

Tax Management Portfolios
Estates, Gifts and Trusts Series
809-1st : Estate Planning for Owners of Closely Held Business Interests

TITLE PAGE

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PORTFOLIO DESCRIPTION SHEET

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Tax Management Portfolio, Estate Planning for Owners of Closely Held Business Interests, No. 809, is designed as a guide to the lifetime and post-mortem estate planning techniques primarily applicable to the owners of interests in closely held businesses.

Detailed consideration is given to various kinds of buy-sell agreements, including cross-purchase and stock redemption agreements; the gift and estate tax rules governing the lifetime disposition of closely held business interests, with special emphasis on §§ 2701-2704; the use of recapitalizations, charitable bail-outs, and private annuities to accomplish retirement, gift, and estate planning goals; §§ 303, 6166, and 2057 "relief"

provisions concerning the payment of estate tax where the estate consists in significant measure of an interest in a closely held business; and the rules which apply to subchapter S corporations.

For additional relevant Tax Management Portfolios, check the "Estates, Gifts and Trusts Series Classification Guide."

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C. Section 6166

1. Background

The Code contains several provisions which permit a taxpayer to defer the payment of estate tax: §§ 6161, 6163 and Section 6166. Although our primary interest here is Section 6166, it is helpful to briefly examine §§ 6161 and 6163. See 219 T.M., Estate Tax Payments and Liabilities, for a more complete discussion of §§ 6161, 6163, and 6166.

a. Section 6161

Section 6161 is broadly drafted to apply to any tax under any provision of the Code including the estate tax, the gift tax, and the generation-skipping transfer tax. In its application to the estate tax, Section 6161 differs very materially from Section 6166, which is discussed below at III, C.

The general rule, set out in Section 6161(a)(1), is that the IRS, "except as otherwise provided in this title," [FN290] may extend the time for the payment of the tax, or any installment of the tax, shown due on any return or declaration required under the Code. The extension may be "for a reasonable period" not to exceed six months for payment of the income or gift tax and 12 months in the case of the estate tax, from the date fixed for the payment of the tax, which in the case of the estate tax, is nine months from the date of death. [FN291]

Regs. Section 20.6161-1(a) gives a number of examples of circumstances which are considered to be "reasonable" within the meaning of Section 6161(a)(1), [FN292] including (1) liquid assets spread over several jurisdictions and not readily marshallable; (2) estate consists largely of assets which are rights to receive future payments, such as royalties, against which it is difficult to borrow; (3) estate consists largely of assets whose collection will require a lawsuit and whose eventual size is not presently ascertainable; and (4) insufficient funds with which to support decedent's

survivors as well as pay claims that are immediately payable. Note: Presumably, these examples are equally apposite in the case of an extension requested under Section 6161(a)(2) for up to 10 years.

Section 6161(a)(2) contains a special rule with respect to the estate tax. An extension may be granted for "reasonable cause," with respect to any part of the estate tax and with respect to any part of any installment of the estate tax under Section 6166. [FN293] The extension under this rule may not exceed a "reasonable period" not greater than 10 years from the date on which the estate tax return was due [FN294] (determined without any extension of time for filing [FN295]), or (in the case of a Section 6166 installment) if later, not greater than 12 months after the due date of the last installment. [FN296]

If an estate tax deficiency has been determined, [FN297] an extension may be granted for its payment "for a reasonable period not to exceed 4 years from the date otherwise fixed for the payment of the deficiency." [FN298] Under Section 6161(b)(3), no extension may be granted for the payment of a deficiency which is due to negligence, intentional disregard of the rules and regulations, or fraud with intent to evade tax.

Section 6503(d) provides that in the case of an extension of time for the payment of the estate tax or any deficiency of estate tax, the running of the period of limitation for the collection of the tax is suspended for the period of any extension of time granted for payment under Section 6161(a)(2) or (b)(2), 6163 or 6166.

If an extension of the time for payment is granted under Section 6161, interest will run at the current interest rate under Section 6621, compounded daily as required by Section 6622. The application is made on Form 4768 (Application for Extension of Time to File U.S. Estate Tax Return and/or Pay Estate Tax).

b. Section 6163

Section 6163 is much narrower in scope than either Section 6161 or 6166. It is concerned solely with extensions for the payment of estate tax on reversionary or remainder interests, and is mentioned here for the sake of comprehensiveness.

Where a reversionary or remainder interest is included in a decedent's gross estate, payment of that part of the estate tax which is attributable to that interest may, if the executor so elects, be postponed until six months "after the termination of the precedent interest or interests in the property, under such regulations as the Secretary may prescribe." [FN299] Regs. Section 20.6163-1(a)(1) states that Section 6163 is limited in its availability "to

cases in which the reversionary or remainder interest is included in the decedent's gross estate as such and [does] not extend to cases in which the decedent creates future interests by his own testamentary act."

At the termination of the unilateral extension period under Section 6163(a), the IRS may upon "reasonable cause" grant a further extension for a period or periods of up to three years. [FN300] The regulations under Section 6163 set out the mechanics for making the election to postpone payment of the tax [FN301] and for computing the amount of estate tax which is attributable to the remainder or reversionary interest. [FN302] Rev. Ruls. 73-311 [FN303] and 83-103 [FN304] address Section 6163.

In Rev. Rul. 73-311, the IRS ruled that the estate of a decedent widow, whose predeceased husband had left her installment payments under a deferred income plan which she in turn gave to her children, could not claim a Section 6163 extension for payment of the estate tax which was attributable to the inclusion in her estate of the installments remaining unpaid at her death. The IRS explained that the remaining payments did not constitute a "remainder" or "reversion" within Section 6163.

In Rev. Rul. 83-103, an election had been made to utilize Section 6163 with respect to tax attributable to a trust remainder, i.e., to defer payment of that tax until the life interest ended. The IRS ruled that the payment of a part of this tax would not accelerate payment of the rest of the tax or accrued interest through the date of the part payment.

As in the case of Section 6161, the IRS may require the furnishing of a bond before granting a Section 6163 extension, but not for more than double the amount for which the extension is granted. [FN305]

c. Old Section 6166A

A better understanding of Section 6166, the principal object of inquiry, may be gained by taking a look at the law in this area before the 1981 repeal of Section 6166A, a former companion section to Section 6166, and the incorporation of many Section 6166A provisions into Section 6166. [FN306]

Installment payment of the estate tax began in 1958 with the enactment of the original Section 6166 which permitted the executors of certain estates to take as much as 10 years to pay the estate tax attributable to interests in closely held businesses and to pay only 4% interest on the unpaid balance. In 1975, this preferential interest rate changed to one based upon the prime rate from time to time in effect.

In 1976, Section 6166 was renumbered Section 6166A and a more liberal

Section 6166 was enacted, which gave a five-year breathing period before the first installment of the closely held business portion of the estate tax had to be paid. This more liberal provision also reinstated the 4% interest rate, and provided that the threshold requirement for Section 6166 installment treatment was that the closely held business interest constitute more than 65% of the decedent's "adjusted gross estate."

As noted, Section 6166A was repealed in 1981 and many of its provisions were carried forward in Section 6166 which, with certain post-1981 amendments, is now the surviving section. Unfortunately, the regulations under Section 6166 do not yet reflect the repeal of Section 6166A. However, the [IRS has stated in PLR 8138151](#) that "the regulations and revenue rulings under Section 6166A are considered in determining whether there has been a disposition of an interest in a closely held business under Section 6166." [FN307]

2. The Basic Scheme of Section 6166

Unlike Section 6163, which is discussed above at III, C, 1, b, Section 6166 is concerned primarily with the estate tax [FN308] and, to a limited extent in Section 6166(i), the generation-skipping transfer tax. It does not apply to any of the other taxes imposed by the Code.

In summary, Section 6166 provides a mechanism for spreading payment of a part of the tax (basically, that fraction which is attributable to the inclusion in the gross estate of a substantial "interest in a closely held business") over two to ten equal installments, [FN309] and allows at least a part of the interest on the unpaid balance of the tax to be paid at the rate of 2%. [FN310] Note: An important distinction between Section 303 and Section 6166 is that the latter provision is not limited to closely held businesses conducted in corporate form but applies equally to partnerships and sole proprietorships.

As one might expect, certain events involving the closely held business interest have the effect of accelerating the payment of the unpaid balance of the estate tax. It is with matters falling under this heading that many of the administrative rulings have been concerned.

The purpose of Section 6166 is neatly summarized in *Parrish v. Loeb*: [FN311]

Section 6166 was designed by Congress to create a safety valve to protect the integrity of closely-held business interests of a decedent against destruction because of the demands of the estate tax provisions of the Code. It provides, in summary, that in those instances in which a substantial part of a decedent's gross estate consists of a closely-held business venture, which the

decedent had conducted in his lifetime, his personal representative may elect to pay that portion of federal estate tax which is attributable to that venture in equal annual installments over a period of time not to exceed ten years. The Section also provides that a personal representative may elect to defer payment of the first annual installment for a period not to exceed five years. During that deferment period, interest on the deferred tax is payable annually at a nominal rate fixed by the statute.

Estates of decedents dying after August 5, 1997 may file a declaratory judgment action in the Tax Court to resolve disputes over the estate's initial and continuing eligibility for Section 6166 estate tax deferral without requiring the prepayment of the disputed tax. [FN311.1] The action may be brought by the executor or any person who has assumed an obligation to make the Section 6166 payments (but only if all obligated persons are joined as parties). [FN311.2] Exhaustion of administrative remedies is required before the Tax Court action may be initiated but the IRS' failure to make a determination will not excessively delay the proceeding because the IRS' failure to act within 180 days after a request has been made is treated as satisfying the exhaustion requirement if the taxpayer has taken all reasonable steps in a timely manner to secure the IRS determination. [FN311.3] The Tax Court action must be filed before the 91st day after the IRS mails notice by certified or registered mail of a determination to deny initial or continuing Section 6166 eligibility. [FN311.4]

Congress also ensured estates greater access to the courts to resolve estate tax deferral issues by enacting Section 7422(j), which overruled judicial decisions that denied taxpayers access to the courts for a refund claim until the entire estate tax liability had been paid (i.e., timely payment of the Section 6166 installments due prior to bringing an action was not sufficient to invoke jurisdiction). [FN311.5] An estate may file an action in the Court of Federal Claims or a U.S. district court to determine the correct amount of estate tax liability (or refund) as long as the following conditions are met: (1) no portion of the Section 6166 installments have been accelerated; (2) the estate has fully paid each installment of principal and/or interest due (and all non-Section 6166-related estate taxes due); (3) there are no suits for declaratory judgment under Section 7479 pending; and (4) there is no outstanding deficiency notice against the estate. [FN311.6]

If the estate files a Section 7479 declaratory judgment action, the two-year statute of limitations under Section 6532(a)(1) for filing a refund action is suspended until the Tax Court decision is final. [FN311.7]

In general, to the extent an estate previously litigated its estate tax liability, the estate would not be able to take advantage of a Section 7422(j) action under the principles of res judicata. [FN311.8] All installment payments that become due during the pendency of the suit must be paid; failure to make the payments triggers acceleration under Section 6166(g)(3)). [FN311.9]

3. Detailed Analysis of Section 6166

Section 6166(a)(1) provides:

In general. If the value of an interest in a closely held business, which is included in determining the gross estate of a decedent who was (at the date of his death) a citizen or resident of the United States exceeds 35 percent of the adjusted gross estate, the executor may elect to pay part or all of the tax imposed by section 2001 in 2 or more (but not exceeding 10) equal installments.

There are several elements to Section 6166 which can be examined separately.

a. Estates Which May Benefit from Section 6166

The terms of Section 6166(a)(1) provide that Section 6166 is available only to the estate of a decedent who at the date of his or her death was either a U.S. citizen or a resident alien.

b. Required Size of the Closely Held Business Interest

Before an estate may avail itself of Section 6166, the interest in a closely held business must have an estate tax value which exceeds 35% of the decedent's adjusted gross estate. [FN312]

(1) "Adjusted Gross Estate" Defined

The term "adjusted gross estate" (formerly a measuring stick for the estate tax marital deduction when it was limited to 50% of the adjusted gross estate) [FN313] is defined by Section 6166(b)(6) as

the value of the gross estate reduced by the sum of the amounts allowable as a deduction under section 2053 or 2054. Such sum shall be determined on the basis of the facts and circumstances in existence on the date (including extensions) for filing the [estate tax] return... (or, if earlier, the date on which such return is filed). (emphasis supplied).

(2) "Allowable" as a Deduction Under Section 2053 or Section 2054

Section 2053, referenced in the above definition, permits an estate, in arriving at its taxable estate, to deduct funeral expenses, administration expenses, claims against the estate, and unpaid mortgages on or indebtedness in respect of property whose value is included in the gross estate. [FN314] Section 2054, also referenced in the Section 6166(b)(6) definition of adjusted gross estate, provides a deduction for certain uncompensated casualty losses arising from fires, storms, shipwrecks, theft, etc., which occur during the administration of the estate. While the two sections are discussed in detail in 840 T.M., Estate Tax Deductions -- Sections 2053 and 2054, one point is made here which directly concerns the availability of Section 6166. Section 6166(b)(6) speaks of amounts "allowable" as deductions under Section 2053 or Section 2054, not of amounts "allowed," and the difference is important. The old definition of "adjusted gross estate" used the term "allowed," which meant that if the executor opted to claim a particular administration expense as an income tax deduction under Subchapter J rather than as an estate tax deduction under Section 2053, the adjusted gross estate would not reflect that expense. [FN315] But in the determination of the availability of Section 6166 (does the closely held business interest amount to more than 35% of the adjusted gross estate?), it is immaterial whether the expense is taken as an estate tax or an income deduction; all that matters is whether the expense in question is eligible for deduction under Section 2053.

c. The Nature of the Section 6166 Relief

The prize which awaits the estate which satisfies the Section 6166(a)(1) entrance requirements is the right to elect to pay part or all of the estate tax [FN316] in two or more but not more than 10 installments and to enjoy the reduced interest rate under Section 6601(j). There is, however, a limitation on the maximum amount of tax which may be so paid, and there are provisions as to when the installments must be paid. In addition, there are rules prescribing when payments of interest are due.

(1) Limitation on Amount of Estate Tax Which May Be Paid in Installments

Section 6166(a)(2) places a cap on the amount of estate tax which may be paid in installments equal to

an amount which bears the same ratio to the [estate tax] (reduced by the credits against such tax) as --

(A) the closely held business amount, bears to

(B) the amount of the adjusted gross estate.

The term "closely held business amount" is defined by Section 6166(b)(5) as "the value of the interest in a closely held business which qualifies under subsection (a)(1)."

The following example illustrates how the limitation worked in estates of decedents dying in 1987 through 1997 when a \$192,800 unified credit applied.

Example: X died with a total gross estate of \$3,600,000. X, unmarried at death, was survived by two children. His estate included an 80% stock interest in a corporation which makes sink stoppers. The other 20% of the stock was owned by unrelated third parties. X's interest in the business was valued at \$1,000,000. X's will made a specific charitable bequest of \$50,000. Deductions were allowable under §§ 2053 and 2054 in the amount of \$1,050,000, leaving an adjusted gross estate for Section 6166 purposes of \$2,550,000. X's taxable estate (gross estate minus charitable and §§ 2053 and 2054 deductions) equalled \$2,500,000. X's federal estate tax bill (net of the unified credit and the credit for state death taxes) was \$694,200. The percentage of the estate tax that could be deferred under Section 6166 was 39.2% (\$1,000,000 closely held business amount divided by \$2,550,000 adjusted gross estate). The amount of estate tax qualifying for Section 6166 treatment was \$272,126 (\$694,200 "net" federal estate tax x .392). Observation: The Section 6166(a)(2) limitation on the amount of estate tax which may be paid in installments was not adjusted to take into account the Section 2057 deduction for qualified family-owned business interests available in estates of decedents dying after 1997 and before 2004. Because the limitation is measured by comparing the value of closely held business interests included in the decedent's gross estate with the value of the decedent's adjusted gross estate (defined by Section 6166(b)(6) as the gross estate reduced only by allowable deductions under §§ 2053 and 2054), Section 6166(a)(2) appears to allow deferral for an amount that exceeds the estate tax actually attributable to the closely held business interests.

Example: The facts are the same as in the above example except that X's interest in the business was valued at \$1,500,000. X dies in 1998 and leaves his interest in the corporation to his two children, who are qualified heirs under Section 2057(i)(1). X's adjusted gross estate for Section 6166 purposes is still \$2,550,000 (\$3,600,000 minus \$1,050,000 in deductions under §§ 2053 and 2054). X's taxable estate, however, is reduced by a \$675,000 deduction under Section 2057 for qualified family-owned business interests in addition to the §§ 2053 and 2054 and charitable deductions available to the pre-1998 decedent, leaving a taxable estate of \$1,825,000 (\$3,600,000 - 50,000 - 1,050,000 - 675,000). X's federal estate tax bill (net of the unified credit and the credit for state death taxes) is \$413,000. Applying Section 6166(a)(2), the percentage of the estate tax that may be deferred under Section 6166 is 58.8% (\$1,500,000 closely held business amount divided by \$2,550,000 adjusted gross estate) and the amount of estate tax qualifying for Section 6166

treatment is \$239,540 (\$413,000 "net" federal estate tax x.588). The percentage of estate tax actually attributable to the closely held business interest, however, is 45.2% (\$825,000 value of the corporation subject to estate tax (\$1,500,000 minus \$675,000 maximum allowable Section 2057 deduction) divided by \$1,825,000 taxable estate) and the amount of estate tax attributable to the business is \$186,676. Comment: It seems likely that the result illustrated above is an unintended consequence of the conversion of the qualified family-owned business interest benefit from an exclusion to a deduction, particularly when considered with Section 6601(j), which ties the interest rate on estate tax deferred under Section 6166 to the taxable value of the closely held business interests. See III, C, 3, c, (3), below.

(2) Number of and Due Dates for Installments

Section 6166(a) permits the executor to pay the qualifying portion of the estate tax in up to 10 installments. Section 6166(a)(3) requires the first installment to be paid "on or before the date selected by the executor which is not more than 5 years after the date prescribed in section 6151(a) for payment of the tax." [FN317] This means that the payment of the estate tax may be spread over a period of as much as 14 years from the date the tax is generally payable. [FN318]

The date chosen for payment of the first installment of tax need not be an anniversary of the original due date determined under Section 6151, but (presumably to facilitate the computation of interest) must be the same date within any month which corresponds to the day of the month determined under Section 6151(a). [FN319]

Example: If X died on July 15, 1998, the tax would be due nine months later, on April 15, 1999. If X's executor avails himself of Section 6166, he may pay the first installment of the tax deferred on the 15th of any month through April of 2004.

(3) Rate of and Due Date for Interest

For estates of decedents dying after 1997, Section 6601(j) establishes a 2% rate for interest payable on the deferred tax attributable to the first \$1 million in taxable value of a closely held business. [FN319.1] In other words, the tax attributable to the first \$1 million in value in excess of the effective exemption provided by the unified credit and any other credits is subject to interest at a 2% rate. Section 6601(j)(2) terms this amount the 2% portion. Interest on the deferred tax that exceeds the 2% portion is payable at a rate equal to 45% of the annual underpayment rate established under Section 6621. [FN319.2] Section 6601(j)(1) also applies the 2% rate to an estate tax

deficiency which is prorated to installments pursuant to Section 6166(e).

Section 6601(j)(2) defines the "2-percent portion" as the lesser of--

(A)(i) the amount of the tentative tax which would be determined under the rate schedule set forth in section 2001(c) if the amount with respect to which such tentative tax is to be computed were the sum of \$1,000,000 and the applicable exclusion amount in effect under section 2010(c), reduced by

(ii) the applicable credit amount in effect under Section 2010(c), or

(B) the amount of the tax imposed by chapter 11 which is extended as provided in Section 6166. Note : Effective for estates of decedents dying after December 31, 2001, the 2001 Tax Relief Act, [P.L. 107-16, Section 571](#), increased the maximum number of partners in a partnership and the maximum number of shareholders in a corporation from 15 to 45 for purposes of Section 6166.

Example: The decedent (D) died in 1998 owning a closely held business that meets the requirements for a Section 2057 deduction from D's gross estate for qualified family-owned business interests. D's business is valued at \$6 million for estate tax purposes. The first \$1.3 million in value is not subject to estate tax by virtue of the unified credit and Section 2057 deduction. After application of the unified credit and Section 2057 deduction, D's estate has business interests of \$4.7 million in taxable value. D's executor makes the Section 6166 election to pay the estate tax in installments. Interest on the tax attributable to the inclusion of \$1 million of value in D's estate is payable at the 2% rate. The tax attributable to the remaining \$3.7 million is payable at 45% of the underpayment rate. The interest is not deductible on the estate return or the estate's fiduciary income tax return.

The 2% portion will be adjusted annually for inflation for estates of decedents dying after 1998. [FN319.3]

Previously, Section 6601(j) provided a special 4% interest rate for the interest on the tax attributable to the first \$1 million of the interest in a closely held business interest. [FN320] A transition rule allows the executor of an estate deferring tax under the pre-1997 rules to make a one-time irrevocable election to use the lower interest rates and forego interest deductions for installments due after the effective date of the election. [FN321] Observation: The Section 6601(j)(2) definition of the amount eligible for the 2% interest rate allows a larger amount of deferred tax to qualify for the most favorable rate than did the pre-1997 Act Section 6601(j)(2) definition of the 4% rate. The prior formulation allowed a maximum of \$153,000 (\$345,800 - 192,800) in deferred tax to qualify for the most favorable rate. The formulation in revised Section 6601(j) allows the tax deferred on the entire \$1 million (without reduction for the unified credit) to qualify for the most

favorable rate. The revised structure also allows for straight forward inflation adjustments for the \$1 million amount in later years under Section 6601(j)(3) as well as preventing the later increases in the amount excluded by the unified credit from eroding the value of the provision. [FN322]

Section 6601(j)(4), provides that if the deferred tax exceeds the 2% amount (i.e., if Section 6601(j)(2)(B) applies), any payment of a part of the deferred tax is treated as reducing the 2% portion by an amount bearing the same ratio to the payment as the 2% portion (determined without regard to Section 6601(j)(4)) bears to the total deferred.

Section 6622(a) requires that the interest rate be compounded daily. [FN323]

An interest rate equal to 45% of the underpayment rate, rather than the 2% rate, applies if the executor chooses the benefits of Section 6166(b)(7)(A)(iii), relating to partnership interests and stock which is not readily tradable, or Section 6166(b)(8)(A)(iii), relating to holding company stock treated as business company stock in certain cases. [FN324] Both Section 6166(b)(7)(A)(iii) and (8)(A)(iii) are discussed at III, C, 3, d, (3), (d) and (e), below.

Section 6166(f) addresses the question of when interest on Section 6166 postponed estate tax is due, with Section 6166(f)(1) providing that during the first five years, interest is payable annually. Section 6166(f)(2) provides that for periods after the first five years, interest is paid annually, at the same time as, and as a part of, each installment payment.

Where a deficiency has been assessed after the close of the five-year period and has been prorated to installments in accordance with Section 6166(e), interest attributable to the five-year period and interest assigned under Section 6166(f)(2) to any installment whose payment date arrived on or before the date of assessment of the deficiency, is payable upon notice and demand from the IRS. [FN325] If the executor selects a period of less than five years for the payment of the first installment, as Section 6166(a)(3) permits, Section 6166(f)(4) provides that the shorter period is substituted throughout the provisions summarized above.

To offset the decrease in the interest rate applicable to estates of decedents dying after 1997, Section 2053(c)(1)(D) disallows an estate tax deduction for any interest payable under Section 6601(j) on the estate tax deferred under Section 6166. Section 163(k) similarly disallows an income tax deduction for the interest. [FN326]

(4) Making the Section 6166(a)(1) Election

Regs. Section 20.6166-1(a), along with Section 6166(d), specifies the details of making an election under Section 6166(a)(1). [FN327] Section 6166(d) specifies that the election must be made no later than the time prescribed by Section 6075(a) for filing the estate tax return (nine months from the date of death), or on the last date of the extension of time for filing granted under Section 6081.

(a) At Time When Estate Tax Return Is Filed

If the election is made at the time the estate tax return is filed, it applies to the estate tax originally determined to be due and to the portion of any future deficiency which may be assessed which is attributable to a closely held business interest. [FN328]

(b) Later

If no election is made when the estate tax return is filed, the executor may elect under Section 6166(a) to pay the portion of the deficiency attributable to the closely held business interest (but not the tax originally determined to be due) in installments (provided, of course, that the entrance requirements of Section 6166(a)(1) have been satisfied), based upon values as finally determined or agreed to following audit. [FN329] Further details of the mechanics of making the election and the payments which must accompany it are set out in the regulation.

(c) Protective Election

A protective election may be made with a timely filed estate tax return in order to defer payment of so much of the tax as remains unpaid when values are finally determined or agreed to following audit and any deficiencies which are attributable to the closely held interest. [FN330] This election, however, does not extend the time for the payment of any tax; a final notice of election is required within 60 days after values are finally determined or agreed to following audit, accompanied by certain specified payments. [FN331]

d. "Interest in a Closely Held Business"

The entry requirement for Section 6166 is that there be an "interest in a closely held business," a term which is specifically defined by Section 6166(b)(1) as follows:

(A) an interest as a proprietor in a trade or business carried on as a proprietorship;

(B) an interest as a partner in a partnership carrying on a trade or business, if --

(i) 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or

(ii) such partnership had 15 or fewer partners; or

(C) stock in a corporation carrying on a trade or business if --

(i) 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or

(ii) such corporation had 15 or fewer shareholders.

There are two ways in which an activity which might at first glance be considered a "business" for Section 6166 purposes may in effect be disregarded, and Section 6166 thereby rendered unavailable. First, the activity may not satisfy the "level of active involvement" requirements which derive from the body of rulings and cases which have examined the meaning of the term "business," and which are discussed immediately below. Second, if the activity involves passive assets, it may trigger Section 6166(b)(9)(B) [FN332] which provides that the passive assets portion of the value of a closely held business interest is disregarded in determining the value of that interest, and which is also discussed in detail below.

(1) "Business" Defined

One of the earliest interpretations of the term "business" in this context is [Rev. Rul. 61-55](#), [FN333] in which the IRS considered the definition of the very similar term, "closely held business" then contained in Section 6166(c). It ruled that whereas working interests in oil and gas properties, which the decedent owned, operated, explored and developed, constitute a Section 6166 trade or business, mere royalty interests in such properties do not. Accordingly, the IRS concluded that the 40% of the decedent's gross estate which comprised working interests would be taken into account in testing for the availability of Section 6166, but the royalty interests, comprising another 6% of the estate, would be ignored. [FN334]

This same distinction between passive ownership and active participation is drawn in [Rev. Rul. 75-365](#) [FN335] and its two companion rulings -- [Rev.](#)

[Ruls. 75-366](#) [FN336] and 75-367, [FN337] as well as in PLR 7917006. In [Rev. Rul. 75-365](#), the IRS ruled that a decedent's management through his business office of commercial and farm rental properties and certain notes receivable derived in connection with these properties did not constitute a business for Section 6166 purposes. Conceding that such activities might constitute a "business" for other Code sections such as Section 162 or Section 355, [FN338] the IRS stated in [Rev. Rul. 75-365](#) that this finding should not be the sole determinant under Section 6166. It explained that

[w]hat amounts to a "trade or business" within Section 6166]... should be found in keeping with the intent of the legislature in enacting section 6166. Although the management of rental property by the owner may, for some purposes, be considered the conduct of business in the case of a sole proprietorship, 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.

... [T]he mere grouping together of income-producing assets from which a decedent obtained income only through ownership of the property rather than from the conduct of a business, in and of itself, does not amount to an interest in a closely held business within the intent of the statute.

The IRS reached the opposite result in [Rev. Rul. 75-366](#), where the decedent owned farms which were operated by tenant farmers under agreements which gave the decedent 40% of the crops and required him to bear 40% of the expenses. The decedent played an active role in the farming operation which the IRS considered to be "a productive enterprise which is like a manufacturing enterprise as distinguished from management of investment assets."

In [Rev. Rul. 75-367](#), the decedent was a builder who: (1) did home construction through a wholly-owned small business corporation and through a proprietorship; (2) conducted a real estate development and sales operation; (3) owned a business office and warehouse both of which were used by the corporation and the development and sales operation; and (4) owned and rented out several houses which he had built. The IRS ruled that while the rental activity consisted of mere investment assets and did not represent a business for Section 6166 purposes, [FN339] the other three activities had the requisite status, and since the decedent owned more than a 50% interest in each activity (as the statute then required), all three could be aggregated and treated as an interest in a single closely held business.

[Rev. Ruls. 75-365](#) and 75-367 were both cited and followed in [PLR 8352086](#), which involved management of a motel, four individual rental units, and a bowling alley. The IRS ruled that the level of the decedent's corporations' activities was insufficient to raise them to the level of a business for Section 6166 purposes. In contrast, applying the standards of [Rev. Ruls. 75-365](#) and 75-367 in [PLR 9634006](#), the IRS concluded that a property management

corporation provided the substantial services necessary to qualify it as a Section 6166 trade or business. The IRS listed the following activities conducted in properties it owned in reaching its conclusion: maintaining common areas, water, heating and sewer systems; installing and repairing fixtures, painting and making ordinary plumbing and electrical repairs; disposing of garbage; satisfying recycling requirements; mediating tenant disputes; and providing 24-hour emergency service. The IRS also found that the portion of the business devoted to managing properties owned by others qualified as a trade or business. Rev. Rul. 75-365 was also cited and followed in PLR 8020101, where the decedent died in 1978 at the age of 97 owning a large farm property in his own name and miscellaneous farm assets jointly with his children. In the three years before his death, he gave his children \$75,000 worth of livestock which was included in his estate under then Section 2035. Noting that at the time of his death and for a year before, the decedent had not taken any active part in farm management, the IRS ruled that Section 6166 was unavailable to the estate. TAM 9635004 also cited Rev. Ruls. 75-365, 75-366, and 75-367 in advising that an asset the decedent owned, which comprised two-thirds of the land used in the cattle ranching business the decedent engaged in as the proprietor of a sole proprietorship and a partner in a partnership, was an interest in a closely held business under Section 6166(b)(1)(A). The National Office concluded that the asset qualifies for Section 6166 treatment even though it was owned by the decedent individually, and not by the partnership, noting that the decedent's ownership did not diminish its essentialness to the overall operation of the cattle ranching business.

This same splintering approach of looking separately at the decedent's level of participation in each activity within a group of activities, was followed in PLR 7917006, where the decedent's activities in connection with the leasing of property to his wholly owned corporation (which the IRS agreed was a "business" within the meaning of the statute) were ruled to be insufficient, thereby disqualifying the estate from using the installment provisions.

In PLR 8229099, the activity under scrutiny was the operation of a cattle ranch. The decedent and her husband were killed in an airplane crash, with the husband dying one hour before the decedent. Despite the fact that her husband owned and operated the ranch and that the "[d]ecedent performed the usual duties of a ranch wife and did not own any of the ranch real estate (except for a half interest in a forty acre tract) or personal property," the IRS nevertheless ruled that her estate could make a Section 6166 election because the husband's ranching business had the same character in her hands that it had had in his.

The IRS explained:

A determination as to whether an interest in a closely held business exists is to be made as of the time immediately before the decedent's death. Therefore, if it has been determined that the ranch and farm included in the

deceased spouse's estate qualify as an interest in a closely held business, they would retain the same character when distributed to the decedent's estate. As long as the ranch and farm are actively engaged in a trade or business operated by the decedent, her employee or her agent (trustee) acting in her behalf, the ranch and farm are to the decedent what they were to the deceased spouse. [FN340]

Further weakening the precedential value of the ruling, the IRS' concluding paragraph stated:

This ruling is directed only to the estate that requested it and does not make a determination as to whether or not the deceased spouse's ranch and farm qualify as an interest in a closely held business.

PLR 8240055 involved the status of a real estate rental business in which the decedent had been engaged as a sole proprietor of 50 pieces of rental real estate, including 323 separate living units, as well as three commercial offices, a furniture store, and a warehouse. She directly supervised a number of employees and outside independent contractors who performed administrative, maintenance, and repair functions; she was personally responsible for determining maintenance work priorities; she or her staff negotiated leases, collected rents, and initiated eviction proceedings. Distinguishing two earlier published rulings, [Rev. Ruls. 75-365](#) and 75-367, on the degree of the personal involvement of the decedent and her business, the IRS ruled that the decedent's interest in the properties constituted a business stating

If a proprietorship that leases real property to others does more than merely collect rents, administer mortgages, and pay property taxes, etc. (considered management of investments), it is considered to be a service enterprise, carrying on a trade or business for purposes of Section 6166.

There have been quite a few other private rulings on the question whether an aggregate of activities constitutes a business for purposes of Section 6166. [FN341]

(a) Section 6166(b)(9) Denial of Deferral for Passive Assets

The Tax Reform Act of 1984 amended Section 6166(b) by adding paragraph (9). [FN342] The general rule of this addition, which applies to estates of decedents dying after July 18, 1984, is to exclude from the determination of the value [FN343] of an interest in a closely held business qualifying under Section 6166(a)(1) the value of that portion of the interest which is attributable to "passive assets" held by the business.

The purpose of this addition was to place Section 6166(a)(1) closely held

business interests in partnerships or corporations on a par with sole proprietorships. [FN344] Thus, under the prior regulations, the determination of the value of a sole proprietorship interest under Section 6166(a)(1) was based solely upon assets used in the decedent's trade or business and did not include passive assets; [FN345] whereas for the corresponding determination with respect to partnerships and corporations all assets were included. [FN346]

A "passive asset" is generally defined for purposes of Section 6166(b)(9) as "any asset other than an asset used in carrying on a trade or business." [FN347] This presumably throws one back on the administrative interpretations of "business" discussed above at III, C, 3, d, (1).

Section 6166(b)(9)(B)(ii) states that stock in another corporation will be considered a passive asset unless the stock

(1) is treated as held by the decedent by reason of an election under Section 6166(b)(8) [FN348] and

(2) qualified under Section 6166(a)(1) (i.e., it constituted an interest in a closely held business).

Example: D owns 90% of the stock of X Corp., which in turn owns 100% of H Corp. X's main business is a manufacturing one; H's activities are confined to investment in the securities market. D dies. For purposes of Section 6166(a)(1), the value of D's interest in a closely held business is determined without reference to that portion of the value of his X Corp. stock which is attributable to its ownership of its investment subsidiary (which does not constitute a "business" for Section 6166 purposes).

However, there is an exception to the general rule of Section 6166(b)(9)(B)(ii) treatment of stock as a passive asset. This is found in Section 6166(b)(9)(B)(iii), which provides:

EXCEPTION FOR ACTIVE CORPORATIONS--If--

(I) a corporation owns 20 percent or more in value of the voting stock of another corporation, or such other corporation has 15 or fewer shareholders, and

(II) 80 percent or more of the value of the assets of each such corporation is attributable to assets used in carrying on a trade or business,

then such corporations shall be treated as 1 corporation for purposes of clause (ii). For purposes of applying subclause (II) to the corporation holding the stock of the other corporation, such stock shall not be taken into account.

Example: D owns 90% of the stock of X Corp. which owns 51% of the stock of

Y Corp. More than 80% of the value of the assets of X Corp., exclusive of its Y Corp. stock, is made up of assets used in carrying on an active trade or business; and more than 80% of Y's assets is similarly composed. For purposes of Section 6166(b)(9)(B)(ii), X and Y Corps. are treated as one. Note : Effective for estates of decedents dying after December 31, 2001, the 2001 Tax Relief Act, [P.L. 107-16, Section 571](#), amended Section 6166(b)(9)(B)(iii)(I) to increase the maximum number of shareholders in a corporation from 15 to 45.

(b) Timing of Section 6166(a)(1) Determination

At what point in time is the determination made as to whether the decedent owns an interest in a closely held business of the requisite value? As to quantum of ownership, the determination is made immediately before the decedent's death, [FN349] subject only to the comment that since the test is one as to "value," [FN350] the valuation of the interest as so determined may be the date-of-death valuation, [FN351] the alternate valuation, [FN352] or, in an appropriate case, the valuation under Section 2032A.

(c) Stock Acquired in a Reorganization

If after the decedent's death, there is a corporate reorganization involving the stock which he or she owned while alive, and as a consequence that stock is exchanged for stock in another corporation, this reorganization does not necessarily render the benefits of Section 6166 unavailable to the estate. In [PLR 8607089](#), the decedent owned 80% of A Corp., with X and Y owning 7% and 13%, respectively. Substantially all of A Corp.'s net assets were acquired by B Corp. in a stock-for-property reorganization; [FN353] A Corp. shareholders received B Corp. stock and A Corp. was dissolved. The IRS ruled that the decedent's estate was entitled to treat the B Corp. stock received by it as an interest qualifying under Section 6166(a)(1).

(2) An "Interest in a Closely Held Business"

The discussion of the meaning of the term "business" in a Section 6166(a) context (see III, C, 2, d, (1) above) revealed that its meaning is not as broad as the meaning given to it, for example, by Section 162. Assuming, then, that the decedent was involved in a group of activities sufficient to amount to a Section 6166 business, what additional requirements are there before the "closely held" element can be deemed satisfied? Section 6166(b) gives the term three separate definitions, depending upon the vehicle by which the business was conducted.

(a) Proprietorship

The first definition of "interest in a closely held business" states that the term means "an interest as a proprietor in a trade or business carried on as a proprietorship." [FN354]

Example: B, a widower, owns and operates a highly successful dry-cleaning business which is valued, at his death, at \$250,000. B exhausted his unified credit during his lifetime on gifts to family members. His total gross estate amounts to \$400,000. B's dry-cleaning proprietorship is an interest in a closely held business for purposes of Section 6166(a)(1) and clearly exceeds the requisite 35% of his adjusted gross estate.

(b) Partnership Interest

For an interest as a partner in a partnership carrying on a trade or business to be classified as an interest in a closely held business, one of two conditions must be satisfied. Either 20% or more of the total capital interest in the partnership must be included in determining the decedent's gross estate or the partnership must have had 15 or fewer partners. [FN355]

For purposes of the partnership provision and the companion corporation provision discussed immediately below, the constructive ownership rules of Section 6166(b)(2)(B), (C), and (D) apply. [FN356]

(c) Stock in a Corporation

For stock in a corporation to be an interest in a closely held business, either 20% or more in value of the corporation's voting stock must be included in determining the decedent's gross estate or the corporation must have 15 or fewer shareholders. [FN357] Note that under the first option, the statute does not require that the decedent's interest in the closely held business be constituted exclusively of voting stock; the requirement that 20% or more of the voting stock be included in his gross estate goes to the definition of the kind of corporation which must be involved.

Example: ABC Corp. has three classes of common stock, Class A voting, Class B non-voting common, and preferred. The Class A common is worth \$1,000,000 and the Class B \$800,000. D, the decedent, had an adjusted gross estate worth \$7 million. D owned 51% of the Class A common which by itself would not be sufficient to meet the 35%-of-adjusted-gross-estate requirement. D also owned 25% of the Class B, non-voting common stock and \$2,000,000 in value

of ABC Corp.'s preferred.

Whether D's estate may avail itself of the provisions of Section 6166 depends upon whether the aggregate of D's investments in the company (\$2,710,000) exceeds 35% of his \$7 million adjusted gross estate. It is immaterial that D's \$510,000 in value of the Class A stock is considerably less than 35% of D's adjusted gross estate; what counts is that more than 20% of the Class A stock is included in the gross estate, which makes D's ABC stock an interest in a closely held business.

It should be noted that the "maximum number of shareholders" alternative requirement makes no reference to the class of stock which the shareholders own. If a decedent's estate owned, e.g., 15% of the voting stock of a corporation with five unrelated individuals owning the other 85%, but there was a class of preferred stock which was owned by a group of 50 or more, the decedent's 15% voting stock interest might be well in excess of 35% of his adjusted gross estate, but Section 6166 would unfortunately be beyond his executor's reach because the decedent's estate would be unable to satisfy either Section 6166(b)(1)(C) alternative.

(d) Farmhouses and Certain Other Structures

Section 6166(b)(3), which might be named the bunkhouse provision, provides that where the closely held business is farming, the interest in that business is, for purposes of the 35% test, deemed to include

an interest in residential buildings and related improvements on the farm which are occupied on a regular basis by the owner or lessee of the farm or by persons employed by such owner or lessee for purposes of operating or maintaining the farm. [FN358]

This presumably applies in the situation in which a farm is incorporated, but the homestead property where the family lives is held, for example, by the farmer and his wife. The whole complex, including the farmhouse (to the extent included in the decedent farmer's gross estate), would be available to satisfy the requirement that the interest in the closely held business exceed 35% of the decedent's adjusted gross estate.

Example: D, a widow, owned land on which are located (1) a farmstand, (2) a farm, (3) a greenhouse, and (4) two residences, one of which was occupied by D and the other by D's son and his family. D's son was a partner in the family-run business. D was actively engaged in running the farm, the greenhouse, and the farmstand as long as she was physically able, after which her son and his family continued the business up to and after her death. All of D's land -- including the portions used for the family residences, qualifies for the

Section 6166(a) election. [FN358.1]

(3) Special Rules

There are a series of special rules which are applied to the proprietorship, partnership, and shareholder interest discussed above, in order to determine whether there is an interest in a closely held business. [FN359] These rules fall under the following headings:

(I) Husband and wife (Section 6166(b)(2)(B));

(II) Indirect ownership (Section 6166(b)(2)(C));

(III) Decedent's family (Section 6166(b)(2)(D));

(IV) Farmhouses, etc. (Section 6166(b)(3));

(V) Partnership interests and stock which is not readily tradable (Section 6166(b)(7));

(VI) Certain holding company stock (Section 6166(b)(8)); and

(VII) Interests in two or more closely held businesses (Section 6166(c)).

(VIII) Qualifying lending and finance business stock (Section 6166(b)(10)).

(a) Husband and Wife

For purposes of determining whether there is an interest in a closely held business, stock or partnership interests held in certain modes by a husband and wife are treated as being held by one of them. [FN360] Note that this rule applies only to questions arising under Section 6166(b)(1)(C)(ii) (number of shareholders).

More precisely, the statute deals with two situations. The first is where applicable state community property law treats the interest in question as the spouses' community property or the income therefrom as their community income. [FN361] The second is where the couple hold the interest jointly, either as joint tenants, tenants by the entirety, or tenants in common. [FN362]

Example: H and W own 18% in value of the voting stock of X Corp. as joint tenants with right of survivorship. H's cousin and her husband are also the joint owners of X stock, as are W's nephew and his wife. Eleven unrelated

employees of X Corp. own the rest of its stock. H dies, survived by W. Since H and W owned only 18% of the X Corp. stock, only one-half of which is included in H's gross estate, [FN363] H's estate cannot satisfy the requirements of Section 6166(b)(1)(C)(i) that 20% or more in value of the voting stock is included in the decedent's gross estate. [FN364] H's estate can satisfy the 15-or-fewer-shareholders alternative under Section 6166(b)(1)(C)(ii), however, because under the husband-wife rule, X Corp. is deemed to have 14 shareholders (the 11 employees, plus the three husband-wife combinations). Therefore, the X stock owned by H's estate is an interest in a closely held business for purposes of Section 6166(a)(1). Note that this example uses the limitation on the maximum number of shareholders in effect for estates of decedents dying before January 1, 2002.

(b) Indirect Ownership

Section 6166(b)(2)(C) provides that "property owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries." A person is regarded as a "beneficiary" of a trust only if the interest owned is a present interest. [FN365]

This attribution is by its terms very limited and, in contrast to the broadly worded attribution rules of Section 318, flows in one direction only - from entity to participant -- and not "upstream."

Example: Father, F, bequeathed X Corp. voting stock to his son, S. There are over 50 shareholders of X Corp. S dies before receiving the bequest from F's estate. S, an X Corp. voting stock shareholder in his own right, also is the holder of a remainder interest in an irrevocable trust created by his grandfather. For generation-skipping transfer tax purposes, [FN366] S's grandfather's trust provides that if, as has happened, S dies before attaining age 40, the trust principal remaining at his death passes to his estate with no gift over. At S's death, the trust owns some X Corp. voting stock.

To determine whether S's estate satisfies the at-least-20% requirement of Section 6166(b)(1)(C)(i), all three holdings of X Corp. stock are aggregated: F's bequest to S, S's own stock, and the shares held in the trust set up by S's grandfather. [FN366.1]

In cases where the Section 6166(b)(2)(C) indirect ownership rule fails to get an estate over the 20% hump, that same provision may block the alternative 15 or fewer shareholders route to qualification. [FN367]

Example: The decedent, D, was a 15% partner in a partnership with 19 other individuals. The partnership owns 1,000 shares of X Corp., or 50% of the total

value of the X Corp. voting stock. D's estate may aggregate 5% (1/20th) of the 1,000 shares with D's personal holdings in X Corp. to try to meet the 20% test (although only the shares actually included in D's estate would be taken into account in applying the 35% of adjusted gross estate test). If the aggregation does not result in D's estate becoming a 20% shareholder, the alternative route is unavailable, because X Corp. will be deemed to have at least 20 shareholders, i.e., D and his 19 partners. Note that this example uses the limitation on the maximum number of shareholders in effect for estates of decedents dying before January 1, 2002.

(c) Decedent's Family

Section 6166(b)(2)(D) incorporates the Section 267(c)(4) attribution rule and provides that any stock or partnership interest held by the decedent or any member of his or her "family" as defined in Section 267(c)(4) is treated as owned by the decedent. According to the IRS, [FN367.1] the Section 6166(b)(2) attribution rules apply for purposes of determining whether a partnership or corporation has exceeded the maximum number of partners/shareholders within the meaning of Section 6166(b)(1), but do not apply for purposes of the 35% of adjusted gross estate test of Section 6166(a)(1), the 20% test in §§ 6166(b)(1)(B)(i) and 6166(b)(1)(C)(i), or the formula used in determining the maximum amount of tax that may be paid in installments set forth in Section 6166(a)(2).

Section 267(c)(4) states in full:

The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. Regs. Section 1.267(c)-1(a)(4) provides that in the application of this definition, full effect is to be given to legal adoptions.

(d) Partnership Interests and Stock Which Is Not Readily Tradable

Section 6166(b)(7) provides a separate, more involved, set of attribution rules for determining whether a decedent has an interest in a closely held business that provide less favorable deferral benefits. The executor's express election is required for deferral under Section 6166(b)(7).

The first thing to be noted is that Section 6166(b)(7) applies only to capital interests in partnerships and non-readily-tradable-stock which (after the application of Section 6166(b)(2)) is treated as owned by the decedent. "Non-readily tradable stock" is defined by Section 6166(b)(7)(B) as "stock for which, at the time of the decedent's death, there was no market on a stock exchange or in an over-the-counter market."

If this initial definitional requirement is met and the executor so elects, then Section 6166(b)(7)(A) provides that the partnership interest or non-readily-tradable stock attributed to the decedent is treated as included in the value of the decedent's gross estate for purposes of:

(1) whichever of Section 6166(b)(1)(B)(i) or (C)(i) is appropriate (the 20% tests for determining the existence of an interest in a closely held business), and

(2) Section 6166(c) (relating to interests in two or more closely held businesses treated as a single entity).

Two consequences automatically flow from the executor's election to have Section 6166(b)(7) apply. First, the 2% interest rate provision of Section 6601(j) does not apply. [FN368] Second, the first installment of tax will be due on the Section 6151(a) date for the payment of the estate tax and there will be no five-year deferral available. [FN369] The following example illustrates the operation of Section 6166(b)(7).

Example: The decedent, D, whose adjusted gross estate equals \$900,000, owned a 10% interest in XYZ Partnership that was worth \$350,000. D's brother, B, also owns a 10% interest in XYZ. XYZ has 50 other unrelated partners. D's executor makes the Section 6166(b)(7) election. For purposes of the "interest in a closely held business" test of Section 6166(b)(1)(B)(i), Section 6166(b)(2)(D) attributes B's XYZ interest to D, resulting in D having a qualifying 20% interest. However, for purposes of the 35% test of Section 6166(a)(1), D's interest in a closely held business is limited to his own 10% interest in XYZ. Since D's adjusted gross estate is \$900,000, D's estate will meet the 35% ($350,000/900,000 = 38.9\%$) test and be eligible for Section 6166(b)(7) deferral. If D's estate had exceeded \$1 million, D's estate would not qualify for deferral because D's interest in a closely held business would not have met the 35% test. [FN369.1]

If D's executor had not made the election under Section 6166(b)(7), D would not qualify as having an interest in a closely held business under Section 6166(b)(1)(B)(i). Thus, even though D's \$350,000 interest in XYZ exceeds 35% of his \$900,000 adjusted gross estate, D's estate would not be eligible for deferral.

Similarly, the decedent's executor may make the Section 6166(b)(7) election for purposes of Section 6166(c), which would allow the decedent's less-than-20% in one entity to be added to another interest in a closely held business to meet the 35% test.

Example: D's 25% partnership interest in ABC comprised \$200,000 of his \$1 million adjusted gross estate. D also was a 10% partner in EFG, a partnership

with 50 partners. D's brother, B, also was a 10% EFG partner. A 10% interest in EFG was worth \$160,000. D's ABC partnership alone does not meet the 35% test ($200,000/1,000,000 = 20\%$) for deferral under Section 6166(a). Therefore, D's executor makes the Section 6166(b)(7) election with respect to EFG, which results in D meeting the Section 6166(b)(1)B(i) 20% test and ABC and EFG being treated as a single closely held business under Section 6166(c). Since the combined value of ABC and EFG exceeds 35% of D's adjusted gross estate, ($[200,000 + 160,000]/1,000,000 = 36\%$), D's estate will qualify for the less-favorable benefits of Section 6166(b)(7).

(e) Certain Holding Company Stock

Section 6166(b)(8), [FN370] in effect, provides an exception to the Section 6166(b)(9) no-deferral-for-passive-assets rule which is discussed at III, C, 2, d, (1), (a), above. As with Section 6166(b)(7), [FN371] the executor must make an election to have Section 6166(b)(8) apply. [FN372] If an election is made, the same consequences flow as in the case of the Section 6166(b)(7) election -- the Section 6601(j) 2% interest rate is not available and the first installment of estate tax is due on the Section 6151(a) date for the payment of estate tax, rather than up to five years later. [FN373]

The effect of making the Section 6166(b)(8) election is that for purposes of Section 6166, "holding company stock" is treated as "business company stock" to the extent that it represents "direct ownership (or indirect ownership through 1 or more other holding companies)" by the holding company in such a business company. [FN374] A "holding company" is any corporation holding stock in another corporation; [FN375] a "business company" is any corporation carrying on a trade or business. [FN376] In other words, the absence of an active business at the holding company level does not prevent the decedent's ownership of holding company stock from being considered an "interest in a closely held business." Note: The only stock which may be taken into account for purposes of Section 6166(b)(8) is "non-readily tradable stock," i.e., stock for which, at the decedent's death, there was no market on a stock exchange or in an over-the-counter market. [FN377] Effective for estates of decedents dying after December 31, 2001, Section 572 of the 2001 Tax Relief Act, [P.L. 107-16](#), amended Section 6166(b)(8)(B) to add a provision in (ii) clarifying that only the stock of the holding companies, not that of the operating subsidiaries, must be non-readily tradable in order to qualify for the Section 6166(b)(8) election. However, if Section 6166(b)(8)(B)(ii) applies (that is, if stock in an operating subsidiary is not non-readily-tradable stock), then the estate must make all installment payments (including principal and interest) over no more than five (instead of 10) years.

Section 6166(b)(8)(C) further provides that for purposes of Section 6166(b)(1)(C)(i), which imposes the requirement that 20% or more in value of the voting stock of the closely held business must be included in determining the decedent's gross estate if it is to constitute an interest in a closely held business, the holding company stock that is deemed to be business company stock pursuant to Section 6166(b)(8)(A) is treated as voting stock "to the extent that voting stock in the holding company owns directly (or through the voting stock of 1 or more other holding companies) voting stock in the business company."

Example: D, the decedent, owned 60% of the voting and sole class of the stock of HC. HC owned 100% of the voting stock of A Corp., 60% of the voting common stock of B Corp., and 50% of the voting common stock of C Corp. A, B and C are engaged in manufacturing businesses.

If D's executor so elects, D's estate will be treated as owning the following percentages of the voting stock of A Corp., B Corp. and C Corp.:

A Corp.	60%	(60% of 100%)
B Corp.	36%	(60% of 60%)
C Corp.	30%	(60% of 50%)

D's estate will therefore be deemed to own an interest in a closely held business with respect to all three of A, B, and C Corporations. See III, B, 2, c, (2), above for a discussion of the Section 303(b)(2)(B) special rule for aggregation of interests in two or more closely held businesses, which is parallel in application to the Section 6166(c) special aggregation rule.

It should be noted that Section 6166(b)(8) may have broader application than merely enabling an estate to meet the Section 6166(b)(1)(C)(i) requirement for the interest in a closely held business. That requirement may be met in some other way (for instance, through D's direct ownership in the preceding example of stock in A Corp., B Corp. and C Corp. or his ownership through family or entity attribution). In such cases, Section 6166(b)(8) would enable D's estate to increase the amount of value attributable to the interest in a closely held business and correspondingly to increase the amount of tax which might be deferred. This is so because the definition of an interest in a closely held business where the business is conducted in corporate form is stock (i.e., all stock) in a corporation if the decedent's gross estate owns 20% or more in value of the corporation's voting stock (or if the corporation does not exceed the Section 6166(b)(1)(C)(ii) limit on the number of shareholders).

(f) Certain Corporations in Existence on June 22, 1984

Under a special grandfather rule in Section 1021(d) of the Tax Reform Act of 1984, if a corporation had 15 or fewer shareholders on June 22, 1984 and at all times before the decedent died, and stock of the corporation is included in the decedent's gross estate, the executor may elect to treat the stock of all wholly owned subsidiaries of the corporation as one corporation for Section 6166 purposes, provided that "at least some of the subsidiaries are carrying on a trade or business." [FN378]

(g) Qualifying Lending and Finance Business Stock

Effective for estates of decedents dying after December 31, 2001, the 2001 Tax Relief Act, [P.L. 107-16, Section 572](#), added Section 6166(b)(10) which expands the availability of Section 6166 to estates with interests in qualifying lending and finance businesses. Section 6166(b)(10)(A) indicates that if a decedent's executor makes an election under Section 6166(b)(10), then any asset used in the qualifying lending and finance business is treated as an asset used in carrying on a trade or business. Under Section 6166(b)(10)(A)(ii), the first installment of tax will be due on the Section 6151(a) date for the payment of the estate tax, so the estate cannot defer principal payments for five years. Under Section 6166(b)(10)(A)(iii), the estate must make all installment payments of principal and interest over no more than five (instead of 10) years.

A lending and finance business is a qualifying lending and finance business if there was substantial lending and finance business activity immediately before the decedent's death, based on all the facts and circumstances. A qualifying lending and finance business also includes a lending and finance business that had, during at least three of the five taxable years ending before the decedent's death, at least: (i) one full-time employee devoting substantially all of his or her services to the active management of the business; (ii) 10 full-time, nonowner employees devoting substantially all of their services in a manner directly related to the business; and (iii) \$5 million in gross receipts from lending and finance business activities. Section 6166(b)(10)(B)(i). A qualifying lending and finance business does not include an interest in an entity if the stock or debt of the entity (or a Section 267(f)(1) controlled group of which the entity is a member) is readily tradable on an established securities market or a secondary market at any time within three years before the decedent's death. Section 6166(b)(10)(B)(iii).

A lending and finance business refers to a trade or business of: (i) making loans; (ii) purchasing or discounting accounts receivable, notes, or installment obligations; (iii) renting and leasing real and tangible personal property (including entering into leases and purchasing, servicing, and disposing of leases and leased assets); (iv) providing services or making

facilities available in the ordinary course of a lending or finance business; and (v) providing services or making facilities available in connection with the activities described in (i) through (iv). Under (v), the services or facilities may be provided by another corporation that is a member of the same affiliated group of corporations as defined in Section 1504 (without regard to Section 1504(b)(3)). Section 6166(b)(10)(B)(ii).

e. Proration of Deficiency to Installments

Section 6166(e) addresses the situation where the executor makes an election under Section 6166(a) (other than the protective election discussed below) to pay the estate tax in installments, and an estate tax deficiency [FN379] is subsequently assessed against the estate. Subject to the limitation of Section 6166(a)(2), the deficiency [FN380] is prorated against the installments so elected. [FN381] As to any installments already paid, that much of the assessed deficiency is payable upon notice and demand by the IRS; [FN382] as to installments which have not already been paid, a proportionate part of the deficiency is added to, and payable at the same time as, each installment of the tax.

Where the executor has not made a Section 6166 election (including a protective election) and an estate tax deficiency is subsequently assessed, the situation comes within Section 6166(h) discussed at f, below.

The protective election is defined in Regs. Section 20.6166-1(d) as an election to defer payment of so much of the tax as remains unpaid when estate tax values are finally determined (or, as is frequently the case, agreed to on audit), as well as any deficiencies [FN383] which are attributable to the closely held business interest. Under Regs. Section 20.6166-1(d), a protective election (which is made by a statement attached to a timely filed estate tax return) does not extend the time for the payment of any tax and has to be "perfected" by the filing of a final election in order to obtain such extension. The final election must contain the same information (specified in Regs. Section 20.6166-1(b) [FN384]) as is required for a full-blown election made with the Form 706. The final election must be accompanied by payment of any amount of previously unpaid tax and interest.

Regs. Section 20.6166-1(i) gives a number of examples of how the election mechanism is intended to work.

Example: The decedent's timely filed Form 706 shows a Section 6166 closely held business consisting of a farm. The decedent's executor (E), makes a Section 6166 protective election with the return, and applies for and receives a one-year Section 6161 extension of time for payment of \$15,000 of the \$30,000 of estate tax shown due on the 706. This extension is renewed at

the end of the year. On audit, the value of the farm is found to be 67% of the adjusted gross estate. E consents to an estate tax deficiency of \$5,000 and 18 months after the Form 706 was filed, E files a final notice of election electing a five-year deferral followed by 10 annual installment payments. The Section 6161 extension was terminated since the tax as to which the extension had been obtained was now included under the Section 6161 election. Sixty-seven percent of the total tax of \$35,000 or \$23,450, is the maximum amount for which E could have extended payment, and the Section 6166 election is considered to be for that amount. E has already paid \$15,000 (with the 706), leaving \$20,000 of unpaid tax. Accordingly, E is considered to have prepaid \$3,450, of which \$2,345 is attributed to the first installment (\$23,450 divided by 10), and the other \$1,105 is applied against the second installment.

E's notice of final election must be accompanied by the payment of all unpaid accrued interest. Interest on the \$5,000 is computed at 4% for the entire 18 months; interest for 12 months of that period is to be paid with the final election. Interest for the remaining six months is due at the next succeeding date for payment of interest. Interest on the \$15,000 of tax extended under Section 6161 is computed at the regular Section 6621 rate until the date of the final election and is payable when the Section 6161 extension terminates. After such termination, the interest on the \$15,000 will also accrue at the 4% rate.

If E's Section 6161 extension had been for \$20,000 rather than \$15,000, the unpaid estate tax (including the deficiency) at the time when the Section 6166 election was made, would have been \$25,000. \$23,450 of this would have been covered by the Section 6166 election, leaving \$1,550 to be paid upon expiration of the Section 6161 extension of time. [FN385]

f. Election in Case of Certain Deficiencies

Section 6166(h) gives the executor the right to elect to pay certain estate tax deficiencies in installments. [FN386] It applies in situations where the estate qualifies under Section 6166(a)(1), [FN387] but no election has been made under Section 6166(a). The executor has 60 days from the issuance of the notice and demand for payment of the deficiency in which to make the election. [FN388]

Subject to the limitation of Section 6166(a)(2), the deficiency is to be prorated to the installments which would have been due if there had been a timely Section 6166(a)(1) election. That part of the deficiency which is prorated to an installment or installments which would already have been paid is required to be paid when the election is made (see example at e, above).

g. Acceleration of Payment

The Code gives and the Code takes away. Section 6166's "taking away" provision is subsection (g), which prescribes in no uncertain terms what happens if various types of disposition are made by the holder of an interest in a closely held business before all of the benefits of Section 6166 have been reaped; the significance of accumulations of income by an estate; and the consequences of a failure to make an interest or principal payment when due. Note : The Conference Agreement accompanying the 2001 Tax Relief Act, [P.L. 107-16](#), indicates that the rules accelerating the unpaid Section 6166 installments if more than 50% of the closely held business is disposed of will continue to apply after 2009 to estates of decedents dying before January 1, 2010, because the repeal of the estate tax is effective only for decedents dying after December 31, 2009.

(1) Disposition of Interest; Withdrawal of Funds from Business

(a) General Rule

Section 6166(g)(1) provides that if any of the events enumerated in Section 6166(g)(1)(A)(i)(I) or (II), and listed below takes place and the aggregate of the distributions, sales, exchanges, or other dispositions and withdrawals from an interest in a qualifying closely held business exceeds 50% of the value of that interest, [FN389] the Section 6166(a) extension of time for the payment of tax ceases to apply, and the balance of the tax which was payable in installments becomes payable upon notice and demand from the IRS.

The prohibited events are:

1. The distribution, sale, exchange or other disposition of any portion of the qualifying interest; and
2. The withdrawal from the underlying trade or business of "money and other property attributable to" the interest. [FN390]

Example: The decedent (D) owns 100% of voting and sale class of stock of X Corp. which qualifies as an interest in a closely held business. D's executor makes a Section 6166(a) election and then receives an offer from an interested third party for the purchase of the stock. If the executor accepts the offer and makes the sale, the extension is terminated and the estate tax attributable to the stock becomes payable upon notice and demand, together with all accrued interest.

The Section 6166(g)(1)(A)(i)(II) prohibition is against withdrawals of money or other property "attributable" to the closely held business interest.

Query whether this would proscribe a loan by a corporation to the estate of a decedent availing itself of Section 6166. It could be argued not to include such a loan on two counts: (1) because a true loan with an enforceable obligation to repay does not amount to a "withdrawal"; and (2) if a loan is a withdrawal, it is not "attributable" to the estate's closely held business interest.

(i) Provisions in the Code

Section 6166(g)(1)(E) clarifies that the general rule of Section 6166(g)(1)(A) applies to the stock of a holding company which, by the application of Section 6166(b)(8)(A), is treated as a business company to the same extent as it does to a "regular" business corporation. The disposition of any qualifying interest in the stock of such a holding company which was included in the decedent's gross estate or the withdrawal of money or other property which was attributable to any such interest is treated as a Section 6166(g)(1)(A) disposition or withdrawal.

Section 6166(g)(1)(F) provides that if Section 6166(b)(8)(A) treats any stock in a holding company as stock in a business company and the holding company disposes of any interest in the business company stock or withdraws any money or other property from the business company, the disposition or withdrawal is to be treated as a disposition or withdrawal with respect to, stock qualifying under Section 6166(a)(1).

(ii) Private Letter Rulings

A number of private letter rulings have addressed the question whether a Section 6166(g) acceleration has been triggered. In [PLR 7825029](#), the IRS ruled that where an estate proposes to transfer stock to trusts for the decedent's children followed by the trusts' transfer of the stock to a limited partnership, the partnership's liquidation of the corporation and distribution of the corporation's assets to itself is a "mere step in the process of changing from a corporate to an unincorporated form." The IRS ruled in [PLR 8441029](#) that an estate's sale of business assets to pay unpaid balances on mortgages which encumbered a closely held business (including accrued interest) is not a disposition of an interest or a withdrawal of funds to the extent that the funds are used to pay down the mortgages that existed at the date of death (including accrued interest). See also [PLRs 8103066](#) and [8213075](#).

In [PLR 8220119](#), the IRS ruled that a mere change in form occurs when a testamentary trust transfers stock and a sole proprietorship interest to a newly formed corporation in exchange for common stock, but the exchange of stock for debentures (which approximate the size and times of the later Section

6166 installments) is a Section 6166(g) "disposition" and not a mere change in form. It stated, however, that if less than one-third (now 50%) of the decedent's closely held stock is involved, no acceleration occurs. See also [PLRs 8841006](#) (estate's transfer of stock to partnership which liquidated corporation and sold some of former corporation's assets to discharge partnership debts is disposition, citing [Rev. Rul. 66-62, 1966-1 C.B. 272](#)); 8334022 (estate's distribution of closely held stock to marital trust which subsequently distributed stock to surviving spouse is disposition); and 9202017.

(b) Section 303 Redemption Exception

(i) In General

Section 6166(g)(1)(B)(i) provides that subject to satisfaction of a prescribed condition in Section 6166(g)(1)(B) which is discussed immediately below, a redemption of stock to which Section 303 (or so much of Section 304 as relates to Section 303) applies, and the withdrawal from the corporation comprising the closely held business interest of the money or other property distributed in the redemption, is not treated as a Section 6166(g)(1)(A) distribution or withdrawal. In addition, for purposes of the subsequent application of Section 6166(g)(1)(A), the value of the closely held business interest is reduced by the value of the stock so redeemed. [FN391]

The condition upon which Section 6166(g)(1)(B)(i) and (ii) is based is that on or before the date fixed by Section 6166(a)(3) [FN392] for the payment of the first installment of the deferred estate tax which becomes due after the date of the distribution (of, if earlier, on or before the day which is one year after the date of the distribution), an amount of tax is paid which is at least equal to the amount of money and other property which was distributed. [FN393]

(ii) Interrelationship of Sections 6166 and 303

Sections 6166 and 303 should "operate in harmony." As the 1976 House Report on Section 303 put it:

The extended period for redemption is intended to more closely correlate [the two sections], particularly in that it would allow the corporation to build up liquid assets and redeem stock so that the payment of the estate taxes might be made at any time throughout the period for making the installment payments of tax. [FN394]

(iii) Certain "Reorganization" Exchanges Excepted

Under Section 6166(g)(1)(C), Section 6166(g)(1)(A)(i) does not apply to an "exchange of stock pursuant to a plan of reorganization described in subparagraph (D), (E), or (F) of section 368(a)(1) [or] to an exchange to which section 355 (or so much of section 356 as relates to section 355) applies." [FN395] The stock received in such an exchange is treated for Section 6166(g)(1)(A)(i) purposes as a closely held business interest. [FN396] A "(D)" reorganization is an asset for stock reorganization; an "(E)" reorganization is a recapitalization; and an "(F)" reorganization involves "a mere change in identity, form, or place of organization of one corporation, however effected."

(iv) Certain Transfers to Beneficiaries Excepted

Section 6166(g)(1)(D) provides that Section 6166(g)(1)(A)(i) does not apply to

a transfer of property of the decedent to a person entitled by reason of the decedent's death to receive such property [1] under the decedent's will, [2] the applicable law of descent and distribution, or [3] a trust created by the decedent. A similar rule shall apply in the case of a series of subsequent transfers of the property by reason of death so long as each transfer is to a member of the family (within the meaning of section 267(c)(4)) of the transferor in such transfer. [FN397]

(2) Undistributed Income of an Estate

Section 6166(g)(2) requires the electing estate of a decedent to use its "undistributed net income" to pay down the unpaid portion of the estate tax which is payable in installments. More specifically, Section 6166(g)(2)(A) states that the undistributed net income "for any taxable year ending on or after the due date for the first installment" must be so applied "on or before the date prescribed by law for filing the income tax return for each taxable year (including extensions thereof)."

Section 6166(g)(2)(B) provides that "undistributed net income" is the amount by which the estate's distributable net income for the taxable year exceeds the sum of

(1) the estate's Section 6166(a)(1) and (a)(2) distribution deductions for such year;

(2) the income tax "imposed" on the estate for such year; and

(3) the amount of estate tax imposed by Section 2001 (including interest) and paid by the estate during the year (otherwise than as a result of Section 6166(g)(2)).

Section 6166(g)(2)(C) has a special sub-rule for stock of a holding company which is treated by Section 6166(b)(8)(A) as being stock of the business company which it owns, requiring that any dividends paid to the holding company by the business company are to be treated as having been paid to the estate to the extent that those dividends are attributable to so much of the business company's stock as constitutes the interest in a closely held business interest.

(3) Failure to Pay Principal or Interest

The general rule (Section 6166(g)(3)(A)) is that if there is a failure to pay principal or interest under Section 6166 on or before the date fixed for its payment (including any extension of time), the balance of the estate tax payable in installments is required to be paid upon notice and demand from the IRS.

However, Section 6166(g)(3)(B) gives a reprieve if the unpaid principal or interest is paid within six months of the date fixed for its payment. In that case, Section 6166(g)(3)(A) does not apply; the Section 6601(j) provision for determination of interest on the payment does not apply; and there is imposed a penalty (treated as a penalty imposed under chapter 68B (§§ 6671-6724) in an amount equal to the product of (a) 5% of the unpaid payment and (b) the number of months or fractions of months after the payment date and before payment is actually made.

h. Special Rule for Certain "Direct Skips"

A Section 2612(c) "direct skip" is a generation-skipping transfer of an interest in property to a Section 2613 "skip person" that is subject to estate or gift tax. A skip person is defined in Section 2613(a) as either (a) a natural person assigned to two or more generations below the generation of the transferor, or (b) a trust in which all interests are held by skip persons or in which no person holds an interest and no time may a trust distribution be made to anyone who is not a skip person.

Section 6166(i) provides that if an interest in a closely held business is the subject of a direct skip which occurs at the same time as, and as a result of, the decedent's death, any generation-skipping transfer tax imposed by

Section 2601 on the transfer of the interest is treated for purposes of Section 6166 as if it were additional estate tax, and is therefore eligible for installment payment treatment.

For a detailed discussion of the generation-skipping transfer tax, see 850 T.M., Generation-Skipping Tax.

i. Cross References

(1) Authority to Require Security

Section 6165 authorizes the Commissioner to require the taxpayer to post a bond in order to secure the payment of estate tax for which a Section 6166 extension has been obtained. The bond may not be in an amount which is more than twice the extension amount.

(2) Special Lien

Under Section 6324A, if the executor makes a Section 6324A(a) election and files an agreement under Section 6324A(c), the deferred amount of estate tax [FN398] is a lien in favor of the U.S. on the "section 6166 lien property." [FN399]

(3) Statute of Limitations Extended

Section 6503(d) extends the period of limitation "for the period of any extension of time for payment granted under the provisions of section... 6166."

(4) Stock Transferred within Three Years of Death

Section 2035(c)(2) [FN399.1] coordinates Section 2035 with Section 6166, providing

An estate shall be treated as meeting the 35 percent of adjusted gross estate requirement of section 6166(a)(1) only if the estate meets such requirement both with and without the application of subsection (a) [requiring the inclusion of property transferred within three years of death].

In other words, because testing for the 35% requirement of Section

6166 is done both with and without including property transferred within three years of death, Section 2035 inclusion cannot be used to enable an estate to meet the 35% test if it would not otherwise do so. Section 2035 is discussed in detail in 818 T.M., Section 2035 Transfers.

D. Section 2057

1. Purpose and General Rule Summarized

Section 2057 is designed to reduce the estate tax burden on owners of closely held businesses and permit the continued operation of such businesses as family enterprises. Section 2057, enacted by the Internal Revenue Service Restructuring and Reform Act of 1998, [FN399.2] approaches this goal through an estate tax deduction for "qualified family-owned business interests" (QFOBIs).

Section 2057 was Congress's second attempt in as many years to provide estate tax relief to closely held businesses. Congress initially enacted Section 2033A, which allowed the decedent's executor to elect to exclude the value of qualified family-owned business interests from the decedent's gross estate. [FN399.3] In general, Section 2033A was to operate with the exemption from estate tax provided by the unified credit to allow the exclusion of \$1.3 million from the decedent's gross estate. In response to concerns raised about the interaction of the qualified family-owned business exclusion, the unified credit, and other Code sections, however, in 1998 Congress converted the exclusion into a deduction, and redesignated Section 2033A as Section 2057.

In general, Section 2057 operates to allow the executor of the estate of a U.S. citizen or resident to elect to deduct the adjusted value of the QFOBIs (up to \$675,000) from the value of the decedent's gross estate. [FN399.4] The benefit of the deduction is subject to recapture if the business is disposed of or family members later fail to materially participate in its operation. [FN399.5] The qualified family-owned business deduction is not available for generation-skipping transfer tax purposes. The Section 2057 deduction, like the provision it replaced, is effective for estates of decedents dying after December 31, 1997. Effective for estates of decedents dying after December 31, 2003, the 2001 Tax Relief Act, [P.L. 107-16, Section 521](#), repealed Section 2057. Beginning for estates of decedents dying after that date, the unified credit exemption amount will exceed the combined \$1.3 million offset allowed by the unified credit exemption amount and the Section 2057 deduction.

For a detailed discussion, 829 T.M., The Family-Owned Business Exclusion - Section 2033A.

Comment: The rules for applying Section 2057 are complex, requiring attention to qualification issues both before the decedent's death and during