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CLOSELY HELD STOCKS—DEFERRAL AND FINANCING OF ESTATE TAX COSTS THROUGH SECTIONS 303 AND 6166

*Douglas A. Kahn**

Editor's Note

Professor Kahn's article may be read either as a guide through the section 6166 labyrinth or as a plea for much-needed legislative simplification.

The statutory test to qualify an estate for the benefits of section 6166 is arbitrary, complex, difficult to plan for, controversial in its administration, and ineligible for judicial review.

Interest on the deferred estate tax accrues on a daily basis over a 14-year period and may be claimed as an estate tax deduction as it accrues. Each additional deduction claimed reduces the estate tax liability, the amount deferrable, and the total amount of the interest payable.

The executor who wishes to fund the deferred estate tax payments by turning in corporate stock for redemption under section 303 embarks upon uncharted waters. Attempts to use sections 303 and 6166 in tandem involve substantial risks, sometimes resulting in inadvertent sacrifice of the sections' benefits.

The Section of Taxation is developing a set of proposals for refashioning section 6166 along simpler and more workable lines. The suggestions under study include a less arbitrary test for qualification, a reduced rate of interest coupled with its nondeductibility, and a less intricate interplay between sections 303 and 6166. A reading of Professor Kahn's article will demonstrate the potential utility of that project.

I. INTRODUCTION

The enactment of the Economic Recovery Tax Act of 1981 (hereinafter referred to as "the 1981 Act") will reduce both the impact of federal wealth transfer taxes and the number of persons still subject to them. Nevertheless, even after the 1981 Act takes full effect, a category of persons remains for whom wealth transfer taxes will constitute a mean-

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ingful burden and whose estates face a liquidity problem in satisfying the estate tax liability.

The focus of this article is on two statutory techniques: redemptions of stock pursuant to section 303[1] and deferral of estate tax payments under section 6166.[2] These two techniques ease the burden of satisfying the estate tax liability when a closely held business constitutes a significant portion of the estate. While there are other important Code sections that permit the redemption of stock without incurring dividend treatment (for example, section 302(b)), only section 303 is examined here because that section is more closely coordinated with section 6166, the principal subject of this article.

This article first deals with section 303 and then examines the operation of section 6166 and the interaction of section 6166 and section 303. Finally, it discusses certain pre-mortem planning considerations.

II. REDEMPTION OF STOCK THAT WAS INCLUDED IN A DECEDENT'S GROSS ESTATE

Section 303 grants a special exemption from dividend treatment for the proceeds of a redemption of corporate stock that was included in a decedent's gross estate, provided that certain statutory requisites are satisfied. The provisions of section 303 are primarily of importance to owners of stock of a closely held corporation because of the operation of the percentage qualification tests.

A. *The Percentage Qualification Tests.*

Section 303 provides that a corporation's redemption of stock included in a decedent's gross estate for federal estate tax purposes will be deemed a distribution in full payment for the stock (and thus excluded from section 301) if the estate tax value of the stock of the redeeming corporation that is included in the decedent's gross estate is greater than thirty-five percent of the difference between the value of the decedent's gross estate and the aggregate amount of deductions allowable under sections 2053 and 2054.[3] For convenience, this difference between the decedent's gross

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[1] I.R.C. § 303.

[2] I.R.C. § 6166.

[3] I.R.C. § 303(b)(2)(A) provides:

> **(2) Relationship of stock to decedent's estate.—**
>
> (A) **In general.**—Subsection (a) small apply to a distribution by a corporation only if the value (for Federal estate tax purposes) of all the stock of such corporation which is included in determining the value of the decedent's gross estate exceeds 35 percent of the excess of —
>
> (i) the value of the gross estate of such decedent, over
>
> (ii) the sum of the amounts allowable as a deduction under section 2053 or 2054.

Examples of deductions under sections 2053 and 2054 include funeral and administration expenses, claims against the estate, debts, and casualty losses. I.R.C. §§ 2053, 2054.

estate and the described estate tax deductions is referred to in this article as the "adjusted gross estate," although that term is not used in section 303.[4]

Under section 303(b)(2)(B), when stock of two or more corporations is included in the gross estate, the value of the stock of those corporations can be combined in determining whether the thirty-five percent test is satisfied, but only if twenty percent or more of the value of the outstanding stock of each such corporation is included in the gross estate. For the purpose of determining whether the twenty percent test is met, stock owned by the decedent and his surviving spouse at his death as community property, as joint tenants, as tenants by the entirety, or as tenants in common is considered to be included in the gross estate.[5]

Prior to enactment of the 1981 Act, a gratuitous transfer of property made within three years of the donor's death was included in his gross estate under section 2035(a). Subject to certain collateral exceptions, one of which relates to section 303(b),[6] the 1981 Act made section 2035(a) inapplicable to donors who die after 1981.[7] For purposes of applying the thirty-five percent requirement, properties that were gratuitously transferred by a decedent within three years of his death are included in his gross estate and, therefore, in his adjusted gross estate.[8] This provision is designed to preclude the use of deathbed gifts to increase the percentage of the adjusted gross estate represented by stock of a closely held corporation and, accordingly, to enhance the prospect of qualifying redemption of that stock for section 303 treatment.

The transferred properties that are captured in the donor's gross estate by section 2035(a) do not include gifts which are excluded by section 2035(b). That subsection excludes bona fide sales and gifts made by the donor for which a gift tax return is not required by section 6019 other than by reason of section 6019(a)(2), which relates to gifts to the spouse that qualify for the marital deduction.[9] This exclusion does not apply to a gift of a life insurance policy.[10] For gifts made after 1981, no gift tax return is required when the donor gives no more than $10,000 to any donee in a calendar year, provided that the gifts are of present interests.[11] Accordingly, a donor can give $10,000 to each of his children, children-in-law, and grandchildren every year without incurring gift tax, and the donated property will be excluded from the donor's gross estate even if he dies shortly after making the gift. A similar exclusion is available for a donor's

[4] Code section 6166(b)(6) uses essentially the same concept and terms it "adjusted gross estate."
[5] I.R.C. § 303(b)(2)(B).
[6] *See* I.R.C. § 2035(d)(3)(A).
[7] I.R.C. § 2035(d).
[8] I.R.C. § 2035(a); *see* I.R.C. § 2035(d)(3)(A).
[9] I.R.C. § 2035(b)(2); *see* I.R.C. §§ 6019, 2523.
[10] I.R.C. § 2035(b)(2).
[11] I.R.C. § 6019(a)(1); *see* I.R.C. § 2503(b).

direct payment of a donee's qualified medical care or educational expenses.[12]

The provision of section 2035(d)(3)(A) excluding section 303(b) from the repeal of the "within three years of death" rule presumably also operates in determining whether the "20% or more" rule of section 303(b)(2)(B) for combining the stocks of several corporations is applicable.[13]

Notwithstanding general language in the House report,[14] the repeal of section 2035(a) does apply to subsections of section 303 other than section 303(b).[15] For example, if three months before his death in 1982, *D* gave his daughter some shares of stock of *X* Corporation, the shares will not be included in *D*'s gross estate by section 2035(a). A redemption of those shares from *D*'s daughter will not qualify for section 303 treatment even if the thirty-five percent of adjusted gross estate requirement is satisfied, since it is not a redemption to pay death taxes.

B. *The Shareholder Liability Limitation.*

Section 303 treatment applies only to redemptions of stock of a shareholder whose interest in property acquired from the decedent is directly reduced (or indirectly reduced through a binding obligation to contribute) by any payment of death taxes or of funeral and administration expenses which qualify as allowable deductions under section 2053, and applies then only to the extent that the shareholder whose stock is redeemed is liable for those payments.[16]

The allocation of the liability for death taxes and expenses among the recipients of the decedent's properties usually is determined by the will or by state law. If the decedent's will directs that death taxes be paid out of certain properties of his probate estate,[17] that instruction will control. In the absence of explicit direction, local law provides an apportionment formula, which in most states is established by statute. Under these statutes, unless the will provides otherwise, death taxes are apportioned among recipients of both nonprobate and probate assets according to each recipient's respective share of the decedent's gross estate as determined for federal estate tax purposes.[18] In making this allocation, an estate tax

[12] I.R.C. § 6019(a)(1); *see* I.R.C. § 2503(e).

[13] According to the report of the Committee on Ways and Means, "all transfers within 3 years of death (other than gifts available for the annual gift tax exclusion) will be included [in the decedent's gross estate] for purposes of determining the estate's qualification for special redemption, valuation, and deferral purposes" under sections 303, 2032A, and 6166. H.R. Rep. No. 97-201, 97th Cong., 1st Sess. 187 (1981).

[14] *See* note 13 *supra*.

[15] I.R.C. § 2035(d)(1), (d)(3).

[16] I.R.C. § 303(b)(3).

[17] Typically, a testator will direct that most, or all, death taxes be paid out of his residuary estate.

[18] *See, e.g.*, N.Y. Est., Powers & Trusts Law § 2-1.8 (McKinney 1981); R.I. Gen. Laws §§ 44-23.1-2, -4(a) (1980); Uniform Estate Tax Apportionment Act §§ 2, 4(a) (1964 version); Uniform Probate Code § 3-916.

deduction allowed because of the status of a recipient of property inures to the benefit of that recipient.[19]

Under these statutes, to the extent that property passing from the decedent to his surviving spouse or to a trust for her benefit qualifies for the marital deduction, the surviving spouse or the trustee will not be liable for death taxes; thus a redemption of stock passing in this manner will not qualify for section 303 treatment. Also, the decedent may direct in his will that none of the death taxes or expenses be satisfied out of assets so passing, which would likewise preclude section 303 treatment for redemptions of stock so passing.

However, if the section 303 stock is redeemed from the executor, this limitation usually will not be a problem because the decedent's estate will be liable for most, or all, of the decedent's federal estate tax.[20] A stock redemption from the executor should qualify for section 303 treatment even if the proceeds of the redemption are subsequently distributed to the surviving spouse or to a marital trust.

C. *Time Limitations.*

Section 303 applies only to distributions made in redemption of stock within the period commencing with the decedent's death and ending on whichever of the following dates is applicable:

(1) Except where paragraph (2) or (3) applies, the ninetieth day after the expiration of the period of limitations provided by section 6501(a) for the assessment of the federal estate tax.[21]

(2) If a timely petition for redetermination of an estate tax deficiency is filed with the Tax Court, the sixtieth day after the Tax Court's decision becomes final.[22]

(3) If the decedent's estate makes a valid election under section 6166 to defer the payment of part of the federal estate tax for up to fourteen years

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[19] *See, e.g.*, N.Y. EST., POWERS & TRUSTS LAW § 2-1.8(c)(2) (McKinney 1981); R.I. GEN. LAWS § 44-23.1-5 (1980); UNIFORM ESTATE TAX APPORTIONMENT ACT § 5 (1964 version); UNIFORM PROBATE CODE § 3-916(e).

[20] *See* I.R.S. Letter Ruling 8022043, March 4, 1980.

[21] I.R.C. § 303(b)(1)(A). The period of limitation in section 6501(a) runs for three years after the estate tax return is filed. Because the estate tax return is due within nine months of the decedent's death, *see* I.R.C. § 6075(a), the corporation has approximately four years to make a section 303 distribution. The time period for a corporate distribution under section 303 is not shortened when the decedent's estate tax return is filed early because, for purposes of computing the period of limitations under section 6501(b)(1), the return is deemed filed on the last permissible day. Rev. Rul 69-47, 1969-1 C.B. 94. However, the Service has ruled that if the estate tax return is filed late, a redemption under section 303 may be made within three years and ninety days of the late return's filing. Rev. Rul. 73-204, 1973-1 C.B. 170.

[22] I.R.C. § 303(b)(1)(B). The Tax Court proceeding must be a bona fide contest and not a suit initiated solely to extend the period of applicability of section 303. Reg. § 1.303-2(e). No provision exists for extending the applicability of section 303 when a suit for refund of estate tax is instituted in a district court or the Court of Claims.

under an installment payment plan, the last day of the extended payment period.[23]

D. *The Quantitative Reach of Section 303.*

The maximum amount of corporate distributions that can be excluded from dividend treatment under section 303 is the sum of the death taxes (including interest thereon) and the funeral and administration expenses allowable as estate tax deductions.[24] That limit may be reduced by the shareholder liability limitation discussed above.[25]

For distributions made more than four years after the decedent's death, the amount received in redemption of stock that qualifies for section 303 treatment is limited to the lesser of: (1) the aggregate of such taxes and expenses that remained unpaid immediately prior to the distribution or (2) the aggregate of such taxes and expenses that are paid within one year after the date of the distribution.[26]

E. *Other Rules.*

Comparable provision is made for the redemption of stock subject to generation-skipping transfer taxes under section 2601 on the death of a deemed transferor. Such stock is treated as if it were included in the gross estate of the deemed transferor.[27]

Section 303 redemptions normally will be made of stock owned by the decedent at his death, but the dividend exemption provided by section 303 is not limited to redemptions of such stock. Any stock which was included in the decedent's gross estate for federal estate tax purposes is covered by section 303 if the terms of that section are satisfied.[28]

Shareholders whose stock is redeemed in compliance with section 302(b)(2)[29] or section 302(b)(3)[30] do not need the protection of section 303. If the redeemed stock of these shareholders was included in the decedent's gross estate and otherwise qualified for section 303 treatment, the amount distributed in redemption of that stock will be charged against the maximum amount permitted to be distributed under section 303.[31]

Section 303 does not apply to redemptions of stock from persons who acquired the decedent's stock by gift or purchase from third parties, nor

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[23] I.R.C. § 303(b)(1)(C).

[24] I.R.C. § 303(a).

[25] *See* note 16 *supra* and accompanying text.

[26] I.R.C. § 303(b)(4).

[27] I.R.C. § 303(d).

[28] *See, e.g.*, I.R.C. §§ 2036-2038, 2040, 2041 (transfers during life, jointly owned property, and powers of appointment).

[29] I.R.C. § 302(b)(1) (redemption not essentially equivalent to dividend).

[30] I.R.C. § 302(b)(2) (substantially disproportionate redemption).

[31] Reg. § 1.303-2(g). This regulation also provides that if the amount of distributions exceeds the allowable ceiling, section 303 will apply to redemptions in chronological order, rather than pro rata.

does it apply to redemptions of stock from shareholders who received the stock in satisfaction of specific monetary bequests, because they are deemed to have acquired the stock by purchase rather than by bequest.[32] That exception would appear to cover stock distributed by the decedent's estate to the decedent's surviving spouse or to a marital trust in satisfaction of a pecuniary formula bequest.[33]

When a shareholder receives "new stock" in a corporation, the basis of which is determined by reference to the basis of "old stock" included in the decedent's gross estate which qualified for redemption under section 303, then the "new stock" may also be redeemed under section 303(c).[34] Even if this new stock is "section 306 stock," section 303 will take priority over section 306, and the redemption will not be treated as a dividend to the extent that section 303 is applicable.[35]

A corporation may not have sufficient funds available to redeem the stock of a deceased shareholder within the time permitted by section 303.[36] In such an event the corporation may redeem stock by distributing promissory notes of the corporation to the shareholder within the statutory period, even though the corporation's payment of such notes will be made after the statutory period has expired.[37] Caution should be exer-

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[32] *See* Reg. § 1.303-2(f). There is no specific Code language to this effect, and while there is some support in the legislative history, *see* S. REP. No. 2375, 81st Cong., 1st Sess. 83 (1950), the regulation has been criticized by at least one court as exceeding the scope of section 303. *See* United States v. Lake, 406 F.2d 941, 947-49 (5th Cir. 1969).

[33] Stock distributed to a surviving spouse or to a trust on her behalf in satisfaction of a pecuniary bequest and redeemed usually will fail to qualify for section 303 treatment because the death taxes and expenses typically will not be borne by that spouse or by her trust. *See* I.R.C. § 303(b)(3).

In Revenue Ruling 70-297, however, the Service held that when an executor satisfied a pecuniary bequest to the decedent's widow by distributing to her corporate stock having a value equal to the amount of the pecuniary bequest pursuant to a provision of state law which permitted the widow to consent to a distribution in kind, the corporation's subsequent redemption of the stock from the widow did not qualify for section 303 treatment because the will did not authorize the executor to satisfy the bequest by distributing property in kind. The Service stated that if the executor had been granted discretionary power to satisfy the bequest by distributing property in kind, section 303 would then have applied to the subsequent redemption of the stock. Rev. Rul. 70-297, 1970-1 C.B. 66. In *United States v. Lake,* the court refused to apply Regulations section 1.303-2(f) because the redemption of stock from the decedent's daughter was consistent with the statutory purpose of section 303 even though she did not acquire the redeemed stock directly from the decedent but from a testamentary trust of which she was the beneficiary. United States v. Lake, 406 F.2d at 949-50.

[34] Reg. § 1.303-2(d).

[35] *Id.*

[36] *See* notes 21-23 *supra* and accompanying text (time limitations). If a corporation attempts to retain liquid assets in order to fund a contemplated purchase of a shareholder's stock on his subsequent death, the corporation may incur a surtax liability under the accumulated earnings tax provisions. *See* I.R.C. §§ 531-537. However, section 537(a)(2) expressly permits a corporation to accumulate income after a decedent's death for the purpose of redeeming stock which qualifies for redemption under section 303 because of having been included in the decedent's gross estate.

[37] *See* Rev. Rul. 67-425, 1967-2 C.B. 134 (each distribution in redemption of stock within

cised to ensure that these distributed "notes" do not constitute equity interests in the corporation.[38]

Although the rationale for enacting section 303 was to provide liquidity for an estate, the operation of section 303 is not limited to circumstances in which liquidity is a problem. Section 303 may be employed even though the estate has sufficient liquid assets.[39]

The consequence of having stock redeemed under section 303 is that the shareholder incurs little or no income tax liability. This is because under section 1014 the shareholder's basis in the redeemed stock equals the estate tax value of that stock. The price at redemption normally will not be greatly in excess of that value, so that the shareholder will recognize gain, if any, only on the appreciation that occurs after the estate tax valuation date. Typically, any such gain would be long-term capital gain.[40]

III. INSTALLMENT PAYMENT OF ESTATE TAX

Unless an extension of time for filing is granted, the estate tax return is required to be filed nine months after the decedent's death.[41] The payment of the estate tax is also to be made nine months after the decedent's death, unless an extension of time for payment is obtained or applicable.[42] Obtaining an extension of time for filing the estate tax return does not in itself extend the time for payment.[43]

This section III focuses on section 6166, a provision that permits payment of the estate tax to be made in installments. Other provisions for extension of time for payment are not discussed. However, the possibility of obtaining an extension of time for payment for reasonable cause under section 6161(a), either as an alternative to or as a supplement to section 6166, should not be overlooked.[44]

Prior to the enactment of the Economic Recovery Tax Act of 1981, there were two provisions dealing with the deferral of estate tax payment for estates holding an interest in a closely held business. Section 6166 was the younger of the two provisions, having been adopted in 1976.[45] What

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statutory period specified in section 303(b)(1)(A) may qualify as distribution in redemption of stock to pay death taxes under section 303); Rev. Rul. 65-289, 1965-2 C.B. 86 (distribution of corporation's own notes satisfies requirements in section 303).

[38] *See* Reg. §§ 1.385-1 to -10 (criteria for determining whether purported debt is equity interest).

[39] I.R.C. § 1014; *see* Reg. §§ 1.1014-1, -3.

[40] I.R.C. § 1223(11).

[41] I.R.C. § 6075(a).

[42] I.R.C. §§ 6151(a), 6161.

[43] *See* I.R.C. § 6081; Reg. § 1.6081-1(a).

[44] *See* I.R.C. § 6161(a)(1) (six month general rule on extensions); I.R.C. § 6161(a)(2) (four year extension for reasonable cause for payment of estate tax deficiency); I.R.C. § 6163 (extension of time for payment of estate tax on value of reversionary or remainder interest in property).

[45] Tax Reform Act of 1976, Pub. L. No. 94-455, § 2004, 90 Stat. 1520, 1862-68.

was designated as section 6166A by the Tax Reform Act of 1976 had previously existed as section 6166.[46] In the 1981 Act, Congress repealed section 6166A and moved some of its features into section 6166.[47] Because many of the terms of the two sections were identical, much of the regulatory and administrative construction of the repealed section is relevant to the construction of current section 6166. Accordingly, interpretations of the now-repealed section 6166A are cited here in analyzing section 6166.

In general, section 6166 permits the executor of an estate holding an interest in a closely held business to elect to defer the payment of a portion of the estate tax and to pay that portion of the tax in installments. The maximum period of deferral (including installment payments) ends fourteen years after the date on which the tax normally would be payable under section 6151. The provision is sometimes referred to, however, as a fifteen-year deferral. Interest is payable on the deferred tax.[48]

For convenience of reference, the interest in a closely held trade or business that qualifies an estate to defer payment of a portion of the estate tax under section 6166 is hereinafter referred to as a "qualifying interest in a trade or business" or simply as a "qualifying interest."

The purpose of granting an extension of time under section 6166 to an estate when an interest in a closely held trade or business comprises a significant portion of the gross estate is to ease the burden of satisfying the estate tax liability so that the qualifying interest can be retained. The extension of time is, in theory, intended to permit time for the trade or business to earn and distribute sufficient income to permit the estate to pay the tax primarily out of income, rather than having to liquidate the interest in the trade or business.[49]

The qualifying interest need not be an asset of the decedent's probate estate. It is sufficient if the interest is included in the decedent's gross estate for federal estate tax purposes.[50]

A. *Qualification for the Section 6166 Election.*

To qualify for the section 6166 election, the decedent's gross estate must include an interest in a closely held business the estate tax value of which exceeds thirty-five percent of the "adjusted gross estate."[51] The term "adjusted gross estate" means the value of the decedent's gross estate reduced by the sum of the estate tax deductions allowable under section 2053 or section 2054—namely, the deductions allowable for the decedent's debts, administration and funeral expenses, and losses from

[46] *Id.* § 2004(a).
[47] Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 422, 95 Stat. 314.
[48] *See* I.R.C. § 6166(a)(1), (a)(3), (f).
[49] *See* H.R. REP. No. 94-1380, 94th Cong. 2d Sess. 28-31 (1976).
[50] I.R.C. § 6166(a)(1); *see* H.R. REP. No. 94-1380, *supra* note 49, at 28-31.
[51] I.R.C. § 6166(a)(1).

casualty or theft during the administration of the estate.[52] Because the computation of the adjusted gross estate reflects allowable estate tax deductions, the amount of the adjusted gross estate will not depend upon an election under section 642(g)[53] to treat administration expenses as income tax deductions rather than as estate tax deductions.

As noted earlier, the 1981 Act repealed, except for certain collateral purposes, the rule that properties which were gratuitously transferred by a decedent within three years of his death were included in his gross estate for estate tax purposes.[54] One of the exceptions relates to section 6166. Except for gifts excluded from the gross estate by section 2035(b)(2),[55] gifts made within three years of his death are included in the decedent's gross estate for the purpose of determining whether the section 6166 qualification requirement is met.[56] This precludes the use of deathbed transfers, other than those covered by section 2035(b)(2), to alter the percentage of the adjusted gross estate represented by an interest in a closely held business.

B. *The Making of the Election.*

To be effective, the election must be made not later than the time for filing the return (including extensions).[57] If that election is not made, an election may, nevertheless, be made within sixty days after receiving a notice and demand for the payment of an estate tax deficiency. An election that is not filed until that time, however, only defers payment of the deficiency.[58]

Section 6166 permits the filing of a protective election with the estate tax return.[59] If the estate does not appear to qualify for section 6166 at the time that the estate tax return is filed, a protective election should be considered, so that the benefit will be available if it is later discovered that the estate does qualify. For example, the valuation of the estate's assets

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[52] I.R.C. § 6166(b)(6); *see* I.R.C. § 2053 (expenses, indebtedness, and taxes); I.R.C. § 2054 (casualty losses); note 4 *supra* and accompanying text (concept of "adjusted gross estate" as it appears in section 303).

[53] I.R.C. § 642 (special rules for credits and deductions).

[54] Economic Recovery Tax Act of 1981, § 424; *see* note 8 *supra* and accompanying text (amendment of section 2035 excluding certain gratuitous transfers by decedent within three years of death from gross estate for estate tax purposes).

[55] In general, the gifts excluded by section 2035(b)(2) are gifts of present interests that do not exceed $10,000 per donee per year (other than a gift of a life insurance policy), *see* I.R.C. § 2035(b), gifts made to a donee by making direct payment to an educational institution of tuition expenses for such donee, *see* I.R.C. § 2503(e)(2)(A), and gifts made to a donee by making direct payment of medical care expenses incurred by that donee. *See* I.R.C. § 2503(e)(2)(B); *see also* I.R.C. § 6019(a).

[56] I.R.C. § 2035(d)(3)(C).

[57] I.R.C. § 6166(d); *see* I.R.C. § 6075(a).

[58] I.R.C. § 6166(h); Reg. § 20.6166-1(c).

[59] *See* Reg. § 20.6166-1(d)(3) (protective election).

may change as a result of an audit, and the change could result in the estate's qualification for deferral.

C. *Section 6166 Estate Tax Deferment.*

A valid election under section 6166 permits the executor to defer payment of the portion of the estate tax attributable to the inclusion of the interest in the closely held business in the decedent's gross estate.[60] The appropriate fraction of the estate tax to be deferred is determined by dividing the value of the qualifying interest in the closely held business (referred to in the statute as the "closely held business amount") by the amount of the adjusted gross estate.[61] In algebraic form, the calculation of the amount of tax to be deferred is made as follows:

$$\frac{\text{closely held business amount}}{\text{adjusted gross estate}} \times \text{estate tax payable}$$ [62]

The deferral can also apply to an estate tax deficiency that is subsequently determined.[63]

The portion of the estate tax that is deferrable under section 6166 (hereinafter referred to as "the section 6166 portion") can be deferred for up to five years after the normal due date. The period of time is chosen by the executor in making his election, but the maximum period is five years.[64] During the period of deferral, no payment is made on the principal amount of the section 6166 portion of the tax, but interest payments are made annually.[65] At the expiration of the period, the principal amount of the section 6166 portion becomes payable in equal annual installments over a period chosen by the executor in his election.[66] The number of such installments cannot exceed ten, including the first one payable at the end of the initial deferral period.[67] The aggregate amount of estate tax that may be deferred (and the amount of each annual installment) may be recomputed as a result of audit adjustments after the estate tax return is filed.[68] Interest on the remaining balance of the tax is payable annually with each installment payment of principal.[69]

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[60] I.R.C. § 6166(a).
[61] I.R.C. § 6166(a)(2), (b)(5).
[62] *See* Reg. § 20.6166A-1(b) (formula for calculation of amount of tax deferral).
[63] *See* I.R.C. § 6166(e) (proration of deficiency to installments).
[64] I.R.C. § 6166(a)(3).
[65] I.R.C. § 6166(f)(1).
[66] I.R.C. § 6166(a)(3).
[67] I.R.C. § 6166(a)(1).
[68] *See* Rev. Rul. 81-294, 1981-50 I.R.B. 14, (Dec. 14) for a series of examples on the method for recalculating installment payments following audit adjustments to an estate tax return.
[69] I.R.C. § 6166(f)(2).

D. *Interest on Deferred Payments.*

The statute imposes an interest rate of only four percent on all or a portion of the deferred section 6166 portion; the portion of the deferred estate tax that qualifies for the four percent rate is called "the four percent portion."[70] The four percent portion is the lesser of the section 6166 portion of the tax, or $345,800 reduced by the unified credit allowed for estate and gift taxes under section 2010.[71] The $345,800 figure is the amount of estate tax imposed on a $1,000,000 estate; thus, the thrust of the provision is to provide a four percent interest rate for the deferral of the estate tax imposed on up to $1,000,000 in value of the interest in a closely held business that qualifies for section 6166 treatment. The rate of interest on the remaining portion of the deferred tax is determined under section 6621. Beginning on February 1, 1982, the interest rate under section 6621 will be adjusted every year to the average prime rate available on bank loans to large businesses.[72]

The size of the unified credit for estate and gift taxes was increased by the 1981 Act. The amount of the increase is to be phased in over a six-year period. By 1987, the credit is scheduled to reach $192,800, a figure which will insulate $600,000 of an individual's wealth from estate and gift taxation.[73] This increase in the unified credit reduces the significance of the special four percent interest rate allowance. For decedents dying in 1987 or thereafter, the maximum amount of deferred estate tax that can qualify for the four percent interest rate is $153,000.[74]

If the section 6166 portion of the estate tax is greater than the four percent portion (this will occur if the closely held business interest that qualifies for the section 6166 election is greater than $1,000,000), then each installment payment is allocated pro rata between the tax that qualifies for the four percent rate and the tax that does not qualify.[75] Thus, after each installment payment a lesser amount of tax will qualify for the four percent rate, but the percentage of the deferred tax that qualifies for the four percent rate will remain the same.

E. *Deductibility of Interest on Deferred Payments and Resulting Complexities.*

In *Estate of Bahr v. Commissioner,*[76] the Tax Court held that interest paid on deferred tax constitutes an expense of administering the estate and is deductible from the gross estate under section 2053.[77] The Commis-

[70] I.R.C. § 6601(j).
[71] I.R.C. § 6601(j)(A), (j)(B).
[72] I.R.C. § 6621(b).
[73] *See* I.R.C. §§ 2010(a)-(b), 2505(a)-(b).
[74] I.R.C. § 6601(j)(2)(A).
[75] Reg. § 20.6166-1(f), (i) Ex. 3.
[76] 68 T.C. 74 (1977), *acq.*, 1978-1 C.B. 1.
[77] *Id.* at 83.

sioner has adopted the *Bahr* position.[78] The estate tax regulations provide that a deduction for an administration expense that has not been incurred at the time of final audit of the estate tax return will be allowed only if the expense is ascertainable with reasonable certainty.[79] Applying that requirement, the Commissioner does not allow a deduction for interest on deferred estate tax until the interest accrues—that is, until the date on which the interest becomes payable.[80] The Commissioner reasons that, because the installments can be prepaid (and prepayment must be made in certain circumstances) and because a prepayment will reduce the amount of the interest, the aggregate amount of interest that will be paid is not ascertainable with reasonable certainty before the full amount of tax liability is satisfied.

The executor can elect with each interest payment whether to take the payment as an income tax deduction or as an estate deduction.[81] An election made for one payment does not commit the executor to the same treatment for the next payment.[82] If an interest payment is taken as an estate tax deduction, it will reduce the amount of the estate tax. In consequence, all prior payments of tax and of interest will have exceeded the appropriate figures after the additional deduction is given effect. A mathematical problem that arises is how to compute the effect of the interest overpayments on the current and future dollar obligations. The remaining balance of the unpaid estate tax will also be reduced. Because each subsequent interest payment that is treated as an estate tax deduction will have the same effect, the estate tax liability, the cumulative overpayment, and the unpaid balance will have to be recomputed each year.[83]

The Commissioner has stated that no refund of an overpayment will be made until the entire estate tax liability has been paid,[84] and section 6404(b) bars the estate from claiming abatement of the overassessment of the unpaid balance of the section 6166 portion of the tax. The Commissioner has also stated, however, that if the parties can agree on the computation of the amounts involved, the overassessment of the unpaid section 6166 portion of the tax will be abated (pursuant to section 6404(a)) and any overpayment of the installment payments previously made on the section 6166 portion of the estate tax, plus the overpayment of interest thereon, will be credited to the earliest of the next installment payments

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[78] Rev. Rul. 78-125, 1978-1 C.B. 292; Rev. Rul. 80-159, 1980-1 C.B. 206.

[79] Reg. § 20.2053-1(b)(3).

[80] Rev. Rul. 80-250, 1980-2 C.B. 278; *see* Rev. Proc. 81-27, 1981-27 I.R.B. 21 (July 6) (procedure for recomputation of installment payments due to reduction in estate tax caused by payment of interest on tax).

[81] I.R.C. § 642(g).

[82] *See* I.R.S. Letter Ruling 8022023, February 27, 1980 (taxpayer may claim deduction for administration expenses incurred and payable by estate without jeopardizing future allowance on estate's fiduciary income tax return.).

[83] *See* Rev. Proc. 81-27, 1981-27 I.R.B. 21 (July 6).

[84] Rev. Rul. 80-250, 1980-2 C.B. 278.

due from the estate. Any overpayment remaining after the last installment will be refunded.[85]

The Commissioner has not indicated whether an overpayment of the non-section 6166 portion of the tax will be credited against future installment payments. Because the Commissioner relied on section 6403 for authority to credit the overage of installment payments against future installments and because section 6403 authorizes the crediting of excess installment payments only, it is possible that an overpayment of the non-section 6166 portion will not be so credited but instead will be refunded when the tax is paid in full. However, the Commissioner is authorized by section 6402(a) to permit an overpayment of the non-section 6166 portion to be credited against future installments, and there seems little reason for him not to do so.[86] If the overpayment of the non-section 6166 portion is so credited, it is possible that it will be credited against the entire unpaid section 6166 portion (rather than credited against the earliest installment payments) and will therefore reduce the total amount payable ratably over the remaining years of deferral. This complication can be avoided if the executor elects to treat the interest payments as income tax deductions.

What would otherwise be a substantial additional complication is forestalled by the second sentence of section 6166(b)(6), which provides that the "adjusted gross estate" shall be computed, for the purposes of section 6166, by reference to the amounts deductible under sections 2053 and 2054 under the "facts and circumstances in existence" on the earlier of the due date of the estate tax return or the date of its actual filing.[87] Under that test, the interest payments on the deferred estate tax do not enter into the computation of the adjusted gross estate. Whether those interest payments will ever be made will depend on facts and circumstances not yet in existence at the test date. Therefore, those interest payments will not reduce the denominator of the fraction in the formula discussed above[88] for determining the portion of the estate tax payment of which can be deferred under section 6166.

F. *Definition of Closely Held Business Interest.*

The determination of the qualification of an estate for section 6166 treatment and of the amount of estate tax to be deferred rest on the percentage of the adjusted gross estate that is represented by the value of the qualified interest in the closely held business that is included in the decedent's gross estate. The statutory definition of an "interest in a closely held business" is, therefore, crucial. Section 6166(b)(1) defines such an interest as:

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[85] Rev. Proc. 81-27, 1981-27 I.R.B. 21 (July 6); *see* I.R.C. § 6404.
[86] I.R.C. § 6402(a).
[87] I.R.C. § 6166(b)(6).
[88] *See* notes 60-63 *supra* and accompanying text.

(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.[89]

The determination of whether an interest included in the decedent's gross estate qualifies as an interest in a closely held business is made "as of the time immediately before the decedent's death."[90]

For the purpose of determining the number of shareholders or partners of a corporation or partnership, stock or a partnership interest held by a husband and wife as joint tenants, tenants by the entirety, tenants in common, or community property (or the income from which is community property) is treated as owned by one shareholder or by one partner.[91] With one minor exception, a spouse's interest which is so attributed to the decedent will also be treated as being owned by him for the purpose of determining whether, under section 6166(c), interests of the decedent in several closely held businesses can be combined and treated as an interest in a single trade or business. Unless the interest of the decedent's spouse is included in the decedent's gross estate (and it is unlikely to be so), it will not be treated as section 6166 property for other purposes such as the determination of whether the value of section 6166 property exceeds thirty-five percent of the decedent's adjusted gross estate or whether the requirement that twenty percent or more of capital value of a partnership or twenty percent or more of voting stock of a corporation be included in the decedent's gross estate is satisfied.[92]

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."[93] For that purpose, only a person having a present interest in a trust is treated as a beneficiary thereof.[94] The legisla-

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[89] I.R.C. § 6166(b)(1).

[90] I.R.C. § 6166(b)(2)(A).

[91] I.R.C. § 6166(b)(2)(B).

[92] *See* Rev. Rul. 61-91, 1961-1 C.B. 714 (community interest of surviving spouse in closely held business cannot be combined with deceased spouse's interest to determine whether section 6166(a) percentage requirements are met).

[93] I.R.C. § 6166(b)(2)(C).

[94] *Id.*

tive history of the Tax Reform Act of 1976 states that the purpose of including the above provision for indirect ownership in section 6166 was "to prevent avoidance of the shareholder or partnership limitations by the use of partnerships, trusts, or tiers of corporations."[95] If that were the exclusive purpose for adopting section 6166(b)(2)(C), then it is not clear why the indirect ownership rule was extended to property held by an estate. In that connection, because estates are included, it is strange that the present interest limitation on a person's constituting a beneficiary of a trust was not extended to beneficiaries of estates. While there is no statutory language in section 318 restricting the beneficiary of an estate or trust to persons having a present interest therein, the regulations interpreting that section have so restricted the term when applied to beneficiaries of estates (but not of trusts).[96] Perhaps this same restriction will be read into section 6166(b)(2)(C), but the express reference in the statute to beneficiaries of trusts suggests that the omission of a reference to estates was deliberate.

For purposes of determining whether the number of partners or shareholders of a partnership or corporation exceeds fifteen, the partnership interest or stock owned by a spouse, brother or sister (by whole or half blood), ancestor, or lineal descendant of the decedent is treated as owned by the decedent as a single partner or shareholder as the case may be.[97] This is a type of family attribution rule. If the indirect ownership rule for beneficiaries, partners, and shareholders, section 6166(b)(2)(C), causes a member of the decedent's family to be treated as the owner of a partnership interest or stock, the attribution rule of section 6166(b)(2)(D), if applicable, will treat the decedent as the owner of that partnership interest or stock.[98] While this provision for family attribution of stock and partnership interests applies only for the purpose of determining the number of shareholders or partners, in certain circumstances the decedent's executor can elect to have it apply for other purposes; but there is a cost to making that election.[99] If the election is made, any "non-readily-tradable stock" or partnership interest of a member of the decedent's family that is attributed to the decedent under section 6166(b)(2)(D) will be treated as property that was included in the decedent's gross estate.[100] Consequently, the value of any such non-readily-tradable stock and the capital interest in a partnership attributed to the decedent will be taken into account both (1) in applying the twenty percent or more rule of sections 6166(b)(1)(B)(i) and (b)(1)(C)(i) for determining whether a

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[95] STAFF OF JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 at 548 (Comm. Print 1976).

[96] Reg. § 1.318-3(a) Exs. 1 & 2.

[97] I.R.C. § 6166(b)(2)(D).

[98] *See* H.R. REP. NO. 95-1286, 95th Cong. 2d Sess. 12-13 (1978) (bill applies attribution rules to determine number of shareholders in corporation or partners in partnership).

[99] I.R.C. § 6166(b)(7).

[100] *Id.*

partnership or stock interest constitutes an interest in a closely held business, and (2) in determining under section 6166(c) whether the decedent's interests in several closely held businesses are of sufficient magnitude to combine them and treat them as an interest in a single trade or business. Even if the election is made, the interests attributed to the decedent from members of his family will not be treated as part of his gross estate for any other purpose. For example, such interests are not included in determining whether the thirty-five percent of adjusted gross estate requirement is satisfied. The term "non-readily-tradable stock" refers to stock for which, at the time of the decedent's death, there was no market either on an exchange or in an over-the-counter market.[101]

If the election under section 6166(b)(7) is made by the executor, two of the provisions that normally apply to section 6166 elections will not apply: the four percent interest rate on part or all of the deferred tax and the five-year deferral for the payment of principal.[102] Instead, installment payments will commence on the date prescribed by section 6151(a), that is, the date for filing the return, unless an extension of time for reasonable cause is obtained under section 6161.

In certain circumstances, the decedent's interests in two or more trades or businesses can be combined and treated as an interest in a single trade or business.[103] An interest in a trade or business can be so combined with other such interests of the decedent if the value of the interest included in the decedent's gross estate is at least twenty percent of the total value of such business.[104] Each interest of the decedent which satisfies that twenty-percent rule can be combined with other such interests. In determining whether the twenty percent requirement is satisfied, with one exception, the interest of the decedent's spouse in co-owned or community property that is attributed to him by section 6166(b)(2)(B) is treated as the decedent's interest.[105] The one exception relates to separate property of the spouse the income from which is community property. Also, for this purpose, if the executor elects coverage under section 6166(b)(7), an interest of a family member of the decedent that is attributed to him under section 6166(b)(2)(D) is treated as the decedent's interest.[106]

G. *Acceleration of Payment.*

In certain circumstances, an estate can lose its right to continue deferral of estate tax payment. In that event, the entire unpaid balance of the tax becomes payable upon notice and demand from the district director. This loss of deferral is referred to as "acceleration of payment."[107]

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[101] I.R.C. § 6166(b)(7)(B).
[102] I.R.C. § 6166(b)(7)(A).
[103] I.R.C. § 6166(c).
[104] *Id.*
[105] *Id.*
[106] I.R.C. § 6166(b)(7).
[107] *See* I.R.C. § 6166(g).

1. *Delinquency in making an installment payment.*

One cause for acceleration of payment is the failure of the estate to make an interest payment or an installment payment on time—that is, by the date set for such payment, including any extension of time obtained therefor.[108] If additional time to make a payment is needed, the executor should make a timely application under section 6161 for an extension of time for reasonable cause.[109] The penalty for a late payment is severe: deferral is lost for the unpaid tax.[110] However, the 1981 Act amended section 6166 to provide a six-month grace period for tardy payments.[111] If a payment is made within six months after it is due, there will be no acceleration of the unpaid tax, but two penalties are then imposed. First, no part of the interest payable on a tardy installment payment will qualify for the special four percent interest rate and, second, a penalty is imposed in the amount of five percent of the tardy payment for each month (or fraction thereof) that the payment is late (i.e., the maximum penalty is thirty percent of the overdue payment).[112]

2. *Utilization of undistributed net income.*

A consequence of extending the time for paying the estate tax is that the estate will remain open until the tax is fully paid. In the absence of such an extension, an estate subject to estate tax typically will be closed and distributed within three to four years. The Service opposes any unnecessary postponement of the closing of an estate because so long as the estate exists it constitutes an additional taxpayer which can be employed for income splitting purposes.[113] To protect against the extended use of an estate as a separate income tax paying entity, an estate which has deferred its estate tax liability under section 6166 is required after a certain period of time to utilize its "undistributed net income"[114] by applying that

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[108] I.R.C. § 6166(g)(3).

[109] *See* notes 41-43 *supra* (timely filing of estate tax returns). To be "timely" an application for an extension must be filed within nine months of the decedent's death. I.R.C. § 6075(a).

[110] I.R.C. § 6166(g)(3)(A). Upon failure to make timely payment, the unpaid portion of the deferred installments shall be paid upon notice and demand from the Secretary. *Id.*

[111] I.R.C. § 6166(g)(3)(B).

[112] I.R.C. § 6166(g)(3)(B)(ii)-(g)(3)(B)(iii).

[113] *See* Reg. § 1.641(b)-3 (income of estate is that received by estate during period of administration or settlement; defines period as time actually required by administrator or executor to perform ordinary duties of administration; period of administration may not be unduly prolonged, and if so, estate considered terminated for federal income tax purposes after expiration of reasonable period for performance of all duties of administration). The income splitting problem is more acute for estates than it is for trusts because estates are not subject to the throwback rules of Code sections 665-667.

[114] The "undistributed net income" of an estate as defined in section 6166(g)(2)(B) is the excess of the estate's distributable net income (defined in section 643) over the sume of: (1) the total of the estate's distributions for that year that are deductible under section 661(a); (2) the federal income tax imposed on the estate for the taxable year; and (3) the amount of

amount to payment on the remaining balance of the deferred tax.[115] Any such payment is divided equally among the remaining installments due after the payment is made and thus reduces each such installment accordingly.[116]

The requirement that the estate pay out its undistributed net income in the above manner applies only to the income for taxable years ending on or after the due date for the first installment of principal.[117] If the executor elects the maximum five-year period of total deferment provided by section 6166, the estate can accumulate income for five years or more (taking into account the nine-month period prior to the date on which the estate tax return is due). It is only in a taxable year in which an installment payment is due that the estate's income cannot be accumulated.

A judicious choice of taxable year for the estate can provide it with some additional time to accumulate income. Consider the following example.

> *D* died on October 10, 1980. *D*'s estate tax return is due to be filed on July 10, 1981, and unless an extension of time is obtained, the estate tax is payable on the same date. *D*'s executor makes a valid election under section 6166 to defer payment of the tax for five years and then to pay the tax in ten annual installments. The first installment is due on July 10, 1986—five years after the due date for filing the estate tax return. Consider the following alternatives:
>
> (1) *D*'s executor adopts a calendar year for reporting the estate's income for income tax purposes. The first taxable year then is October 11, 1980 to December 31, 1980. *D*'s estate can accumulate income for those two and one-half months and for the five calendar years 1981 through 1985. For the calendar year 1986, and for the years thereafter, the estate cannot accumulate income. Thus, the estate can accumulate income for approximately five years and two and one-half months.
>
> (2) Instead of electing a calendar year, the executor elects a fiscal year ending on June 30 (the end of the month prior to the month in which the estate tax return is due to be filed). The estate can accumulate income for the short taxable year October 11, 1980 to June 30, 1981 (a period of about eight and one-half months) and for the five ensuing full fiscal years. The final such fiscal year ends on June 30, 1986, which is prior to the

estate tax (plus interest thereon) paid by the executor in the taxable year (other than amounts paid pursuant to the requirement that the estate disgorge its undistributed net income).

[115] I.R.C. § 6166(g)(2).

[116] Reg. § 20.6166A-3(b)(3). Although section 6166A was repealed by the 1981 Act, many of its terms are identical to those now encompassed by section 6166. Thus, much of the regulatory and administrative construction of the repealed section is relevant to the construction of the current section 6166.

[117] I.R.C. § 6166(g)(2)(A).

> July 10, 1986 due date for the first installment. By adopting a June 30 fiscal year, the estate is permitted to accumulate income for a period of six months more than would be obtained by adopting a calendar year.

Of course, other tax considerations may weigh against the choice of a taxable year that maximizes the permissible period for accumulating income, but it is a factor to be considered.

When an estate has undistributed net income for a taxable year in which accumulations are not permitted, the executor is directed to pay the Service an amount equal to the undistributed net income no later than the due date for filing the income tax return for such year.[118] Failure to make the required payment within six months of that date (the grace period granted by the 1981 Act) will accelerate the due date of the entire unpaid balance of the deferred estate tax.[119] If payment equal to the undistributed net income is not made on the due date but is made within the six-month grace period, the five percent per month penalty described above will be imposed.[120]

3. *Disposition of or withdrawal of funds from the business.*

From the planning viewpoint, the most important of the acceleration provisions is the one restricting the extent to which an estate can dispose of its interest in the closely held trade or business that qualifies the estate for deferral treatment and the extent to which the estate can withdraw funds from that trade or business.[121] The rationale underlying this provision is that sale or liquidation of the qualifying interest terminates the need for deferring payment of the estate tax.

Specifically, section 6166(g)(1)(A) provides (with an exception for certain, but not all, section 303 redemptions) that the entire balance of the unpaid estate tax becomes payable upon notice and demand therefor if the value of the portions of the qualifying interest that are distributed, sold, exchanged, or otherwise disposed of, plus the aggregate withdrawals[122]

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[118] *Id.*

[119] I.R.C. § 6166(g)(3)(A).

[120] I.R.C. § 6166(g)(3)(B); *see* text accompanying notes 111-12 *supra*.

[121] I.R.C. § 6166(g)(1).

[122] A withdrawal of property from a closely held corporation, the stock of which constitutes a qualifying interest, will be taken into account in applying the restriction on withdrawal only to the extent that the property withdrawn from the corporation constitutes "included property" as that term is employed in the regulations, Reg. § 20.2032-1(d), which construe the operation of the alternative valuation date election. Regulations section 20.2032-1(d) provides in pertinent part that all property interests existing at the date of decedent's death that form a part of the gross estate as determined under sections 2033 through 2044 of the Code are included property. Property earned or accrued after the date of the decedent's death is excluded property. *See also* Reg. § 6166A-3(d)(1) (privilege of paying in installments terminates upon withdrawal of 50% of value of business if it is a withdrawal of money or other property which constitutes "included" property as defined by Regulations section 20.2032-1(d); acceleration provision does not apply to withdrawal of excluded property).

from the trade or business made with respect to the qualifying interest, equals or exceeds fifty percent of the value of the qualifying interest.[123]

Prior to the enactment of the Economic Recovery Tax Act of 1981, dispositions of qualifying interests and withdrawals made from a trade or business with respect to a qualifying interest were subject to different standards for determining whether an acceleration of estate tax payment was required. As a consequence of the 1981 Act, as indicated above, dispositions and withdrawals are combined and subjected to a single standard for determining whether the estate tax deferral has been terminated.[124]

The following example illustrates how the limitation on dispositions and withdrawals operates when there is no covered redemption under section 303:

> *D* died on November 1, 1982. At the time of his death, he owned 8,000 of the 15,500 shares of *X* Corporation and 2,000 of the 10,000 shares of *Y* Corporation, each of which had only one class of stock. No shares of *X* or *Y* were included in *D*'s gross estate other than the shares owned by him at his death. *D*'s executor did not elect the alternate valuation. On the date of *D*'s death, *X* stock had a value of $50 per share and *Y* stock had a value of $100 per share. Thus, the estate tax value of the 8,000 shares of *X* stock was $400,000 and the estate tax value of the 2,000 shares of *Y* stock was $200,000. The value of all of the outstanding stock of *X* was $775,000 and the value of all of the outstanding stock of *Y* was $1,000,000. The amount of the adjusted gross estate was $1,600,000. After the allowable deductions and credits, the estate tax liability was $520,000. For purposes of sections 303(b)(2)(B) and 6166(c), the value of the *X* and *Y* shares respectively that are included in the gross estate satisfy the twenty percent of value required for combining the two corporations and for treating the stock of both corporations as the stock of a single closely held business.[125] The combined value of the *X* and *Y* shares

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In Revenue Ruling 75-401, 1975-2 C.B. 473, the Commissioner ruled that, to the extent that a cash dividend that was paid on stock (which constituted a qualifying interest under an earlier version of section 6166) is attributable to earnings and profits accumulated prior to the decedent's death, it is "included property" and is taken into account as a withdrawal, but to the extent that the cash dividend is attributable to earnings and profits accumulated after the decedent's death, it is "excluded property" and is not taken into account in applying the restricting on withdrawals. Regulations section 20.2032-1(d)(4) treats all dividends declared and paid after the decedent's death as "excluded property" unless the dividend is of such magnitude as to have a significant impact on the valuation of the stock at the alternative valuation date. In the latter event, only the portion of the dividend that is attributable to earnings and profits accumulated after the decedent's death is taken into account. Presumably, notwithstanding Revenue Ruling 75-401, an ordinary cash dividend declared and paid after the decedent's death that does not substantially reduce the value of the stock will not be treated as a withdrawal for purposes of section 6166(g)(1)(A)(i)(II) regardless of when the earnings of the corporation were accumulated.

[123] I.R.C. § 6166(g)(1)(A).

[124] *See* I.R.C. § 6166(g)(1)(A)(i).

[125] The aggregate value of the outstanding shares of *X* and *Y* is $1,775,000. The combined

included in the gross estate ($600,000) exceeds thirty-five percent of the adjusted gross estate (that is, 35% × $1,600,000 = $560,000). The estate therefore qualifies under section 6166(a)(1) for an election to defer a portion of the estate tax under section 6166. *D*'s executor elected section 6166 deferral when he filed the estate tax return on July 28, 1983. On November 12, 1984, *D*'s executor sold 1000 shares of *Y* stock to an unrelated party for $100,000 cash. At that time, the values of *X* and *Y* shares were $50 per share and $100 per share respectively. Although the estate thereby disposed of fifty percent of the value of its *Y* stock, it did not dispose of fifty percent or more of the value of its combined *X* and *Y* stockholdings, and so there was no acceleration of payment.

The computation of the percentage of value of the qualifying interest that was disposed of is simple where the original value of the *X* and *Y* stocks remains constant. The following formula appears to conform with the method employed in the regulations[126] in connection with the application of a comparable restriction.

$$\frac{\text{value of disposed stocks}}{\text{value of qualifying interest}} \times 100\% = \frac{\text{the percentage of}}{\text{reduction of value}}$$

The values of the disposed stock and of the qualifying interest are to be determined as of the date of disposition. So, under these facts:

$$\frac{\$100{,}000 \text{ (value of the sold } Y \text{ shares)}}{\$600{,}000 \text{ (value of qualifying interest, } i.e.\text{, the } X \text{ and } Y \text{ shares held by the estate)}} \times 100\% = 16.7\%$$

Since the estate disposed of 16.7% of the value of its qualifying interest, the remaining shares of *X* and *Y* retained by the estate represent 83.3% of the value of the qualifying interest.

On December 4, 1986, the estate sold 4,200 shares of *X* stock to a third party for $252,000 cash. At that time, the value of the *Y* shares was $150 per share and the value of the *X* shares was $60 per share. Thus, the value of the 8,000 shares of *X* stock held by the estate at that time was $480,000. The value of the 1,000 shares of *Y* stock held by the estate was $150,000. The aggregate value of the shares of *X* and *Y* retained by the estate was $630,000. Since the entire number of shares held by the estate at that time represented 83.3% of the value of the original qualifying interest, the percentage of reduction of value of the qualifying interest caused by the December 4 sale is the percentage of 83.3% equal to the percentage that the then value of the 4,200 shares of *X* that were sold

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value of the *X* and *Y* shares included in *D*'s gross estate is $600,000, which is greater than 20% of the value of the total outstanding shares of *X* and *Y* stock.

[126] Reg. § 20.6166A-3(d)(3) Ex. 1.

($252,000) represents of the then value of all of the retained shares of *X* and *Y* ($630,000).

$$\frac{\$252{,}000 \text{ (value of 4,200 shares of } X)}{\$630{,}000 \text{ (value of retained } X \text{ and } Y \text{ shares)}} \times 100\% \times 83.3\%$$

$$= 40\% \times 83.3\% = 33.3\%$$

After the December 4, 1986 sale, the total reduction in value of the qualifying interest was 16.7% (reduction from the November 12, 1984 sale) plus 33.3% (reduction from the December 4, 1986 sale). Since this reduction equals exactly fifty percent of the value of the qualifying interest, the payment of the estate tax is accelerated upon the Service's making notice and demand for payment.[127]

The statutory restriction on the extent to which a qualifying interest can be "distributed, sold, exchanged, or otherwise disposed of"[128] does not apply to an exchange made pursuant to a D, E, or F reorganization, nor does it apply to an exchange to which section 355 (or section 356 to the extent that it relates to section 355) applies.[129] In general, the restriction does not apply to a mere change of the form in which a trade or business is conducted, such as a section 351 exchange.[130]

The Commissioner has ruled that a shareholder's surrender of corporate stock (which was a qualifying interest) pursuant to a liquidation of the corporation under section 331 or section 333 does not constitute a disposition or exchange of the qualifying interest when the liquidation did not alter the conduct of the business or the interest of the estate in the business.[131] Even if the estate (or other person who surrenders stock constituting a qualifying interest) is the sole shareholder of the liquidating corporation and continues the business, there still may be an acceleration problem. Even though a corporation may have assets that are not used in the conduct of the trade or business, the qualifying stock interest reflects

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[127] *See* I.R.C. § 6166(g)(1)(A)(ii)(acceleration of payment when aggregate of sales equals or exceeds 50% of value of interest).

[128] I.R.C. § 6166(g)(1)(A)(i)(I).

[129] I.R.C. § 6166(g)(1)(c); *see* I.R.C. §§ 355, 356, 368(a)(1)(D)-(F).

[130] Reg. § 20.6166A-3(e)(2); *see* I.R.C. § 351.

[131] *See* Rev. Rul. 66-62, 1966-1 C.B. 272 (when change in operation of business from corporate to unincorporated form does not materially alter the business, change does not cause a termination of installment provision otherwise available to estate under section 6166(a) of the Code); I.R.S. Letter Ruling 8108090, November 26, 1980 (proposed liquidation of corporation engaged in business of owning and operating mobile home park was not exchange, sale, or other disposition, when co-executors will continue to operate business in substantially identical manner, only as sole proprietorship, instead of in corporate form); I.R.S. Letter Ruling 7926116, March 30, 1979 (proposed section 333 liquidation of farming and ranching business, when operation of said business was to continue with no substantial alteration, not considered withdrawal or disposition of interest in closely held business that would terminate installment payment privilege).

the value of all of the corporation's assets, including assets that are not used in the trade or business. After the liquidation, the business will be conducted as a sole proprietorship, and so those assets distributed in liquidation to the shareholder that are not actually used in the trade or business will be treated as a withdrawal from the trade or business.[132] The corporate liquidation can, therefore, cause an acceleration of payment if the aggregate withdrawals and dispositions exceed the permissible level.[133]

If the estate (or other person) is not the sole shareholder, it is likely that a liquidating distribution to the estate will not cause an acceleration if either the estate acquires sufficient assets to continue to operate the business or if the several shareholders form a partnership to conduct the same business with the distributed assets.[134] Of course, any assets received in liquidation that are not employed in the trade or business will be treated as having been withdrawn from the trade or business. If the liquidation itself does not cause an acceleration, the partnership's subsequent exchange of some of those acquired assets that are used in the trade or business for new assets that are so used or its sale of some of those acquired assets and use of the proceeds to purchase new assets should not constitute a withdrawal from the business so long as the partnership continues to conduct the business and the estate retains its interest in the partnership.[135]

It is interesting to note that the Commissioner promulgated the above-mentioned rulings despite the specific statement in Regulations section 20.6166A-3(e)(2) that the statutory reference to dispositions "includes the surrender of a stock certificate for corporate assets in complete or partial liquidation of a corporation pursuant to section 331."[136] The quoted statement merely serves to show the breadth of the scope of the statutory reference to dispositions, that is, that it applies to all manner of transactions. The regulations do not necessarily imply that all corporate liquidations count toward the test for acceleration.

Section 6166(g)(1)(D) provides that the restriction on dispositions of

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[132] *See* I.R.S. Letter Ruling 8108090, November 26, 1980 (to extent that assets of sole proprietorship would not have qualified as interest in closely held business had business of corporation been conducted as sole proprietorship by decedent, such assets considered withdrawn from business as of time of proposed liquidation).

[133] *See* I.R.C. § 6166(g)(1)(A).

[134] *Cf.* I.R.S. Letter Ruling 8025095, March 28, 1980, *modified,* I.R.S. Letter Ruling 8034165, June 3, 1980 (proposed transfer of estate's business interests in oil, gas, ranching and farming operation to partnership does not constitute withdrawal for purposes of installment payment privilege, but if partnership exchanges or sells over 50% of estate's interests, this will result in an acceleration of the payments).

[135] I.R.S. Letter Ruling 8034165, June 3, 1980, *modifying* I.R.S. Letter Ruling 8025095 (partner's interest and not assets of partnership is interest in closely held business owned by estate; proposed exchanges for similar properties or sales and purchases of assets by partnership will not constitute disposition and cause acceleration of tax).

[136] Reg. § 20.6166A-3(e)(2).

qualifying interests does not apply to the transfer of property of the decedent "to a person entitled by reason of the decedent's death to receive such property under the decedent's will, the applicable law of descent and distribution, or a trust created by the decedent."[137] As a consequence of an amendment adopted as part of the 1981 Act, a similar exception applies to a series of subsequent transfers of the property by reason of death but only "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."[138] Thus a transfer of a qualifying interest from the executor to a beneficiary or heir (whether a natural person or a trustee of a testamentary or inter vivos trust) will not be considered in applying the acceleration rules. However, a subsequent disposition of qualifying interest property by such transferee, other than certain dispositions caused by the death of the transferee, will be taken into account, with a possible exception for transfers made from a testamentary trust to its beneficiaries. If a transferee of qualifying interest property dies and leaves the property to someone who is not a relative within the scope of section 267(c)(4), the disposition will be taken into account in determining whether estate tax payment is accelerated. Indeed, the language of the statutory amendment suggests that if any part of the qualifying interest property is bequeathed by the transferee to someone who is not within the limited class of relatives prescribed by section 267(c)(4), there will be deemed to have been a disposition of the entire amount of qualified property that was owned by the transferee.[139]

When during his life the decedent had transferred assets that were part of the qualifying interest to a revocable trust and, pursuant to the terms of the trust, the assets are distributed to the beneficiaries of the trust after the decedent's death, there should be no acceleration of payment. The statute expressly excludes transfers of property to persons entitled to receive it by reason of the decedent's death under a trust created by the decedent.[140] It is unclear whether this exception applies to a distribution to beneficiaries from a testamentary trust, or from a trust that was funded by transfers made from the executor, when the trust instrument requires that distributions be made shortly after receipt of the assets. Such transfers should not cause an acceleration of payment, but the issue is not settled.

It is doubtful that the exception for transfers made pursuant to a bequest protects an executor's (or trustee's) transfer of a qualified interest in full or partial satisfaction of a pecuniary bequest. Such transfers have

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[137] I.R.C. § 6166(g)(1)(D).

[138] *Id.* A family member under section 267(c)(4) includes only a spouse, ancestor, lineal descendant, or brother or sister (by whole or half blood). I.R.C. § 267(c)(4).

[139] I.R.C. § 6166(g)(1)(D).

[140] *Id.*

been treated by the Commissioner and by the courts as sales or exchanges[141] and likely will not be treated as transfers made pursuant to the decedent's will. Only transfers made pursuant to a specific or a residuary bequest are likely to qualify.

IV. INTERACTION OF SECTION 6166 WITH SECTION 303

To obtain the maximum dollar benefit from the deferral of tax payment provisions, deferral should be maximized. This is especially true to the extent that the four percent interest rate is available; but even when the interest is payable at the normal rate it will be desirable to defer the payment if the estate can earn a higher rate of income from the funds retained through deferral. In some circumstances, the higher interest rate will induce earlier payment. Of course, other factors pointing toward or against deferral may be of such significance that they will dwarf the consideration of interest rates—for example, liquidity needs may compel deferral, or the beneficiaries' desire that the estate be closed may induce prompt payment of the tax. To evaluate the benefits and costs of maximizing deferral, it is necessary to consider the interaction of deferral with section 303 and the difficulties encountered in obtaining the maximum benefits from both sections 303 and 6166.

A. *Maximizing Benefits.*

The full benefits under section 303 are obtained if the amount distributed in redemption of the estate's stock equals the maximum amount permitted by section 303(a) to be withdrawn from the corporation without causing dividend treatment. A redemption under section 303 often will cause no income recognition to the distributee because of the basis provided for the decedent's stock by section 1014 and because any section 306 stock owned by the decedent loses its taint at his death. Of course, many corporations do not have the liquidity to redeem a large amount of their stock shortly after the decedent's death, in which case redemptions may have to be made over a period of years. If an election is made under section 6166, the section 303 redemptions can take place over a period of almost fifteen years from the decedent's death.[142]

As noted earlier, if a corporate distribution in redemption of stock takes place more than four years after the decedent's death, the distribution can qualify for section 303 protection only to the extent that payment of death

[141] *See* Kenan v. Commissioner, 114 F.2d 217, 220 (2d Cir. 1940) (transfer of securities, which had appreciated in value, by testamentary trustees in partial satisfaction of claim against trust estate did not constitute transmission at death or acquisition by bequest for purposes of determining whether there was a recognition of gain; rather such transfer constituted an "exchange" for purposes of statute).

[142] *See* text accompanying note 23 *supra* (valid election under section 6166 to defer payment for up to fourteen years sets time limit for section 303 redemptions at last day of extended payment period).

taxes or funeral and administration expenses is made within one year after the distribution occurred.[143] The availability of redemption proceeds to make an installment payment due under section 6166 is one of the primary justifications for permitting the simultaneous use of both sections 303 and 6166. If funds that are withdrawn from the corporation under section 303 can be retained by the distributee for some years before using them to pay taxes or expenses, the distributee can retain the after-tax income earned by such funds. This retention can be of substantial value. To utilize section 303 for this purpose, the corporation must distribute a substantial amount of the redemption proceeds within four years after the decedent's death, so as to avoid the requirement that the redemption proceeds promptly be applied to payment of taxes or expenses. The corporation may not have sufficient liquid funds available to make sizeable redemptions within the four-year period, but if such funds are available, consideration should be given to sizeable early redemption.

If the acceleration provisions were to restrict the amount of section 303 redemptions so as effectively to preclude a disposition of an amount of stock equal to or greater than fifty percent of the estate tax value of the qualifying interest (hereinafter called "acceleration base"), sections 6166 and 303 would operate at cross purposes. Accordingly, section 6166(g)(1)(B) (sometimes hereinafter referred to as the "savings clause") provides that the proceeds received in a section 303 redemption (or of a sale of stock to a related corporation that is treated under section 304 as a section 303 redemption) are not treated as a withdrawal from the business, and that the surrender of shares of stock in such a redemption is not treated as a disposition of a qualified interest, if

> on or before the date prescribed . . . for the payment of the first installment which becomes due after the date of the distribution . . . [but not later than one year after the distribution], there is paid an amount of the [estate] tax imposed by section 2001 not less than the amount of money and other property distributed.[144]

Thus, if a sufficient timely estate tax payment is made, a section 303 redemption will not be taken into account in the determination of the amount of withdrawals from the corporation or of stock dispositions.

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[143] *See* text accompanying note 26 *supra* (when distribution made more than four years after decedent's death, amount received in redemption of stock qualifying for section 303 treatment limited to lesser of aggregate of unpaid taxes and aggregate of such taxes and expenses paid within one year after distribution date).

[144] I.R.C. § 6166(g)(1)(B). It is remotely possible that, as a consequence of section 6601(e)(1), the payment of interest on deferred estate tax liability will be treated as a payment of estate tax for the purpose of applying the minimum payment requirement of section 6166(b)(1)(B) to qualify a section 303 redemption as one covered by the exception. However, the regulations and rulings that construe the exception for covered section 303 redemptions make no mention of the payment of interest, and it seems likely that the omission was intentional.

However, if timely and adequate payment of the estate tax is not made, the section 303 redemption will be taken into account. For this purpose, each section 303 redemption is examined separately, and the failure or success of one section 303 redemption to qualify for this exclusion does not affect the qualification of other section 303 redemptions.[145] For convenience, those section 303 redemptions that are excluded from some aspects of the acceleration of payment consequence are referred to herein as "covered section 303 redemptions," and those section 303 redemptions that are not so excluded (because of failure to satisfy the timely payment requirement) as "noncovered section 303 redemptions."

A covered section 303 redemption can trigger acceleration. The acceleration base is reduced by the proportionate part thereof that the redeemed stock represents. Although the proportion of acceleration base represented by the covered section 303 redemption is determined at the time of the redemption, the reduction in acceleration base relates back to the estate tax valuation date (i.e., the date of the decedent's death or the alternate valuation date if the latter was elected by the executor).[146] One consequence of this relation back of the reduction in acceleration base is that a noncovered disposition of stock made after the estate tax valuation date, but before the covered section 303 redemption, may trigger acceleration of payment even though the value of the stock previously disposed of was less than fifty percent of the acceleration base at the time of its disposition.[147] In that event, the acceleration takes effect as of the date of the covered section 303 redemption, because that redemption caused the prior disposition to terminate the deferral.[148]

The following examples illustrate the effect of covered section 303 redemptions on prior or subsequent noncovered dispositions.

> Example 1. *D* died on July 14, 1982, and his executor did not elect the alternate valuation date. At his death, *D* owned 100 shares of stock of *X*

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[145] Reg. § 20.6166A-3(d)(2), -3(e)(5).

[146] Reg. § 20.6166A-3(e)(5).

[147] *See* Reg. § 20.6166A-3(e)(6) Ex. 3 (when decedent owned 100-share interest in closely held corporation and sale of 40 shares was made prior to section 303 redemption of 20 shares, relation back of reduction in interest to 80 shares represents sale of 50% of interest). *See generally* Blum & Trier, *Planning for Maximum Benefits of 303 Redemptions with Estate Tax Deferral,* 53 J. TAX. 236, 242-43 (1980) (construction adopted by regulations makes planning for optimum use of both sections 303 and 6166 difficult); Curran, *Estate Planning for Owners of Closely Held Corporations: A Critical View of Code Sections 303, 6166 and 6166A,* 20 B.C.L. REV. 648, 673 (1979) (criticizes structure of interaction of sections 303 and 6166 because, taken together, they provide more relief than is warranted). Regardless of whether the benefits of sections 303 and 6166 should be reduced by Congress, it is important to consider that a failure to reduce the acceleration base retroactively would permit a greater amount of section 303 redemptions if the noncovered redemptions were made first, followed by the covered redemptions, than would be permitted if the order of redemptions were reversed.

[148] *See* Reg. § 20.6166A-3(e)(6) Ex. 3 (when decedent owned 100 shares in closely held corporation and sale of 40 shares was made prior to section 303 distribution, date of distribution is considered date on which 50% of interest was disposed of).

Corporation, and the value of those shares was sufficent to qualify *D*'s estate for deferral of payment of a portion of the estate tax liability under section 6166 and for section 303 treatment on the redemption of the *X* stock. At the time of *D*'s death, *X* had 200 shares of stock outstanding, all of which were the same class of common voting stock. *D*'s executor made a timely section 6166 election. The qualifying interest of the estate consisted solely of the 100 shares of *X* owned by *D* at his death. The value of a share of *X* stock was the same throughout the period from *D*'s death through January 1, 1987.

On August 5, 1984, *X* redeemed 20 shares of its stock from *D*'s estate and paid cash therefor. The entire amount of the redemption proceeds was treated as a payment for the redeemed shares by virtue of section 303. Within one year after the redemption, the executor paid on the estate tax an amount equal to the redemption proceeds. Consequently, the section 303 redemption is not treated as a disposition of the qualifying interest or a withdrawal of funds from the trade or business. However, the value of the qualifying interest is reduced by the value of the stock redeemed in the covered section 303 redemption. As a result, the decedent's qualifying interest is represented only by the eighty shares of *X* stock retained by the estate.

On December 5, 1986, the executor sold 40 shares of *X* stock to a third party. Since the disposition of *X* stock effected by that sale constituted 50% of the value of the 80 shares of retained stock of *X*, the sale caused acceleration of payment of the estate tax, all of which became due and payable on demand.[149]

Example 2. The facts are the same as in Example 1 except that the order of the redemption and sale is reversed so that the sale of 40 shares of *X* stock to a third party took place on August 5, 1984, and the section 303 redemption of 20 shares of *X* took place on December 5, 1986.

The 1984 sale of 40 shares of *X* stock did not accelerate tax payment since it was a disposition of less than half of the value of the 100 shares of *X* stock that constituted the qualifying interest immediately prior to the sale.

The redemption of 20 shares of *X* stock on December 5, 1986, followed within one year by a payment of estate tax of an amount equal to the redemption proceeds, was a section 303 redemption which does not constitute a disposition of *X* stock for purposes of the acceleration provision. However, the redemption reduces the qualifying interest from 100 shares to 80 shares of *X* stock, and this reduction relates back to the date of *D*'s death on July 14, 1982. As a consequence, the 1984 sale of 40 shares of *X* stock becomes a disposition of half of the value of the then 80-share qualifying interest. Although, technically, it is the 1984 sale of the 40 shares of *X* stock that causes the acceleration of payment, the actual acceleration date is the December 5, 1986 redemption of 20

[149] I.R.C. § 6166(g); *see* Reg. § 20.6166A-3(e)(6) Ex. 2.

shares of *X* stock, since it is that redemption that caused the prior sale of *X* stock to exceed the less than 50% of value limitation.[150]

In the above examples, the qualifying interest constituted one class of stock of a single corporation, so that percentages of value could be determined by examining the percentages of the stock of that corporation that were redeemed or sold. If the qualifying interest had constituted stock of two or more corporations or two or more classes of stock, the percentage of value of the qualifying interest represented by each such transaction would have to be computed. Such percentages are determined by reference to the values at the transactional date, even though the reduction of a percentage of value caused by a covered section 303 redemption relates back to the date of death.[151]

Where an estate tax payment is made in order to satisfy the requirement that a payment at least equal to the section 303 proceeds be made within a specified period if the section 303 redemption is to be a covered redemption, the amount of the payment in excess of the amount required by section 6166 at that time is treated as if it were a voluntary prepayment. It can be applied in satisfaction of such installments, installment, or part of an installment as the person making the excess payment designates.[152]

For maximum use of sections 6166 and 303, a corporation could redeem as much stock as is permitted for noncovered redemptions, and the balance of the section 303 redemptions could be made so as to comply with the savings clause. At first glance, it might appear that an optimum mix of covered and noncovered section 303 redemptions would utilize the maximum percentage of value allowable for noncovered redemptions (half of the acceleration base). The difficulty with this approach is that, as noted earlier, the covered section 303 redemptions will reduce the acceleration base, so that the amount of permissible noncovered redemptions is lowered each time a covered section 303 redemption is made. This adjustment to the acceleration base relates back to the estate tax valuation date and, as shown earlier, can cause a previously made noncovered redemption to terminate tax deferral.

When a mix of covered and noncovered redemptions is planned, the parties usually will wish to have the noncovered section 303 redemption made first, within four years after the decedent's death, because the required application of proceeds of a redemption made after the four-year period to tax payment may forfeit a portion of the tax deferral. Of course, noncovered redemptions can be profitably made after the four-year period has expired if they will qualify for purchase treatment under section 302(b) so that section 303 protection is not needed.

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[150] *See* Reg. § 20.6166A-3(e)(6) Ex.3.

[151] Reg. § 20.6166A-3(e)(5); *see* text accompanying note 125 *supra* (stock held in two close corporations treated as held in one).

[152] Reg. § 20.6166A-1(h).

If a noncovered redemption is made before making covered redemptions, care must be taken to account for the effect that subsequent covered section 303 redemptions will have on the acceleration base. The optimum mix of covered and noncovered redemptions could no doubt be made with a computer, but there may be good reasons not to seek too perfect a combination. The determination of the optimum mix could be upset by revaluation of the estate's assets as the result of audit, conference, or litigation. Moreover, if the qualifying interest consists of stocks of more than one corporation, the determination of the reduction of the acceleration base resulting from a covered section 303 redemption requires that at the time of each redemption a determination be made of the then value of each of the assets comprising the qualifying interest. These potential adjustments to the acceleration base cannot be predicted with precision. There is every reason, therefore, to structure the redemptions so as to be reasonably far removed from the outer limits of the applicable acceleration provision. A valiant effort to provide techniques for obtaining a precise optimum mix has been made by several commentators, and the reader wishing to make that attempt, despite these warnings, should consult those writings.[153]

B. *The Cumulative and Post-redemption Constructions.*

An additional problem exists in coordinating the tax deferral provisions with section 303—namely, that the meaning of the statutory requirement that a specified amount of tax be paid by a certain time after the redemption is unclear. Section 6166(g)(1)(B) establishes a safe zone for a section 303 redemption

> only if, on or before the date prescribed . . . for the payment of the first installment which becomes due after the date of the distribution (or, if earlier, on or before the day which is 1 year after the date of the distribution), there is paid an amount of the tax imposed by section 2001 [the estate tax] not less than the amount of money and other property distributed.[154]

Does the quoted language require that such a payment be made after the redemption took place or is it sufficient that such payment was made at any time prior to the prescribed date? The statutory language is ambigu-

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[153] *See* Blum & Trier, *supra* note 147, at 236 (construction of regulations makes planning for optimal use of sections 303 and 6166 difficult); Fleming, *Funding Estate Tax Installment Payments with Section 303 Redemptions After the 1976 Tax Reform Act,* 4 J. Corp. Tax. 22, 41 (1977) (in cases in which tandem uses of sections 303 and 6166 or 303 and 6166A are available, successful result can be achieved only by having adequate appreciation of nuances of section 303 four-year rule, acceleration rules of section 6166 and section 6166A, and Commissioner's distinction between redemptions in single transactions and redemptions in series of transactions).

[154] I.R.C. § 6166(g)(1)(B).

ous.[155] Regulations section 20.6166A-2(d)(2) states that the exception for section 303 redemptions "does not apply unless *after the redemption,* but on or before the date prescribed for payment of the first installment which becomes due after the redemption, there is paid an amount of estate tax not less than the amount of money or other property distributed."[156] The construction adopted by the cited regulations is hereinafter referred to as the "post-redemption construction" because it requires that the tax payment be made after the redemption.

A different construction of the statute was adopted by the Commissioner in Revenue Ruling 72-188.[157] The construction adopted in that Revenue Ruling is hereinafter referred to as the "cumulative construction." The ruling involved redemptions of an equal number of shares of stock on November 1 of each year for ten years after the decedent's death, beginning with the year following the year in which the decedent died. The decedent died on September 1, 1966. The amount distributed to the shareholder for each such redemption was $50,000. The executor made a valid election under an earlier version of section 6166 to pay $125,000 of the $200,000 estate tax bill in ten installments. On the date for filing the estate tax return, December 1, 1967, the estate made an estate tax payment of $87,500, of which $75,000 was the required payment of the portion of the estate tax not subject to deferral (the non-section 6166 portion) and $12,500 was the first installment payment on the section 6166 portion of the tax. One month prior to that payment, on November 1, 1967, the corporation had distributed $50,000 to the estate as payment for a section 303 redemption of stock. On November 1, 1968, the corporation paid the estate $50,000 for another section 303 redemption. The second installment tax payment of $12,500 was made one month later. Under the post-redemption construction, the 1968 redemption would not qualify for the savings clause because the amount of tax paid after the redemption and by the prescribed date was less than the redemption proceeds. Nevertheless, the Commissioner held that the 1968 redemption qualified for the savings clause.[158] The Commissioner noted that the tax payments

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[155] Blum & Trier, *supra* note 147, at 239. The authors suggest that the statutory reference to a single distribution in redemption and the use of a time limitation measured from the date of that reference suggests that the tax payment must be made after the redemption in question was made. This author fails to draw any inference from the statute that suggests one construction over the other. The requirement that an amount of estate tax be paid by a certain date after the redemption does not indicate that the payment had to be made after the redemption. Payment of the requisite amount before the redemption would comply with the literal requirement that it be made "on or before" the prescribed date. I.R.C. § 6166(g)(1)(B).

[156] Reg. § 20.6166A-2(d)(2) (emphasis added); *cf.* Reg. § 20.6166A-3(e)(5) (rule does not apply unless timely tax installment paid equal to amount of redemption); Reg. § 20.6166A-3(d)(3) Ex. 3 (same).

[157] Rev. Rul. 72-188, 1972-1 C.B. 383.

[158] *Id.*

made during the period from the decedent's death to the prescribed date after the redemption totalled $100,000 ($87,500 on December 1, 1967, and $12,500 on December 1, 1968). In effect, the Commissioner then reduced that $100,000 by $50,000 (the amount of redemption proceeds received prior to the 1968 redemption)[159] and then compared the difference of $50,000 with the $50,000 of redemption proceeds received in 1968. Because the amount of tax paid by the prescribed date less the amounts received in prior redemptions was not less than the amount received in the 1968 redemption, the latter qualified for the savings clause. The Commissioner thus adopted the cumulative construction.

Is the post-redemption construction or the cumulative construction correct? At least one commentator has suggested that both constructions are correct and that compliance with either is sufficient to qualify for the savings clause.[160] However, that commentator further suggests that the cumulative approach applies only if the stock is to be redeemed in a series of two or more redemptions.[161] While the circumstances of the 1972 ruling happened to involve a series of annual redemptions, that fact was not mentioned in the Commissioner's analysis. It seems unlikely that a distinction will be drawn between a series of redemptions on the one hand and a single redemption on the other.[162]

The post-redemption approach squares with the congressional scheme for permitting both section 303 redemptions and the deferral of tax payments. A limited amount of stock redemptions (less than fifty percent of the acceleration base) can be made without causing acceleration even if the proceeds of the redemption are not utilized as a payment on the estate tax liability. In addition to that limited allowance, stock can be redeemed under section 303 provided the redemption proceeds are utilized as estate tax payments by the next installment payment date. By deferring estate tax payments, Congress effectively had the government advance credit to protect continuity of ownership of a closely held business; it did not intend to have the government bankroll other investments or consumption of goods. The post-redemption construction insures that the congressional scheme is not abused. However, as we shall see, the cumulative construction is just as consistent with the congressional scheme.

If an estate tax payment is made in year one and a redemption of a like

[159] What the Commissioner actually did was to compare the aggregate amount of tax payments made by the prescribed date ($100,000) with the aggregate amount of proceeds received from redemption by that date ($100,000), and since the aggregate tax payments at least equaled the aggregate redemptions proceeds, the redemption in question is covered by the savings clause.

[160] Fleming, *supra* note 153, at 37-39.

[161] *Id.*

[162] *See* Blum & Trier, *supra* note 147, at 238 (cumulative approach taken in Revenue Ruling 72-188 should be viewed as governing generally whether or not a series of section 303 redemptions is contemplated).

amount of the distributee's stock occurs in year two, or in some subsequent year, the amount realized from the redemption effectively is a replacement of the funds which were used by the distributee in making the estate tax payment in the earlier year. There seems little reason to provide coverage for redemptions made shortly prior to a tax payment, but not to provide it if the redemption occurs afterwards.

The fact that a payment was made prior to a redemption suggests that the distributee had sufficient funds available to make the payment and did not need the redemption proceeds for that purpose. There are several reasons why that consideration should not prevent the redemption from qualifying for coverage under the savings clause. First, in some cases, the distributee will not have had sufficient funds available, but will have borrowed the money needed to pay the tax. Using the proceeds from the subsequent redemption to repay the loan is essentially the same as using the proceeds to pay the tax itself. Second, there is no requirement in section 303 that the proceeds of a redemption be traced to the funds actually used to pay the tax. It is sufficient for the purposes of section 303 that the distributee is liable for the tax payment.[163] Section 6166 does not require a tracing of funds to qualify for the savings clause, but it does require a matching of redemption proceeds and tax payments. The apparent reason for requiring this matching of receipts and payments is to preclude a deferral of estate tax payment for more than a short time after the redemption proceeds were received. If the tax payment is made before the redemption, the deferral of that part of the tax obligation will be terminated even sooner than if made after the redemption.

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[163] There is a provision restricting section 303 treatment of a redemption occuring more than four years after the decedent's death to the amount of payment of estate tax made within one year after the redemption. I.R.C. § 303(b)(4). In 1976 Congress extended the period during which section 303 redemptions could be made from the then-existing four-year period to a period that covered the time during which estate tax payments were deferred under section 6166. I.R.C. § 303(b)(1)(C). The obvious purpose of this extension was to permit the estate to utilize gradual redemptions of stock as a source of the funds needed to pay the tax installments. This purpose supported the overriding congressional goal of mitigating the burden on estates with closely held businesses so as not to force liquidation of the business or shift of control to others. STAFF OF JOINT COMM. ON TAXATION, *supra* note 95, at 546, 551. The requirement that a matching estate tax and interest payment be made when a redemption occurs after the four-year period was to insure that the extended period for redemption served only the intended purpose and did not simply provide an estate with a greater period of time to withdraw funds from a corporation tax-free. That purpose could have been accomodated by adopting a cumulative approach to tax payments provided that only payments made after the four-year period are taken into account, but Congress instead chose statutory language in section 303 which precludes a cumulative construction, perhaps for reasons of administrative simplicity, perhaps by happenstance. In any event, the language employed in section 6166(g)(1)(B) does not evidence a choice between the post-redemption and cumulative constructions. Also, in view of the manner in which section 6166 integrates the various covered and noncovered redemptions in applying the acceleration of payment rules, there is no added administrative burden to adopting the cumulative construction.

A tax payment made prior to the redemption may have been made in satisfaction of the portion of the estate tax liability that is not qualified for deferral (the non-section 6166 portion). Such was the case in Revenue Ruling 72-188. Because the non-section 6166 portion of the estate tax must be paid by the time the estate tax return is due (unless deferred under some other provision, such as section 6161), that portion of the tax will often be paid before there is a redemption. The use of section 303 redemption proceeds to pay the non-section 6166 portion of the tax is within the letter and the spirit of the coordination of the operation of sections 303 and 6166. Where the redemption proceeds are employed to pay a portion of the estate tax (whether the section 6166 or the non-section 6166 portion), they are not available for retention and investment.

The cumulative construction would be advantageous if, after payment of taxes of a significant amount in prior years, it is desired to make a covered section 303 redemption of such substantial size that a contemporaneous payment of equal amount would be wasteful of the deferral. If the dollar amount of the non-section 6166 portion of the estate tax is large, the payment of that tax on the due date (nine months after the decedent's death) can protect a sizeable section 303 redemption made in a subsequent year. It may not be feasible for the corporation to gather the funds needed for the section 303 redemption prior to the date for payment of the non-section 6166 portion.

One might question whether the cumulative construction is of value to a stock redemption made more than four years after the decedent's death, in view of the fact that such a redemption qualifies for section 303 treatment only to the extent that a contemporaneous payment is made.[164] The answer is that the cumulative approach to the savings clause can be of some help to a post-four-year redemption. The payments that must be made to comply with the savings clause requirement are payments of the estate tax liability and, despite section 6601(e)(1), almost certainly do not include payments of interest thereon.[165] However, the post-four-year redemption payments that qualify for section 303 treatment include payments of both the estate tax and the interest thereon, as well as state or foreign death taxes and administration expenses.[166] Consequently, a payment of a portion of the estate tax and the interest thereon (or other death taxes or expenses) within one year after a post-four-year redemption can qualify the entire redemption for section 303 treatment so long as

[164] *See* text accompanying note 26 *supra* (when distribution made more than four years after decedent's death, redemption qualifying for section 303 treatment is limited to lesser of amount of taxes unpaid immediately prior to distribution or aggregate of taxes paid within one year of distribution).

[165] *See* note 144 *supra* (unlikely that payment of interest on deferred estate tax liability will be treated as payment of tax for purpose of applying minimum payment requirement of section 6166(g)(1)(B)).

[166] I.R.C. § 303(b)(4).

the total amount paid at least equals the redemption proceeds. Since the interest element is excluded in applying the savings clause, however, the redemption will not be a covered section 303 redemption unless prior tax payments were made and are taken into account under the cumulative construction.

A question has been raised as to whether Revenue Ruling 72-188[167] mandates the cumulative construction. As pointed out by the authors of an excellent article in this area, although the ruling utilizes the cumulative construction, it does not discuss whether the post-redemption construction also has a sphere of application.[168] The facts involved in Revenue Ruling 72-188 are such that application of the post-redemption construction would not have classified any of the redemptions in that ruling as covered section 303 redemptions that were treated as noncovered redemptions under the cumulative approach, and so there was no need to examine the issue of concurrent application of the post-redemption construction. In any event, the regulations unambiguously adopt the post-redemption construction.[169]

Blum and Trier present a good illustration of the problem caused by the cumulative construction in their article on this subject. They note, however, that even if the cumulative construction is exclusive, it will not cause any difficulties in planning if that approach is interpreted as requiring a comparison of the sum of tax payments made by the prescribed date with only covered section 303 redemptions.[170] There are good reasons to exclude noncovered section 303 redemptions from that computation. The thrust of the cumulative construction is to allow past tax payments to qualify a subsequent section 303 redemption for the savings clause; to prevent double use of such past tax payments for that purpose, the past payments should be reduced by the amount thereof that was used to qualify prior section 303 redemptions. The purpose is accomplished by subtracting from past tax payments the amount of prior covered section 303 redemptions, because they were covered only because a tax payment of a like amount was made. The noncovered section 303 redemptions made in the past bear no relationship to the amount of tax available to cover a current year's redemption and, therefore, should be disregarded for that purpose.

Under the post-redemption approach, if more than one redemption takes place in a taxable year, how is a timely subsequent tax payment to be allocated? Regulations section 20.6166A-3(d)(2) states that the qualification of each redemption of a series of redemptions is to be determined separately.[171] Assume, for example, that *D* died in 1982. In March, 1988,

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[167] 1972-1 C.B. 383.

[168] Blum & Trier, *supra* note 147, at 238-39.

[169] Reg. § 20.6166A-3(d)(2), -3(e)(5); *see also* Reg. § 20.6166A-3(d)(3) Ex. 3.

[170] Blum & Trier, *supra* note 147, at 239.

[171] Reg. § 20.6166A-3(d)(2).

ten shares of *X* stock are redeemed from *D*'s estate for $100. In May, 1988, ten more shares of *X* are redeemed from the estate for $100. In November, 1988, twenty shares of *X* are redeemed from the estate for $200. All of the redemptions are subject to section 303. On December 4, 1988, the date for payment of an installment pursuant to section 6166, the estate makes an installment estate tax payment of $150 plus an interest payment of $250. Presumably, the $150 estate tax payment cannot qualify both the March and the May redemptions even though a payment was made literally after each of those redemptions and no later than the prescribed date of an amount greater than the redemption proceeds. A likely construction is that the $150 estate tax payment will be applied to the redemptions in chronological order, so that the March redemption will be covered by the savings clause, and a balance of only $50 of tax payment is left to apply to the later redemptions. Because the $50 tax payment is less than the redemption proceeds of either the May or the November redemption, neither of those redemptions is covered by the savings clause.

Blum and Trier suggest that perhaps a single redemption should be permitted to be split into two redemptions so that part of the redemption can qualify for the savings clause if there is sufficient tax payment under either the cumulative or post-redemption approach to cover only part of the redemption proceeds.[172] If so, in the example above, the $50 balance of tax payment remaining after applying $100 to the March redemption could then be applied to qualify $50 of the May redemption. That construction appears most implausible and, as Blum and Trier concede, was impliedly rejected by the Commissioner in Revenue Ruling 72-188.[173]

Referring again to the example, let us reverse the order of the 1988 redemptions so that twenty shares of *X* were redeemed for $200 in March, and ten shares were redeemed in May and again in November for $100 each. How is the $150 tax payment in December to be allocated? It seems that the first redemption in March is not covered since the tax payment is less than the redemption proceeds. The entire $150 tax payment then is available for application to the May redemption, which, therefore, is a covered redemption. The November redemption is not covered because the $50 balance of tax payment is inadequate. There is a possibility, of course, that where several redemptions of the stock of one shareholder are made within a short span of time, the Commissioner will collapse the several transactions and treat them as a single redemption.

C. *Other Matters.*

The Commissioner has ruled that payment of a state death tax that qualified as a credit against the federal estate tax constituted a payment of

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[172] Blum & Trier, *supra* note 147, at 241.
[173] *Id.*

the federal tax to the extent of the credit allowed therefor.[174] The payment to the state was held to qualify a prior section 303 redemption of like amount for the savings clause.[175]

The effect of interest payments on deferred estate tax payments on the section 6166 computation is discussed above.[176] Any such interest payment also has section 303 consequences. First, it is an administration expense which increases the amount that may be distributed under section 303 in redemption of stock without dividend consequences.[177] Second, it reduces the denominator of the fraction in the section 303 qualification test (the "adjusted gross estate"), although it does not do so under section 6166.[178]

V. PRE-MORTEM PLANNING

There are a vast variety of pre-mortem planning options available to ease the problems of the post-mortem period. This article examines only a few planning opportunities related to the facilitation of an estate's obtaining deferral of payment of the estate tax and obtaining section 303 treatment for stock redemptions.

Where an individual owns stock in a closely held corporation, it is important to consider during his life whether the value of his stock is a sufficient percentage of the value of his assets to permit his executor to utilize section 6166 and section 303 after his death. If a current appraisal of the individual's assets suggests that, after taking into account possible fluctuations in value, there is a meaningful risk that his estate will not be eligible for those relief provisions, one or more of the following steps may be of help.

A. *Transfers to a Controlled Corporation.*

The individual who controls a closely held corporation can transfer assets to the corporation in a section 351 tax-free exchange for stock.[179] The simultaneous addition to the value of his corporate stock and the reduction in the value of his other assets will enhance the prospects of qualifying for sections 303 and 6166. It would be preferable if the assets transferred to the corporation were not passive investments, but even the transfer of passive investments should be effective for this purpose so long as the value of the investment assets is not disproportionately large in

[174] I.R.S. Letter Ruling 7602111870A, February 11, 1976.

[175] *Id.*

[176] *See* text accompanying notes 70-86 *supra* (discussion of interest due on deferred estate tax payments).

[177] I.R.C. § 303(a)(1).

[178] I.R.C. § 6166(b)(6); *see also* text accompanying note 4 and final paragraph of section III. E *supra* (definition and computation of "adjusted gross estate").

[179] I.R.C. § 351.

relation to the corporate assets devoted to a trade or business. To qualify the corporate stock as an interest in a closely held business, the corporation must be "carrying on a trade or business,"[180] but there is no reduction in the value of the decedent's stock as a closely held business interest because some of the assets of the corporation are not utilized in a trade or business.[181] If investment assets were transferred to a controlled corporation shortly before the shareholder's death, the Commissioner might object; but as long as the transfer was bona fide, it should be effective regardless of the shareholder's motive for putting the assets into corporate solution. Such transactions may be vulnerable to attack on the ground that they lacked a business purpose and should thus be ignored, a contention which occasionally has been sustained in other areas of tax law.[182]

If a shareholder is leasing property (such as a building) to his corporation, there may be income tax benefits to continuing that leasing arrangement rather than contributing the property to the corporation. Of course, if the income tax benefits outweigh the potential estate tax deferral benefits and section 303 redemption benefits, the ownership of the property should be retained by the shareholder. But where the shareholder is of advanced years and where he does not need the leasing arrangement to obtain deductible payments from the corporation (that is, where he can withdraw sufficient funds for his purposes as a reasonable salary), the property can be a useful asset to contribute to the corporation.

If, at the time of his death, an individual was conducting an activity as a sole proprietorship, then only those assets that are actually utilized by him in a trade or business will qualify for inclusion in the determination of the decedent's interest in a closely held business.[183] To minimize the prospect of the exclusion of assets that are merely tangentially related to the conduct of the activity, all of the properties connected with the activity can be transferred to an existing, or newly created, controlled corporation. As noted, the entire value of the decedent's stock in the corporate enterprise will qualify as an interest in a closely held business if the corporation is carrying on a trade or business.[184]

The Commissioner takes a narrow view as to what types of activities constitute a trade or business for purposes of the estate tax deferral provi-

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[180] I.R.C. § 6166(b)(1)(C).

[181] Reg. § 20.6166A-2(c)(1); *see* I.R.S. Letter Ruling 8108089, November 26, 1980; I.R.S. Letter Ruling 8050002, August 25, 1980.

[182] *See* Basic, Inc. v. United States, 549 F.2d 740 (Ct. Cl. 1977) (when transfer of stock made by subsidiary to its parent corporation was devoid of business purpose but was undertaken to reduce parent's income tax upon subsequent sale of such subsidiary, transfer was not a tax-free intercorporate dividend; court ignored transfer for purpose of calculating gain on sale).

[183] Reg. § 20.6166A-2(c)(2).

[184] *See* note 181 *supra* and accompanying text.

sions.[185] While there is considerable risk that ownership and management of rental property will not constitute a trade or business for the purposes of section 6166, that will not always be the case.[186] In order to avoid the risk that the ownership and management of rental property will not qualify as a trade or business, the property can be transferred to a controlled corporation—either one already existing or, if that is not feasible, to a newly created corporation, provided also that an active business is transferred to or is already conducted by the new corporation. The rental property can be insulated from attack if the corporation conducts another trade or business that clearly qualifies.

Another reason for transferring assets to an existing controlled corporation is to qualify the corporation's stock under section 303. This will not be a useful device unless the amount of redemption proceeds permitted by section 303 is significantly greater than the value of the assets transferred for the purpose of so qualifying the decedent's stock. If it turns out after the decedent's death that his shares of the corporation's stock do not qualify for section 303 treatment, it may be difficult to withdraw property from the corporation without both incurring dividend treatment and, if appreciated property is distributed by the corporation, causing the corporation to recognize gain under section 311(d). For that reason, a transfer of assets to a corporation solely to promote the prospects of a section 303 redemption is not without risks. A similar risk applies where such transfers are made for the purpose of obtaining deferral of estate tax payments. If, at the decedent's death, the decedent's estate does not qualify either for section 303 treatment or for section 6166, the price tag for the ineffective planning effort might be significant.

In transferring assets to a controlled corporation for one of the purposes described above, special consideration should be given to the question of whether depreciable property can be so employed. The transfer to the corporation of depreciable property will not trigger any recapture of depreciation if section 351 applies.[187] However, if a sale of an asset for its

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[185] *See* Revenue Ruling 75-365, 1975-2 C.B. 471, in which the Commissioner stated that the definition of "trade or business" as used in an earlier version of section 6166 is narrower than the definition applied to other Code sections, such as section 162. The Commissioner also stated:

> 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.

Id.; see also Rev. Rul. 75-367, 1975-2 C.B. 472.

[186] *See* Rev. Rul. 75-366, 1975-2 C.B. 472 (farms leased by decedent to tenant farmers held to constitute trade or business when decedent participated in management of farms, rental was based on percentage of crop production rather than fixed rental, and decedent bore percentage of expenses of operating farms).

[187] I.R.C. §§ 1245(b)(3), 1250(d)(3).

value would cause depreciation recapture, the asset typically should not be contributed to the corporation unless it is contemplated that it will be left in corporate solution and will not be used subsequently to redeem stock, because the distribution of the asset would cause the distributing corporation to recognize income under the depreciation recapture provisions.[188] In determining whether to place such an asset in corporate solution, consideration should be given to the fact that, if the asset is not placed in corporate solution, the step-up in the basis of the asset at the decedent's death under section 1014 will eliminate the potential depreciation recapture.[189]

One of the exceptions to the rule that a corporation recognizes gain on the nonliquidating distribution of an appreciated asset is a distribution in a section 303 redemption.[190] Therefore, it is feasible to contribute appreciated property to a corporation with the contemplation that it will be used to redeem shares of the corporation's stock after his death if section 303 will apply to the redemption and if no depreciation recapture is involved.

B. *Gifts.*

Another method for improving the prospects of obtaining tax deferral and section 303 treatment for an individual's estate is to make sizeable gifts to third parties. If the gifts are made more than three years before the donor's death and if the donated properties are not otherwise included in the donor's gross estate for estate tax purposes, the gifts will reduce the size of the donor's gross estate and adjusted gross estate, so that the amount of the qualifying interest needed to comply with the thirty-five percent of adjusted gross estate requirement of section 6166 and section 303 will be reduced.[191] Of course, for this purpose, the gifts must be made of properties other than the corporate stock for which qualification is sought. Indeed, a gift of such corporate stock will make it more difficult for the estate to satisfy the requirements of section 6166 or 303.

If section 6166 is applicable to a decedent's estate, lifetime gifts made by the decedent that reduce the size of his gross estate have the added advantage of increasing the portion of the estate tax that is deferrable under section 6166. To the extent that lifetime gifts reduce the size of the decedent's adjusted gross estate, they will reduce the size of the denominator of the relevant fraction and, thereby, will increase the portion of the estate tax that is deferrable.

Even gifts made within three years of the donor's death can be helpful in certain circumstances. As previously noted, such gifts are, under the

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[188] See I.R.C. §§ 1245, 1250.
[189] I.R.C. § 1014(a).
[190] I.R.C. § 311(d)(2)(D).
[191] I.R.C. § 2035(a), (d)(3)(C).

1981 Act, included in the decedent's gross estate for the purposes of applying sections 303 and 6166.[192] However, except for gifts of life insurance policies and for gifts to a spouse that qualify for the marital deduction, gifts made within three years of death are excluded from the donor's gross estate if the donor was not required by section 6019 to file a gift tax return with respect thereto.[193] For gifts made after 1981, no gift tax return is required for gifts of present interests of no more than $10,000 per donee.[194] In addition, no gift tax return is required for qualified gifts made to a person by paying the donee's tuition at an educational institution or by paying the medical care expenses of the donee.[195] Within these limits, gifts within three years of death are helpful.

An advantage to be derived from making taxable gifts is that if the donor lives for more than three years after making the gift, any gift taxes payable thereon will reduce the size of the donor's gross estate and, therefore, the size of his adjusted gross estate. If the property were retained by the donor, the estate tax payable thereon at his death would not affect the amount of his gross estate or adjusted gross estate. Under section 2035(c), if the donor dies within three years after making the gift, the gift tax payable thereon is included in the donor's gross estate.[196]

If donated property appreciates in value in the donee's hands, and if the property is excluded from the donor's gross estate, the appreciation is also removed from the donor's gross estate. As noted above, in addition to the estate tax savings thereby achieved, the requirements for estate tax deferral and section 303 treatment are easier to satisfy as the gross estate decreases, and the percentage of estate tax that can be deferred will accordingly be increased.

Instead of making gifts to a third party (typically a relative), an individual can also make a charitable contribution of appreciated property. This will reduce his gross estate and adjusted gross estate by the difference between the value of the gift and the income tax benefit obtained by making the charitable contribution. An alternative to making an outright gift to a charity is to employ a charitable lead trust with a remainder to a descendant or descendants of the grantor.[197] The advantages of making gifts to a charitable lead trust are: reduction of the transfer tax costs of routing the donated property to the named descendant or descendants; an immediate income tax deduction to the donor of the present value of the charity's annuity interest for the term of the trust, although the benefit

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[192] *See* text accompanying notes 51 & 55 *supra* (exclusion of certain gifts from decedent's gross estate).

[193] I.R.C. § 2035(b)(2).

[194] I.R.C. §§ 2503(b), 6019(a)(1).

[195] I.R.C. §§ 2503(e), 6019(a)(1).

[196] I.R.C. § 2035(c).

[197] *See* I.R.C. §§ 170(f)(2)(B), 2055(e)(2)(B), 2522(c)(2)(B).

from this deduction is offset by the fact that the trust's income will be taxed to the donor as it is earned; and, of course, improvement of the prospects for qualifying the estate for section 303 treatment and estate tax deferral. If the grantor of the charitable lead trust has no wish to obtain an income tax deduction, the trust can be designed to qualify for an estate tax or gift tax charitable deduction without causing the trust income to be taxed to the grantor.

Another device that might be employed to improve the prospects of qualifying for section 303 or section 6166 is to have family members who own stock in the target corporation make gifts of their shares to a critically ill shareholder shortly before the latter's demise. Alternatively, a critically ill shareholder could buy additional shares and thereby increase the percentage of his estate that is represented by such stock.

VI. CONCLUSION

The interaction of sections 303 and 6166 is an extremely complex area. That complexity provides multiple planning opportunities. But it also increases the risk of stumbling across a booby trap. Aggressive planning is possible and probably even desirable. Care should be taken, however, to minimize the danger of adverse decisions on the issues currently unresolved. It may not be wise to be too aggressive in seeking to obtain every dollar of benefit that might be available.

One of the fascinating aspects of estate planning is the endless variation of problems encountered as a result of the human element. The purpose of planning is to achieve the goals of the client, and tax savings are valuable only if they further the client's objectives. It is often difficult for a client to determine his current objectives for his estate, much less to predict changes in objectives as the years go by. One consideration in planning is to retain sufficient control so that the plan can be restructured if the client later changes his views. That is not always feasible, and complete flexibility will amost never be desirable because the cost of lower benefits will be too great. However, the value of flexibility ought to be factored into the planning equations.