copy of your will or other instrument that created the reversionary or remainder interest. If the reversionary interest is based on the life of an individual, your representative should also note the date of birth of the individual.

The amount of taxes that can be deferred is the total or any portion of the taxes that are attributable to the reversionary interest or remainder interest.

Your estate must pay interest on the unpaid taxes during the extension period.

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