

SECTION 6166 INSTALLMENT PAYMENT OF ESTATE TAX

HIGHLIGHTS OF THE PLAN

Background

When an estate includes a closely-held business, the executor often has the choice of paying the estate tax attributable to the business in a lump-sum within nine months of the decedent's death or in installments over a period of years. Internal Revenue Code Section 6166 permits the executor to delay the first installment for five years after the due date of the tax, which is nine months after the decedent's death. It further permits the executor to pay the tax in from two to ten installments. Since the first payment is due at the end of the fifth year and a payment could be made in each of the succeeding nine years, for a maximum total of ten payments, the maximum deferral is 14 years from the due date of the tax.

Interest is charged and is payable on the amounts of tax deferred in all years of deferral. Interest is charged at a favorable annual rate of 2% on the first \$1,000,000 of business value, and at 45% of the regular underpayment rate on the balance. Beginning in 1998, the \$1,000,000 business value limit for the favorable 2% interest rate is indexed for inflation, rounded down to the next lowest multiple of \$10,000. No deduction is allowed to the estate for estate or income tax purposes for interest paid at these favorable rates.

Qualification Requirements

For an estate to take advantage of the installment payment option under Section 6166, the decedent's interests in one or more businesses at the time of his/her death must be greater than 35% of his/her adjusted gross estate. Ownership interests in any number of businesses may be used to meet the greater-than-35% test as long as the value of the decedent's interest in each business is at least 20% of the total value of the business at the time of decedent's death, and no single business has more than 15 partners or shareholders. Only interests in a trade or business, not those of a holding company, may be considered in determining the applicable percentages.

Example: Mr. Jones had an adjusted gross estate of \$4,000,000 and was part-owner of three separate businesses, Business A, Business B, and Business C. Business A was worth \$1,000,000, and his 50% interest was worth \$500,000. Business B was worth \$1,500,000, and his 40% interest was worth \$600,000. Business C was worth \$5,000,000, and his 10% interest was worth \$500,000. His total interests in the three businesses at this death were worth \$1,600,000. For Mr. Jones' estate to qualify for installment payment of estate taxes under the 35% rule of Section 6166, Mr. Jones' business interests would have to total more than \$1,400,000, that is, \$4,000,000 x 35%. It would appear that his estate would qualify under the greater-than-35% test. However, since his interest in Business C was only 10% and his combined business interests in Businesses A and B were less than \$1,400,000, Mr. Jones' estate

would not qualify for installment tax treatment under Section 6166 because it failed the 20% per business test.

Because it is impossible to know for certain whether an estate qualifies for Section 6166 tax deferral until after the IRS audits the estate and determines all values thereunder, it is best to purchase life insurance on the business owner to provide liquidity to pay estate taxes due on the decedent's business interests.

ADVANTAGES

1. Installment payment of estate taxes are helpful under Section 6166 when the estate does not have enough liquid assets to pay the estate taxes when they are due without selling assets at a substantial discount.
2. The estate receives a special low interest rate on deferred taxes.
3. The estate may engage in an investment arbitrage by investing the amounts that it would have paid in taxes and receiving a greater return on the investment than it pays in interest.
4. Profits or cash flow from the business can be used to pay the deferred taxes due.

DISADVANTAGES

1. The provisions of Section 6166 merely defer the tax due attributable to the business. They do not eliminate the tax. The interest due on the tax acts to increase the total amount due.
2. If the decedent's estate plan contemplated the use of Section 6166 and, for whatever reason did not qualify for installment treatment, there may not be sufficient liquid assets to pay the tax in a lump sum.
3. Section 6166 installment payment provisions do not apply to state death taxes that may be due.
4. Unless a special tax lien upon the business and its successor owners is elected by the successor owners of the business, the executor is personally liable for the deferred tax.
5. Beneficiaries of the decedent's estate will generally have to wait until all deferred taxes are paid until final distribution can occur.