

## Installment Payment of Federal Estate Tax and Change in Business Form – Is it a Disqualifying Disposition?

2321 N. Loop Drive, Ste 200 • Ames, Iowa 50010

[www.calt.iastate.edu](http://www.calt.iastate.edu)

February 7, 2014

- by Roger A. McEowen\*

### Overview<sup>1</sup>

Installment payment of federal estate tax allows a decedent's estate to pay the federal estate tax attributable to closely-held business assets over nearly 15 years.<sup>2</sup> If an installment payment election is made, interest only need be paid for the first five years after the due date for the federal estate tax return (which is nine months after the date of the decedent's death) with the tax paid in two to ten annual installments thereafter with interest on the unpaid balance beginning 69 months after death. The maximum installment payment period is 177 months after death.

**Note:** Interest at 2 percent (compounded daily) is imposed on the amount of deferred estate tax attributable to the first \$1,450,000 in value of taxable estate attributable to a closely-held business for deaths in 2014. For deaths in 2014, the amount eligible is the federal estate tax attributable to a closely-held business between \$5,340,000 and \$6,790,000. If the estate holds an interest in a closely-held business of \$6,790,000, the 2 percent portion would be \$580,000 (the \$2,661,800 estate tax on \$6,790,000 minus \$2,081,800, the credit for the applicable exclusion amount for 2014).<sup>3</sup>

### Eligibility Tests

Two eligibility tests must be satisfied for an estate to qualify for installment payment of federal estate tax. The first test, known as the "Tier I test," requires the decedent to have had an interest in a

closely held business. If the decedent was a shareholder in a corporation, then 20 percent or more of the corporation's voting stock must be in the estate or the corporation must have 45 or fewer shareholders.<sup>4</sup> For partnerships, 20 percent of all the partnership total capital interest must be in the estate or the partnership must have 45 or fewer partners.<sup>5</sup> For sole proprietorships, the interest in the sole proprietorship counts. Land held in a revocable living trust continues to be eligible for installment payment of federal estate tax if it is a "grantor" trust with the settlor continuing to have control over the trust.<sup>6</sup>

**Note:** Often, farmers and ranchers own land and rent it out to a tenant. Land rented under a lease constitutes an interest in a closely held business only if it is a crop share lease or a livestock share lease with active involvement in decision making by the decedent-to-be, or an agent or employee of the decedent-to-be.<sup>7</sup> Passive rental arrangements, such as cash rent leases, are not eligible.

The Tier II test requires that the interest in the closely held business exceed 35 percent of the value of the decedent's adjusted gross estate.<sup>8</sup> For a corporation, corporate stock of any kind, common or preferred, meets the requirement. In the Tier I test, only the voting stock counts. But, for purposes of the Tier II test, any stock can count. For a partnership, an interest in a partnership carrying on a business will count. In a sole proprietorship, the interest in the sole proprietorship will count towards the 35 percent test. Rental arrangements that meet the Tier I test will also meet the Tier II test. Thus,

assets under an active lease arrangement may be applied toward the 35 percent amount.

### **Acceleration of the Deferred Tax**

One of the ways that the installment payments can be accelerated is by a disposition of 50 percent or more in value of the decedent's interest in the closely-held business.<sup>9</sup> Likewise, unpaid installments are accelerated if there is a withdrawal of funds or assets representing 50 percent or more in value of the decedent's interest in the closely-held business.<sup>10</sup> Once an estate executor learns of any transaction that constitutes a withdrawal or disposition that aggregates 50 percent or more of the closely-held business assets, the executor must report the transactions to the IRS within 30 days.<sup>11</sup>

### **Change in organizational form**

Mere changes in organizational form or tax-free exchanges of property do not accelerate installment payments. Over the years, the IRS has issued various pronouncements on whether particular events cause an acceleration of unpaid installments.

Most recently, in Priv. Ltr. Rul. 201403012<sup>12</sup>, the IRS determined that an acceleration of the unpaid installments would not be triggered in a transaction involving a change in business structure. Under the facts of the ruling, the decedent owned a general partnership interest with his son that constituted more than 50 percent of decedent's estate. The partnership assets consisted entirely of commercial real estate parcels titled in the names of the decedent and his son as tenants-in-common as nominee for the partnership. The executor proposed to distribute undivided interests in each parcel to the partner's on a pro-rata basis and then re-contribute such interests to newly formed limited liability companies (LLCs) with each new LLC to hold a separate parcel. No other money or property was involved in the transaction. Based on Rev. Rul. 66-62<sup>13</sup>, the IRS determined that the transaction was a mere change in form with no acceleration of installment payment of estate tax triggered.<sup>14</sup>

### **Helpful IRS pronouncements**

Priv. Ltr. Rul. 201403012 is in line with many IRS pronouncements involving organizational changes to the decedent's business. But, there are some pitfalls to look out for. The following is a listing of some of the more illustrative IRS administrative rulings involving acceleration of installment payments of estate tax. All of the rulings provide helpful guidance to practitioners concerned about triggering acceleration of deferred tax under I.R.C. §6166.<sup>15</sup>

#### **Non-business entity transfers:**

- Priv. Ltr. Rul. 8222006 (Feb. 24, 1982)(transfers of interests in qualifying closely-held business property upon an heir's death constituted a distribution which accelerated unpaid installments)
- Priv. Ltr. Rul. 9202017 (Oct. 10, 1991)(creation of marital and family trusts at death out of the decedent's revocable trust followed by a distribution from family trust to beneficiaries of closely-held business interests not acceleration-triggering event; principal assets of both trusts were stock in corporation, interests in limited partnerships and interests in general partnership).
- Priv. Ltr. Rul. 8626055 (Mar. 28, 1986)(partition in-kind and distribution of farmland from trust to trust beneficiaries not acceleration-triggering event; valid exercise of power of appointment treated as transfer under decedent's will and not a disposition under I.R.C. §6166(g)(1)(a)).
- Priv. Ltr. Rul. 9116009(Jan. 15, 1991)(transfers of an interest in I.R.C. §6166 property among inheriting owners such that each heir would own undivided interest in specific commercial property and one heir would own farmland not dispositions that trigger acceleration of unpaid installments; transaction analogous to like-kind exchange)
- Priv. Ltr. Rul. 8730006 (Apr. 14, 1987)(sale of farmland in decedent's estate by heirs to another heir triggers acceleration where source of funds for purchase comes from outside of

estate; business not merely being reshuffled within the estate).

The IRS has also issued various pronouncements concerning whether certain transactions involving business entities trigger acceleration of unpaid installments:

- Priv. Ltr. Rul. 8740031 (Jul. 7, 1987)(decedent owned minority interest in family farming and ranching corporation and executor elected both special use valuation and installment payment of federal estate tax; executor proposed to divide corporation into separate entities – one for farming and one for ranching; IRS determined that transaction was vertical division and separation of business was mere change in business form; transaction qualified under I.R.C. §355 which satisfied Treas. Reg. §20.6166(g)(1)(a)).
- Priv. Ltr. Rul. 8841006 (Jul. 6, 1988)(estate consisted largely of C corporate stock and IRS had already ruled that transfer of stock to partnership and liquidation of corporation not a disqualifying distribution; subsequent sale by partnership to another partnership in which seller was partner not a disposition).
- Priv. Ltr. Rul. 8839013 (Jun. 27, 1988)(husband and wife died in same year owning all stock of corporation; executor proposed to distribute stock from husband's estate to wife's and then corporation would redeem stock from both estates to pay expenses and taxes; proposal not acceleration triggering event because transaction qualified under I.R.C. §303 to extent distributions less than sum of taxes associated with deaths)
- Priv. Ltr. Rul. 8922035 (Mar. 2, 1989)(estate held 100 percent ownership of stock in holding company; executor proposed merger or liquidation of subsidiaries into parent corporation; proposed transaction would not constitute an accelerating disposition with respect to parent corporation stock; ruling cites Rev. Rul. 1966-62 as constituting mere change

in form of operating estate's interest in closely held business).

- Priv. Ltr. Rul. 7929055 (Apr. 19, 1979)(decedent's estate contained 1605 shares of ranching corporation stock held by trust; executor proposed transfer of 50 percent of corporate assets and liabilities to new ranching corporation in exchange for stock of new corporation with subsequent stock transfer to two other stockholders in exchange for their stock having fair market value equal to stock of new corporation; transaction qualified as reorganization under I.R.C. §368(a)(1)(D) and was not a disposition or withdrawal that triggered acceleration).
- Priv. Ltr. Rul. 8131030 (May 5, 1981)(transfer of decedent's interest in closely-held oil and gas exploration business interest to limited partnership is change in form only; no acceleration triggered; under partnership agreement, business to be operated in same manner as without partnership agreement).
- Priv. Ltr. Rul. 8130175 (May 1, 1981)(stock in closely held mining business that passed from decedent to distributees followed by exchange of stock for stock in holding company not an acceleration triggering event).
- Priv. Ltr. Rul. 7825029 (Mar. 22, 1978)(proposed transaction involved decedent's interest in ranching and dairy corporation where stock passed to testamentary trusts via decedent's will; IRS determined that corporation could be converted to limited partnership operated by decedent's children without triggering acceleration of unpaid installments).
- Priv. Ltr. Rul. 8103066 (Oct. 22, 1980)(corporate liquidation in accordance with I.R.C. §331 with entity becoming a partnership constituted mere change in doing business with no acceleration triggered; ruling cites to Rev. Rul. 66-62; IRS noted that there was no proposed withdrawal of money or other property from the business).

- Priv. Ltr. Rul. 8422145 (Mar. 1, 1984)(corporate liquidation mere change in form of doing business; liquidation of business and distribution of rental properties in-kind to heirs not disposition if heirs continue business).
- Priv. Ltr. Rul. 8330015 (Apr. 20, 1983)(beneficiaries of decedent's inter vivos trust proposed to exchange their undivided interests in decedent's farm for fee interests of equal value; transaction not an accelerating distribution and merely a "reshuffling" of interests between heirs; heirs to continue business).
- Priv. Ltr. Rul. 8525040 (Mar. 25, 1985)(decedent owned one-third community property interest in partnership that owned farm real estate, and one-third community property interest in two closely held corporations engaged in farming which owned the improvements on the farm real estate; estate and co-owners sought partition to separate out estate's business interests from interests of other co-owners; estate and surviving spouse to receive one-third of farm real estate from partnership and corporations to distribute improvements such that they become separate property of estate and surviving spouse; transactions constitute mere change in form of business and won't trigger acceleration of installment payments).
- Priv. Ltr. Rul. 200043030 (Jul. 26, 2000)(father and daughter each died within one year of each other and both estates made I.R.C. §6166 election; father had farmed in sole proprietorship and owned stock in closely-held corporation conducting farming-related services; father's assets passed to daughter and daughter left the assets to her sons; father's estate proposed forming LLC for farming operation and dissolve corporation and transfer its business assets to LLC with everything passing to daughter; IRS determined that "interest in closely held business" includes only active business assets and not passive investments and distribution of any passive investments not

disposition; other transfers simply mere change in form of doing business if business continues).

- Priv. Ltr. Rul. 200129018 (Jul. 23, 2001)(real estate held by decedent and spouse as community property; spouse died and one-half community property interest distributed to two trusts; QTIP trust involved of which decedent was income beneficiary and decedent was discretionary beneficiary of other trust; upon decedent's death trust assets to pass to decedent's children; executor proposed transferring interest in trust to LLC in exchange for LLC membership interest and distribution of other trust assets to beneficiaries; acceleration not triggered; business to continue and only mere change in form involved).
- Priv. Ltr. Rul. 200321006 (Feb. 12, 2003)(decedent was sole proprietor farmer who also stored and processed crops; farming assets passed to decedent's sons and will expressed intent that they continue farming operation; will authorized lease to entities of sons; estate cash leased land to LLCs owned by sons; lease did not trigger acceleration of unpaid installments; not a disqualifying disposition under I.R.C. §6166(g)(1)(A)).

## Conclusion

Most transactions that result in the restructuring of business operations after a decedent's death will not trigger acceleration of unpaid installments of federal estate tax where the business continues after the decedent's death. Priv. Ltr. Rul. 201403012 confirms that long-held view of the IRS.

---

<sup>1</sup> For an overview of installment payment of federal estate tax see, McEowen, *Roger A., Principles of Agricultural Law*, Sec. 8.09[2], Release 34, Jan. 2014.

<sup>2</sup> I.R.C. § 6166.

<sup>3</sup> For deaths after December 31, 1997, interest paid on federal estate tax that is deferred under I.R.C. § 6166 is not deductible for either federal estate tax or federal income tax. In addition, for deaths after December 31, 1998, the \$1,000,000 amount of taxable estate eligible for the reduced interest rate on unpaid federal tax for purposes of 15-year installment payment of federal estate tax is indexed for inflation. The adjustment is to be

---

rounded to the next lowest multiple of \$10,000 and stands at \$1,450,000 for 2014.

<sup>4</sup> I.R.C. § 6166(b)(1)(C)(ii). In some instances, the grandparents or parents may give up their voting stock, but keep the nonvoting preferred stock. This creates a problem if the corporation has more than 15 shareholders (45 after 2001).

<sup>5</sup> I.R.C. § 6166(b)(1)(B)(ii).

<sup>6</sup> Generally, on these points, see *McEowen, Roger A., Principles of Agricultural Law*, Sec. 8.09[2], Release 34, Jan. 2014.

<sup>7</sup> See, e.g., Priv. Ltr. Rul. 8741076 (July 17, 1987).

<sup>8</sup> I.R.C. § 6166(a)(1).

<sup>9</sup> Under I.R.C. § 6166(g)(1)(A), the disposition causing acceleration must be 50 percent or more “in value of an interest in a closely-held business which qualifies,” or must relate to withdrawals of money or property from the trade or business in amounts which exceed 50 per cent “of the value of such trade or business.” Example (1) of Treas. Reg. § 20.6166A-3(d)(3) refers to “value of the trade or business at the time of withdrawal.” This would also indicate that any valuation as determined by I.R.C. § 2032A does *not* control the percentage computation for purposes of disposition or withdrawal for purposes of I.R.C. § 6166.

<sup>10</sup> Id.

<sup>11</sup> Treas. Reg. § 20.6166A-3(f)(1).

<sup>12</sup> Sept. 25, 2013.

<sup>13</sup> 1966-1 C.B. 272.

<sup>14</sup> The IRS made no mention of whether the election itself was valid.

<sup>15</sup> For further discussion of some of the rulings summarized in this section and the next section see Kelley, Donald H., *Estate Planning for Farmers and Ranchers*, §§ 19:36, 19:37, West Group (2013).