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Planning for Estate Tax After Death:

Section 6166 Elections and Graegin Loans

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2019 Estate Tax Exclusion Amounts

- The federal gift and estate tax exclusion amounts in 2019 has increased to $11,400,000 per person, or $22,800,000 for a married couple
- Clients with estates worth less than that no longer have Federal taxable estates (assuming no lifetime gifts)
- Increased exclusion amounts scheduled to sunset on December 31, 2025

Washington Exclusion Amount Unchanged

- The Washington exclusion amount remains relatively low at $2,193,000 per person in 2019
- Clients with estates worth between $2,193,000 and $11,400,000 (or twice that for a married couple) no longer need Federal planning but are still subject to Washington estate tax at rates of 10-20%
- Washington residents with estates in excess of the WA exclusion amount continue to need planning even if not subject to Federal estate tax

Section 6166 and Graegin Loans

- Decedents whose estates include interests in closely-held businesses that meet certain requirements may qualify for estate tax deferral
- Section 6166 permits an estate to defer payment of estate tax for up to 14 years at favorable interest rates. Washington offers this deferral at the state level as well.
- Whether or not an estate qualifies for Section 6166 deferral, estates lacking liquidity to pay estate tax may borrow to fund their tax payments (plus a reasonable reserve) and, if the loan is structured properly, take an upfront deduction on interest payable over the lifetime of the loan

Planning for Section 6166 and Graegin Loans

- **Lifetime Gifts:** Be thoughtful as to what assets are gifted and how much of them is being transferred relative to the entire estate. Gifts may help or hurt the estate's ability to qualify for deferral of estate tax under Section 6166.
- **Restructuring of Business Holdings:** If feasible, restructuring clients' business holdings may help qualify for Section 6166 deferral and maximize its benefits
- **Creating Trusts and Family Entities:** Trusts and family entities created during life may be used to maximize the benefit of a Graegin loan

Estate Administration Considerations

- **Section 6166:**
  - Be thoughtful regarding dispositions or withdrawals of Section 6166 property and undistributed net income of closely-held businesses during the principal repayment period
  - Interest on deferred tax deductible on the Washington estate tax return when paid
- **Graegin Loans:** Be sure the loan is structured properly and administered according to its terms

Section 6166: Purpose and WA Equivalent

- Section 6166 permits deferral of Federal estate tax for a period of up to 14 years
- Intended to prevent fire sales of closely-held businesses in order to fund estate tax liability
- Washington State “will abide by the provisions of section 6166 of the 2005 IRC for granting of payment plans for closely held businesses”

Benefits of Section 6166 Election

- Personal representative may elect to defer portion of estate tax attributable to the interest in a closely-held business
- Payment may be made in up to 10 annual installments, beginning on the date selected by the PR that is no later than 5 years after the unextended due date of the estate tax return
- Interest on the first $620,000 of deferred Federal estate tax in 2019 will accrue at a rate of 2%, and interest on the remaining deferred tax will accrue at 45% of the statutory underpayment rate
    - Deferred Washington estate tax accrues interest at the statutory rate (4% in 2019)

Section 6166 Requirements

- Decedent a U.S. citizen or resident at date of death
- Interest in a closely-held business includible in the gross estate
- Value of the interest in a closely-held business exceeds 35% of the adjusted gross estate ("35% Test")
    - Adjusted gross estate equals the gross estate less any Section 2053 and 2054 deductions

35% Test: Example

- Decedent dies with a $29MM gross estate, consisting of a $10MM interest in a closely-held business and $19MM in other assets
  - The closely-held business interest is 34.48% of the value of the gross estate, less than 35%
  - If the estate has $500,000 of Section 2053 expenses, the adjusted gross estate equals $28,500,000
  - $10MM = 35.09% of adjusted gross estate, and estate may qualify for deferral

Interest in Closely-Held Business

- Sole proprietorship qualifies if decedent carried on a trade or business
- Corporation that carried on a trade or business qualifies if:
  - 20% or more of the total voting stock is includible in the gross estate ("20% Test"), or
  - The corporation has 45 or fewer shareholders ("45-Owner Test")

Interest in Closely-Held Business (cont.)

- Partnerships that carried on a trade or business qualifies if:
  - 20% or more of the total capital interest is includible in the gross estate ("20% Test"), or
  - The partnership has 45 or fewer partners ("45-Owner Test")
- No policy reason to treat corporations and partnerships differently (measuring voting shares v. capital interests for the 20% Test)
- LLCs may qualify whether taxed as a corporation/association, partnership, or disregarded for income tax purposes

Trade or Business

- Regardless of whether the interest is in a sole proprietorship, corporation, or partnership, there must be a trade or business on the date of death
- IRS considers activities of the decedent, entity (if any), and agents and employees
- Activities of a management company in which the decedent owned a “significant interest” may be imputed to the decedent
- Threshold question: did the activities of the decedent or entity exceed the level of someone merely holding an interest in investment property?

Trade or Business: Opco-Propco Structures

- Where an operating company and real property used by that operating company are separately held, analysis can be complicated
- Service has ruled for and against taxpayers in these circumstances
- Where the real property is leased to the operating company in a triple-net lease, this may prevent the Propco from qualifying under Section 6166. See PLR 8140020. But cf. Rev. Rul. 2006-34 and PLR 200006034.

Trade or Business: Property Management

- Rev. Rul. 2006-34 provides guidance on whether management of rental real property rises to the level of a trade or business
- IRS will consider six nonexclusive factors:
    1. The amount of time the decedent, entity, and any agents and employees devoted to property management;
    2. Whether an office was maintained from which the decedent's, entity's, and any agents' and employees' activities were conducted or coordinated, and whether regular business hours were maintained for that purpose;

Trade or Business: Property Management (cont.)

3. The extent to which the decedent, entity, and any agents and employees were actively involved in finding new tenants and negotiating and executing leases;

4. The extent to which the decedent, entity, and any agents and employees provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;

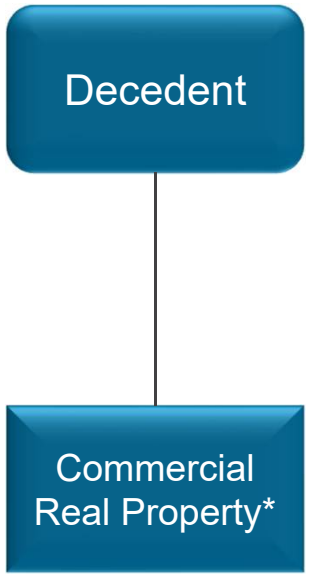
Trade or Business: Property Management (cont.)

5. The extent to which the decedent, entity, and any agents and employees personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and

6. The extent to which the decedent, entity, and any agents and employees handled tenant repair requests and complaints

- Use of an independent management company is a negative factor

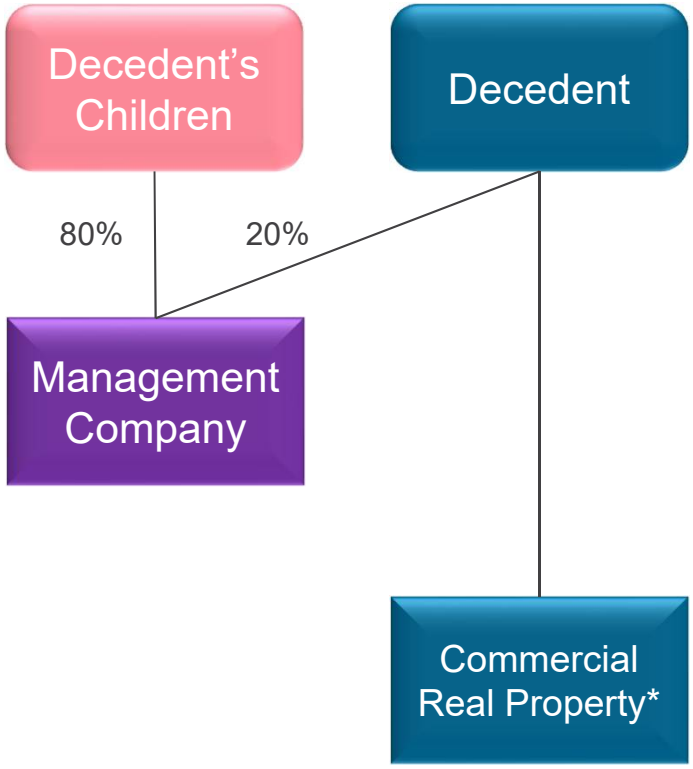
Trade or Business: Property Management Example 1



* Managed by Decedent

- If the decedent handled the day-to-day operation, management, and maintenance of the property, the property will qualify under Section 6166
- Hiring independent contractors to perform repairs that the decedent could not perform personally should not disqualify the property
- The more activities undertaken by an independent contractor, the less likely that the property will qualify
- If the decedent's activities were limited to collecting rent, making mortgage payments, and making necessary repairs, the property should not qualify under Section 6166

Trade or Business: Property Management Example 2



* Managed by Management Company

- Management Company is actively managing the property
- Because the decedent owns a "significant interest" in Management Company, the company's activities permit the property to qualify under Section 6166

Trade or Business (cont.)

- IRS has permitted deferral where a decedent ceased participating in a business due to physical incapacity
- Activities of a deceased spouse may be imputed to surviving spouse for purposes of qualifying for Section 6166 so long as there was no material change in the form or operation of the business between the first and second deaths
- Activities of one division of a corporation may cause the entire corporation to qualify (subject to the passive asset rule discussed below)

Treatment of Multiple Closely-Held Businesses

- If the estate includes interests in 2 or more closely held businesses, and if 20% or more of each such business is included in the value of the decedent's gross estate, then the interests are treated as a single interest
- For purposes of this 20% requirement, the interest of a surviving spouse in property held jointly by the decedent and the surviving spouse is included in determining the value of the decedent's gross estate

Attribution Rules

- Section 6166(b)(2) contains attribution rules
- Plain language of the statute applies these rules both for purposes of the 20% Test and the 45-Owner Test
- IRS position (based in part on legislative history) is that attribution rules apply only for purposes of the 45-Owner Test absent a 6166(b)(7) election (discussed below)

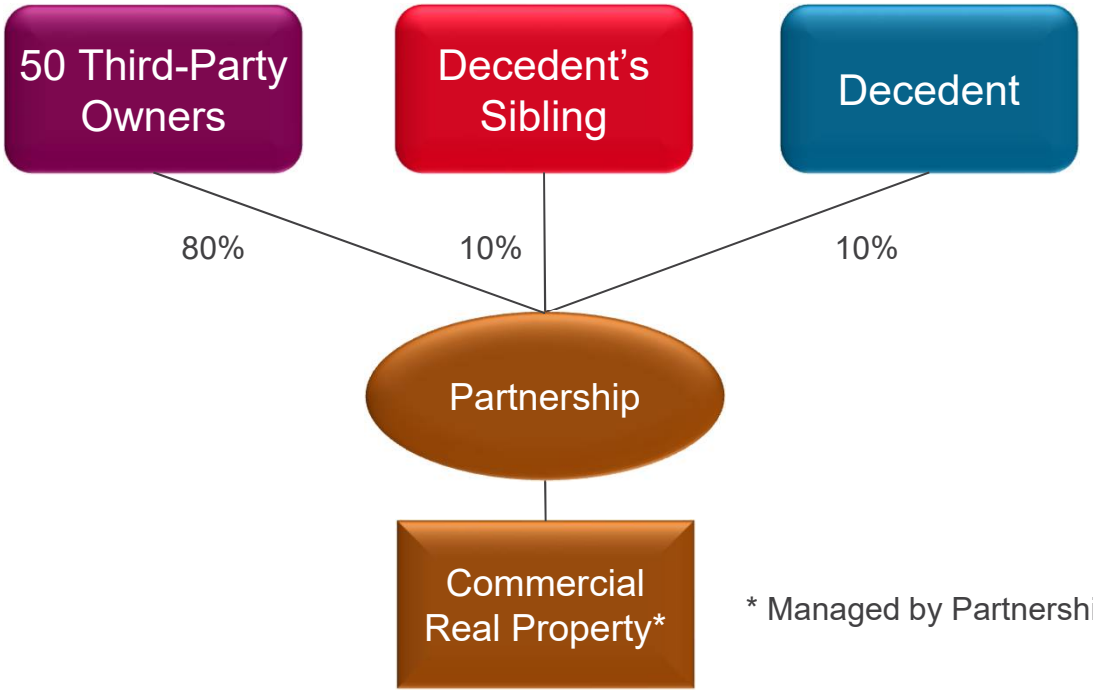
Attribution Rules (cont.)

- Interests owned by spouses as community property, tenants in common, tenants by the entirety, or joint tenants treated as owned by one person
- Interests owned by the decedent's (1) siblings, (2) spouse, (3) ancestors, and (4) lineal descendants treated as owned by decedent
    - Excludes nieces, nephews, and cousins
- Interests owned directly or indirectly by an entity, estate, or trust treated as owned proportionately by shareholders, partners, or current beneficiaries

Effect of Attribution Rules

- For purposes of the 45-Owner Test, a decedent is treated as the owner of any interest in a closely-held business owned by:
  - Siblings, spouse, ancestors, and lineal descendants (“family members”)
  - Corporations wholly owned by decedent and family members
  - Partnerships wholly owned by decedent and family members
  - Trusts, the only current beneficiaries of which are decedent and family members

Example: Property-Holding Partnership



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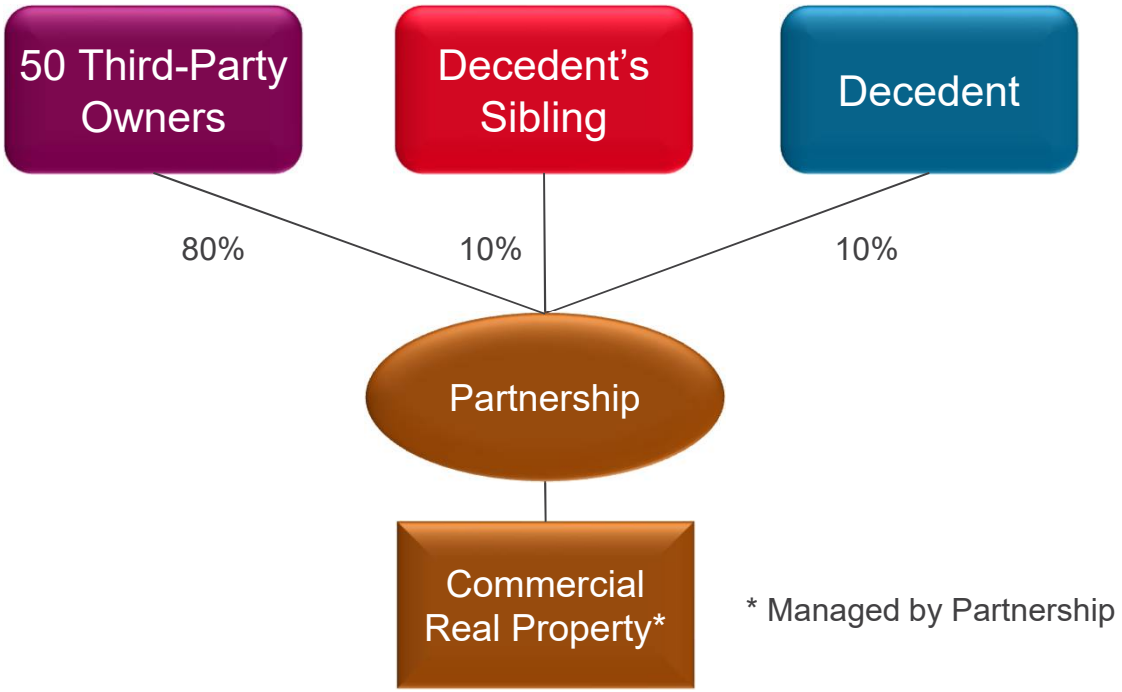
6166(b)(7) Election for Partnerships and Non-Readily Tradable Stock

- The estate may elect under Section 6166(b)(7) to have attribution rules apply for purposes of the 20% Test (including for purposes of aggregating multiple interests in closely-held businesses) to partnership interests and stock that is not readily tradable
- If election is made, estate forgoes first 5 years of principal deferral and cannot take advantage of the 2% interest rate for a portion of the deferred tax
- Election must be made as to all 6166 property

6166(b)(7) Election: Example



- Absent a 6166(b)(7) election, Partnership meets neither the 45-Owner Test nor the 20% Test
- With a 6166(b)(7) election, Sibling's interest is treated as owned by Decedent for purposes of the 20% Test
- 6166(b)(7) election may not qualify Sibling for deferral on his or her death

Example: Holding Company Structure

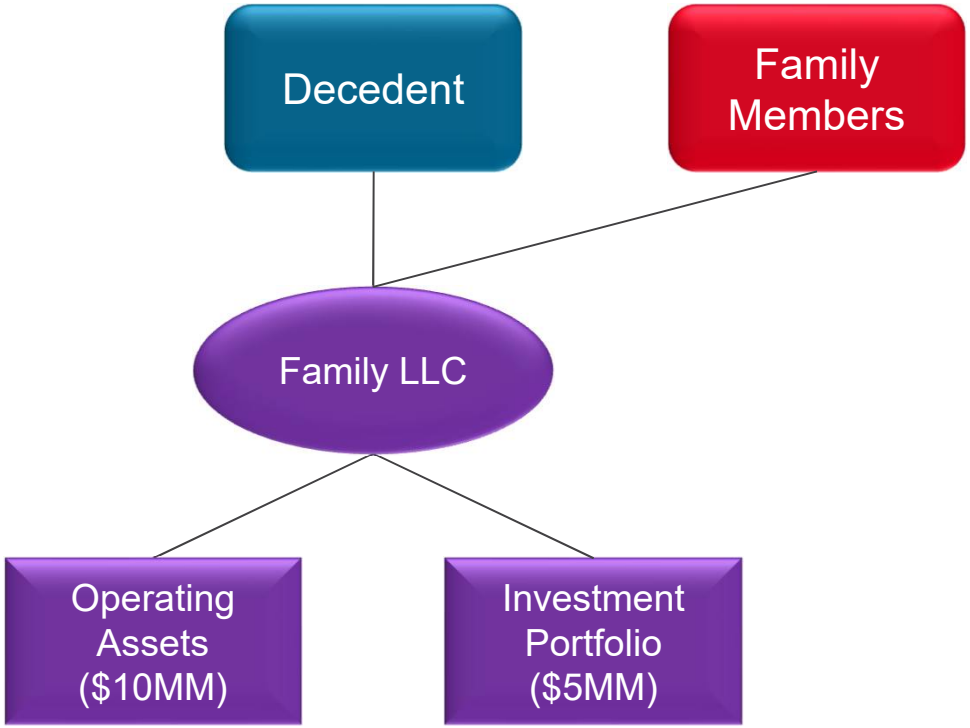
Section 6166(b)(8) Holding Company Election

- Where the estate owns stock in a "holding company" that in turn owns stock in a "business company," the PR may elect to treat both as a single company owned by the estate
- Intended to permit an interest owned through a tiered structure to qualify for deferral
- If election is made, estate forgoes first 5 years of principal deferral and cannot take advantage of the 2% interest rate for a portion of the deferred tax. Election must be made as to all 6166 property.
- Statute defines holding company and business company to include only corporations

Section 6166(b)(8) Holding Company Election: Example

- If Holdco is a passive holding company, it will not qualify under Section 6166 even if its sole asset is an interest in Opco
- A holding company election will cause the two corporations to be treated as a single company, at the cost of 5 years of principal deferral and the favorable 2% interest rate on a portion of the deferred tax
- If Holdco and Opco were both conducting a trade or business, the election might not be required

Example: Company with Passive Assets



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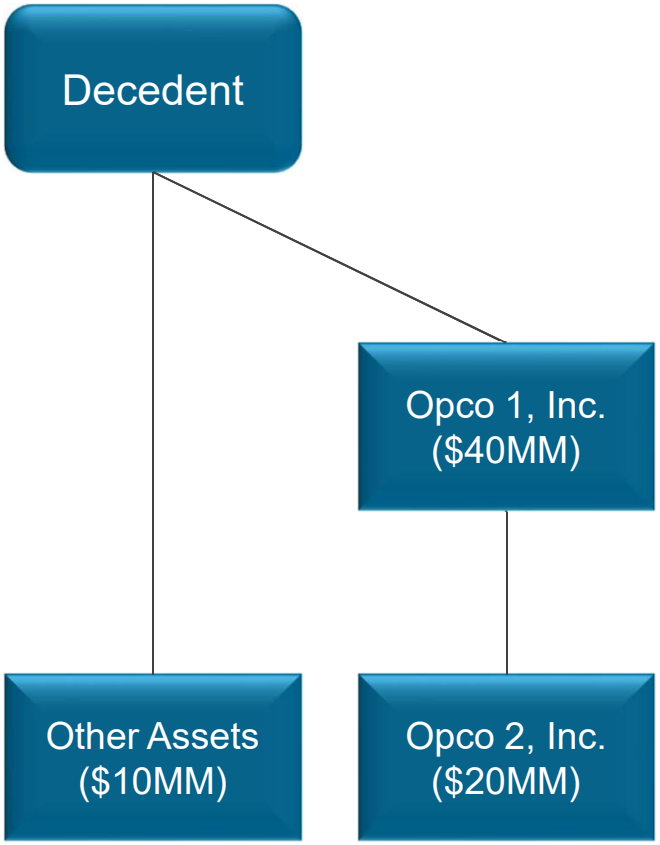
Treatment of Passive Assets

- The value of an interest in a closely held business does not include the portion of that interest attributable to passive assets held by the business
- Passive assets are defined as any asset not used in carrying on a trade or business
- Stock held by an entity is generally treated as a passive asset unless the holding company election is made and the subsidiary's stock meets the 35% Test
    - No policy reason not to treat partnership interests held by an entity as passive assets, although the holding company election on its face does not apply to partnerships

Treatment of Passive Assets (cont.)

- Stock held by another corporation is not treated as a passive asset if:
  - The subsidiary corporation meets either the 45-Owner Test, or the 20% Test with respect to the parent corporation; and
  - 80% or more of the value of assets of both the parent and the subsidiary is attributable to assets used in carrying on a trade or business
  - For purposes of determining whether the parent meets this 80% test, the value attributable to the subsidiary is disregarded

Example: Tiered Operating Companies



- If the value of more than 80% of the assets of both Opco 1 and Opco 2 is attributable to assets used to carry on a trade or business, no holding company election required

Making the 6166 Election

- PR checks the box in Part 3 of Form 706 and attaches a statement to the timely filed return including:
  - Decedent's name and TIN;
  - Amount of the estate tax to be paid in installments;
  - Date selected for the payment of the first installment;
  - Number of annual installments, including the first installment, in which the tax is to be paid;
  - Property shown on the estate tax return that constitutes a closely held business, identified by schedule and item number; and
  - Facts that serve as the basis for the conclusion that the estate qualifies for estate tax deferral
- The election is made on the Washington return by checking the box in Part 3, Line 3, and attaching the notice of election from Form 706

Making the 6166 Election (cont.)

- PR may make a protective 6166 election
- If no election is made on the timely filed return, the election may be made with respect to an estate tax deficiency not attributable to negligence, fraud, or intentional disregard of tax law
    - This election is limited to the deficiency amount and is prorated to the installments that would have been due if an election had been timely made at the time the estate tax return was filed, with the remaining portion payable at the time of the election
    - IRS may limit deferral to the portion of the deficiency equal to the portion of the estate's assets that qualify under Section 6166

Bond Requirement

- IRS can require a bond of up to twice the amount of the deferred estate tax
- Tax Court has held that IRS must determine whether to require bond on a case-by-case basis. IRS has published the factors it will consider in Notice 2007-90.
- Finding a provider for the bond can be difficult and expensive

Alternative to Bond: Special Lien

- As an alternative to posting bond, the PR can elect to submit to a special lien on property equal in value to the deferred tax plus the first four years of interest
- PR submits proposed collateral, which IRS must accept if it is:
  - expected to survive the deferral period;
  - identified in the security agreement; and
  - of sufficient value
- If the value of lien property falls below the required minimum, IRS can request additional security
- IRS typically sends a letter requesting that the estate provide a bond or submit to a special lien. If PR doesn't respond within 30 days, IRS unilaterally determines what security is required.

Administration of 6166 Estate

- Deferral can be terminated if there is:
  - Disposition of the closely-held business interest or withdrawal of funds from the business;
  - Failure to use undistributed income to pay deferred tax;
  - Default in payment of installment amounts or interest; or
  - Violation of a lien condition

Administration of 6166 Estate: Dispositions of 6166 Property

- Estate tax deferral is terminated if:
  - Any portion of an interest in a closely-held business is distributed, sold, exchanged, or otherwise disposed of, or money and other property attributable to such an interest is withdrawn from such business; and
  - The aggregate of such distributions, sales, exchanges, dispositions and withdrawals equals or exceeds 50% of the value of such interest
- If the estate includes more than one interest in a closely-held business, the 50% test takes into account the value of all such businesses

Administration of 6166 Estate: Dispositions of 6166 Property (cont.)

- The following will not jeopardize deferral:
  - Reshuffling of business interests among heirs within an estate;
  - Sale of assets of a closely-held business if the proceeds are applied to debts of the business;
  - Tax-free exchanges of stock under Section 368(a)(1)(D)-(F) and Section 355; and
  - Exchanges of real property for like-kind property under Section 1031

Administration of 6166 Estate: Dispositions of 6166 Property (cont.)

- The following will not jeopardize deferral:
  - Transfers of 6166 property to a decedent's heirs, or transfers of property on the death of those heirs to their family members; and
  - Distributions in redemption of stock under Section 303, if certain conditions are met

Example: Dispositions of 6166 Property

- Estate holds interests in three closely-held businesses, each valued at $5MM, for a total of $15MM Section 6166 property
  - Estate sells its interest in the first business – no loss of deferral, less than 50% of the value of the closely-held business interests
  - Estate then causes $3M of assets in the second business to be sold and the proceeds used to pay down debts of that business – no loss of deferral, and not treated as a disposition or withdrawal
  - Estate then pledges its interest in the third business as collateral for a loan – loss of deferral, as over 50% of the value of the estate's closely-held business interests has now been disposed of or withdrawn

Administration of 6166 Estate: Undistributed Net Income

- If the estate has undistributed net income for any taxable year ending on or after the due date for the first principal installment, PR must, on or before the filing date for the income tax return for such taxable year (including extensions), pay the undistributed net income in liquidation of the unpaid portion of the deferred tax
- Dividends paid to a holding company are treated as having been paid to the estate for these purposes

Administration of 6166 Estate: Failure to Make 6166 Payments

- If the estate misses any payment of principal or interest, the deferred estate tax becomes due and payable upon notice and demand from the IRS
- If the estate misses a payment but makes late payment within 6 months of the due date, deferred estate tax does not become due, but the 2% interest rate does not apply with respect to the payment, and a penalty equal to 5% of the payment, multiplied by the number of months (including fractions thereof) after the due date the payment is made, is imposed

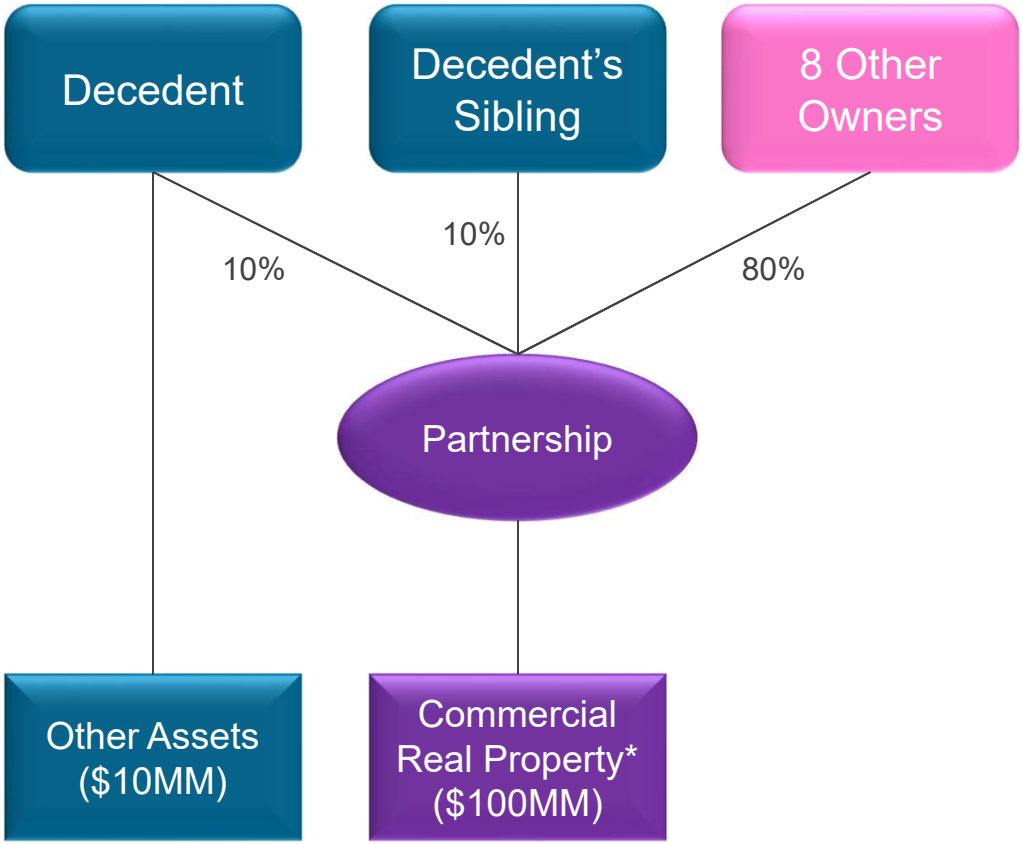
Section 6166: Interaction with Other Code Sections

- **Section 2035:** If property is includible in the estate under Section 2035, the 35% Test must be satisfied both with and without the addition of such property to qualify for Section 6166
- **Section 2032A:** If the conditions of Section 2032A are breached, resulting increase in tax is not eligible for deferral under Section 6166. Breaches resulting from a disposition of assets by a qualified heir can also accelerate the estate's deferred estate tax.
- **Sections 2056 and 2056A:** Property held in a qualified terminable interest property (QTIP) marital trust or a qualified domestic trust (QDOT) may qualify as Section 6166 property
- **Generation-skipping Transfer Tax:** If an interest in 6166 property is the subject of a direct skip, GST tax due is deferred as though it were estate tax

Section 6166: Deductibility of Interest

- Interest paid on estate tax deferred under Section 6166 is not deductible under Section 2053(c)(1)(D)
  - Cf. interest paid on estate tax deferred under Section 6161, which is deductible once paid
- Washington Estate Tax Filing Instructions indicate that accrued interest on deferred tax is deductible once paid
  - Interest on deferred Washington estate tax accrues at a single statutory rate – no 2% portion

Section 6166: Example 1



* Managed by Partnership.

- Trade or business requirement
- 45-Owner Test
- 20% Test
- 35% Test

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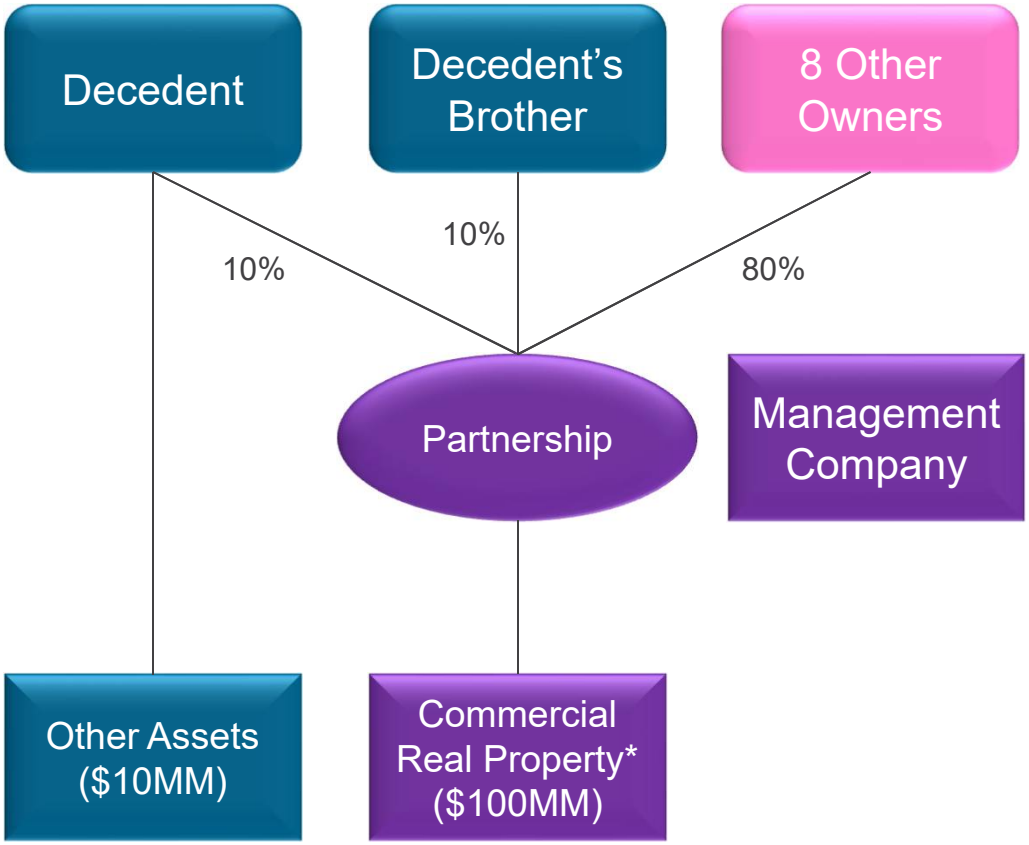
Section 6166: Example 2



- Trade or business requirement
- 45-Owner Test
- 20% Test
- 35% Test

* Managed by Management Company.

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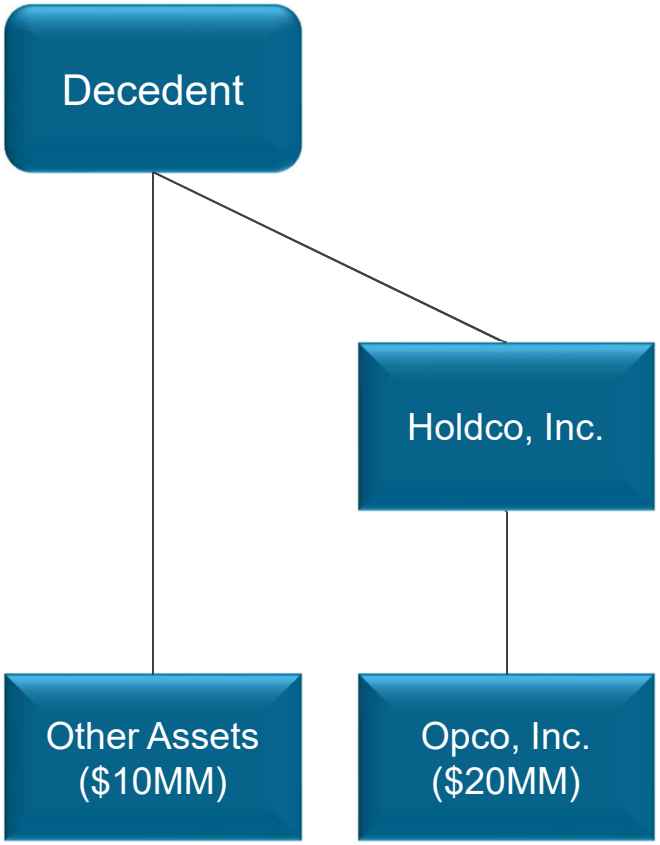
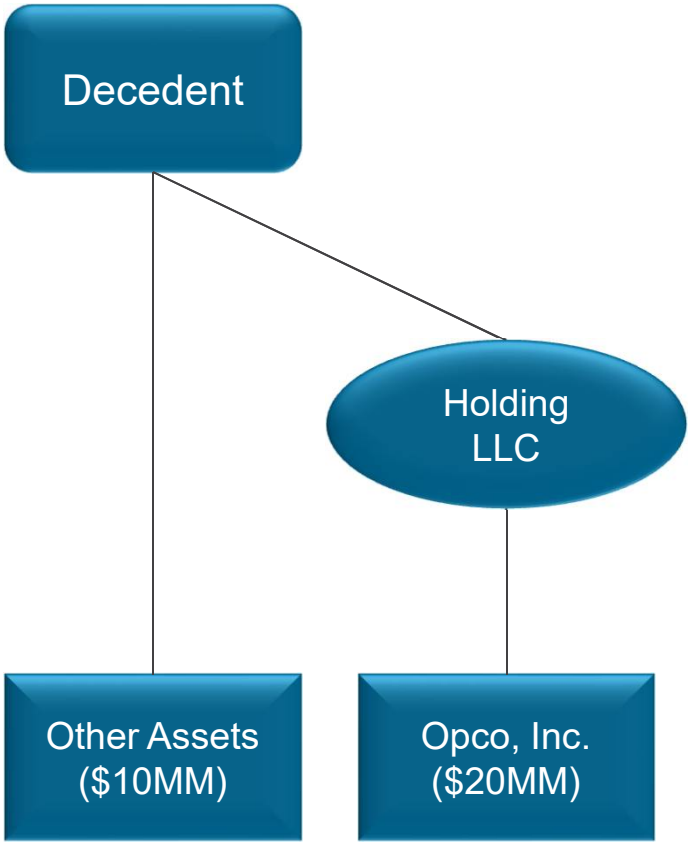
Section 6166: Example 3



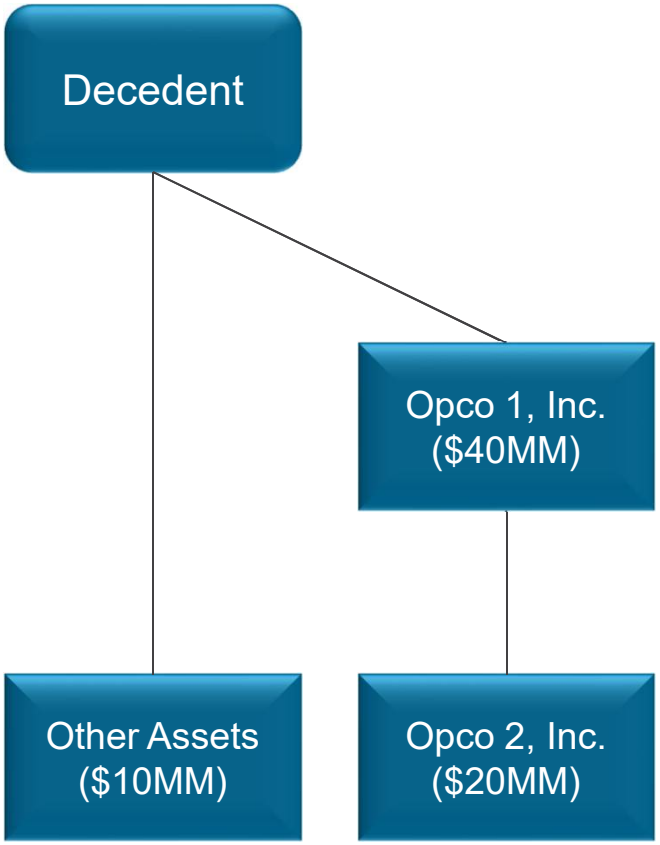
- Trade or business requirement
- 45-Owner Test
- 20% Test
- 35% Test
- Ideally Holdco would be liquidated prior to death to avoid the need for a holding company election and loss of 5 years' principal deferral and 2% interest rate on a portion of the deferred tax

Section 6166: Example 4



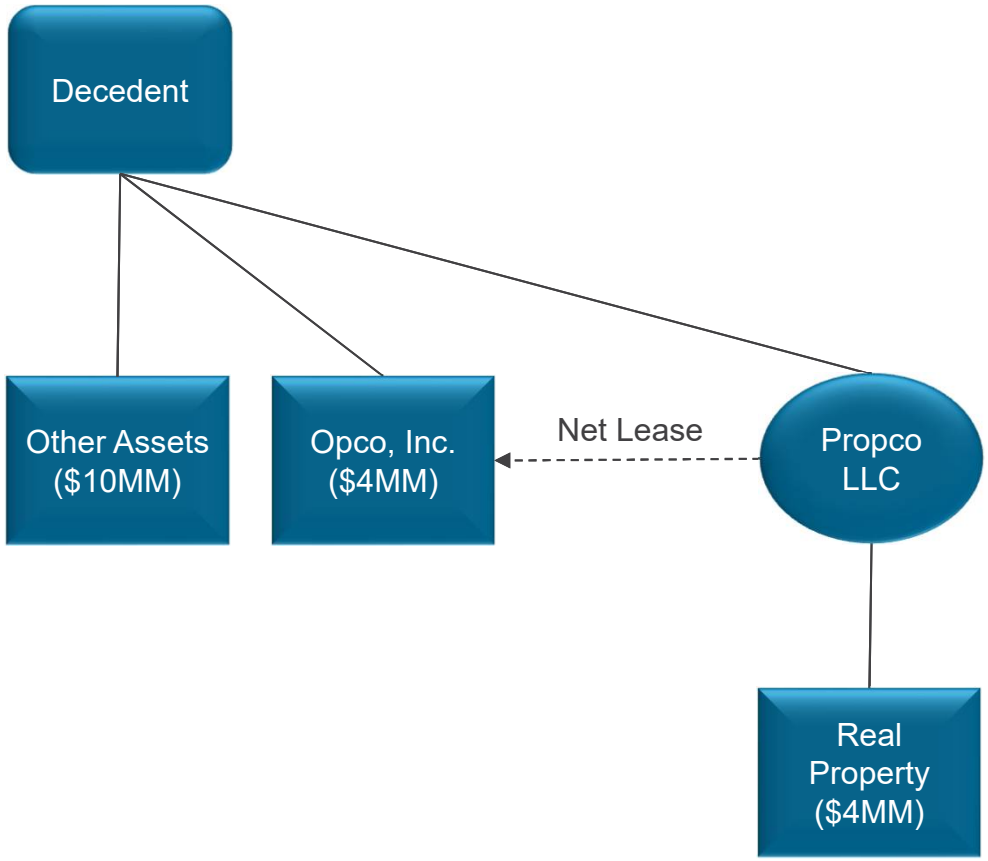
- Trade or business requirement
- 45-Owner Test
- 20% Test
- 35% Test
- Again, ideally Holding LLC would be liquidated prior to death

Section 6166: Example 5



- Trade or business requirement
- 45-Owner Test
- 20% Test
- 35% Test
- If the value of more than 80% of the assets of both Opco 1 and Opco 2 is attributable to assets used to carry on a trade or business, no holding company election required

Section 6166: Example 6



- Trade or business requirement
- 45-Owner Test
- 20% Test
- 35% Test

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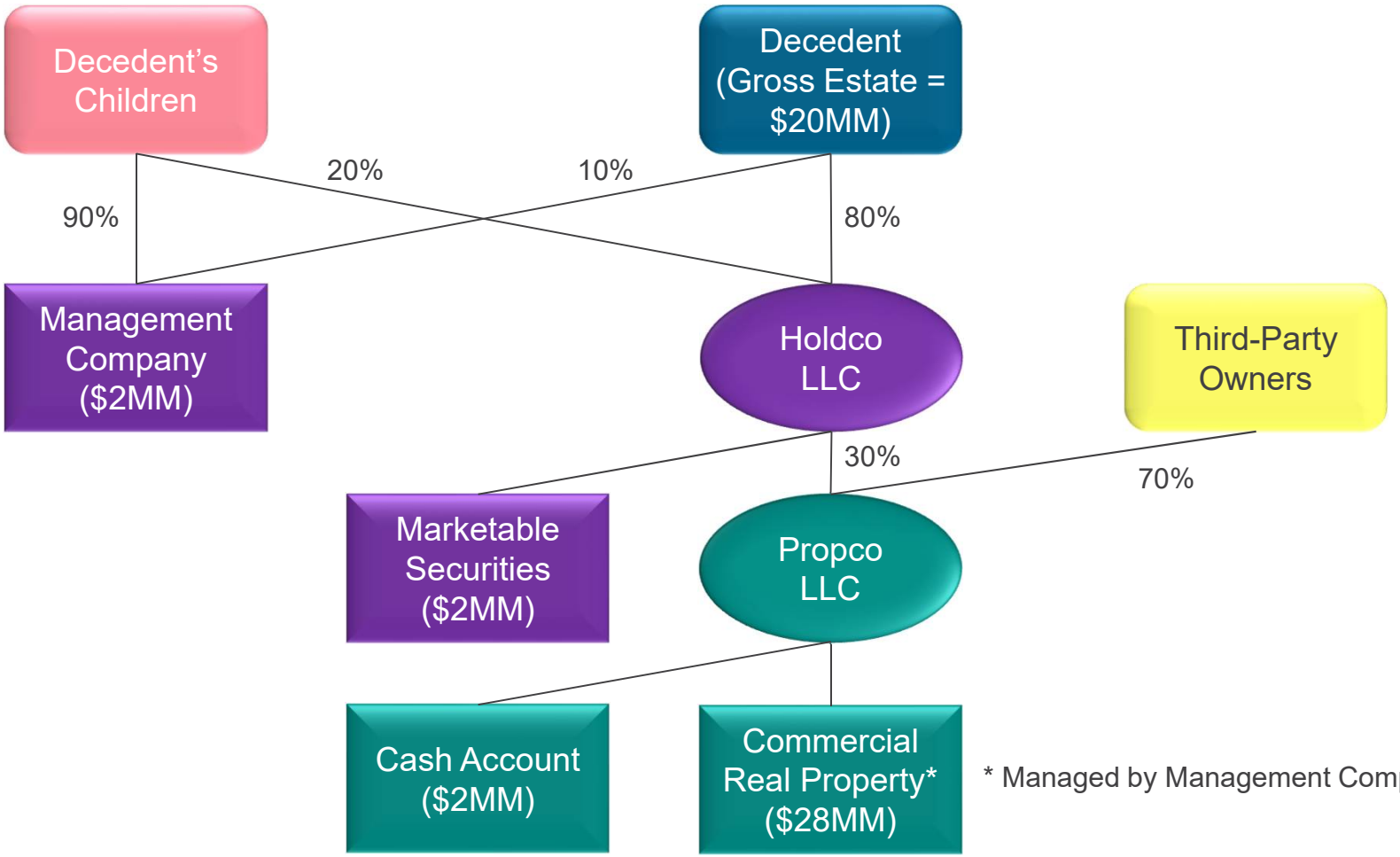
Section 6166: Example 7



* Managed by Management Company

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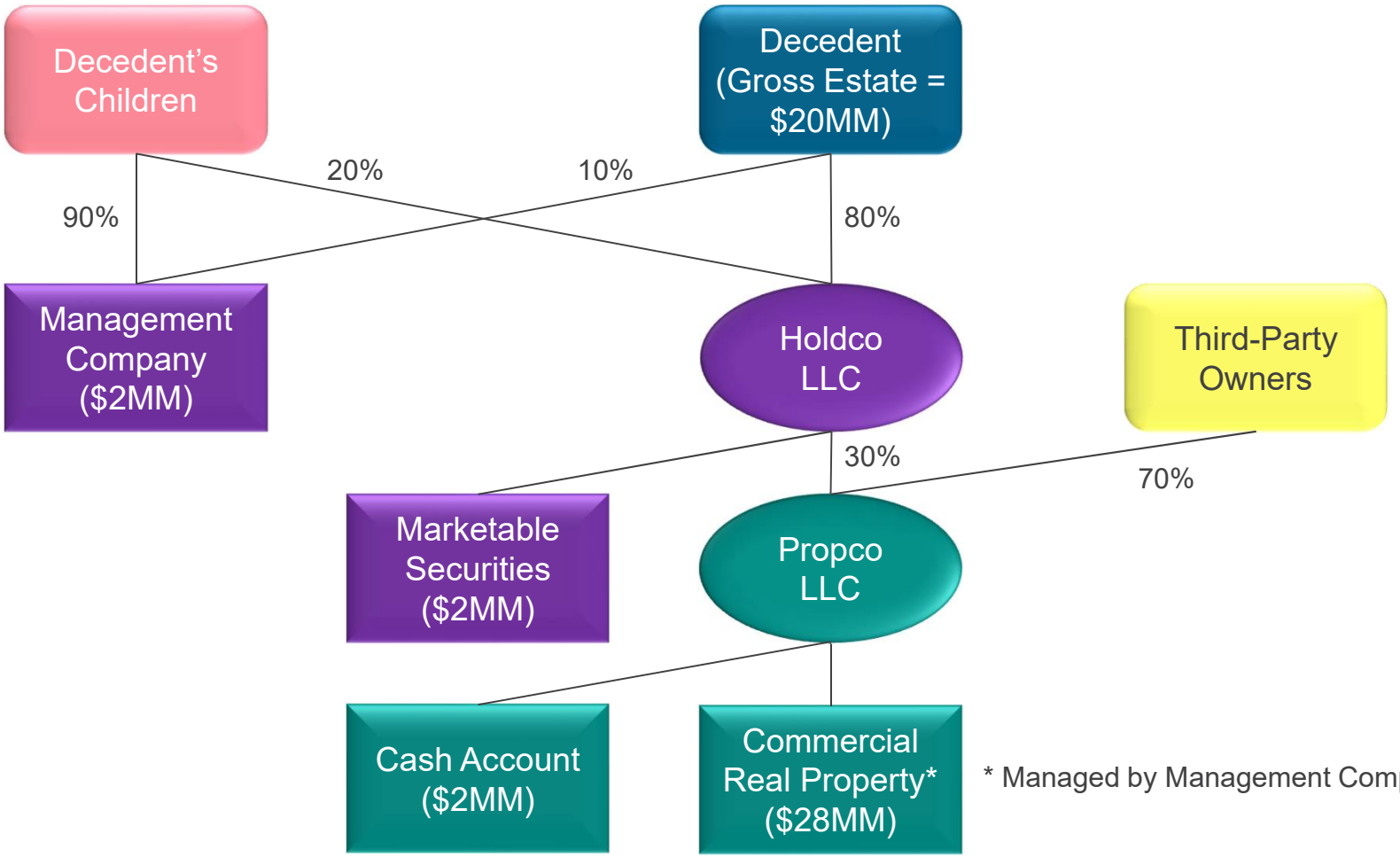
Section 6166: Example 7 (cont.)

- Management Company
  - Trade or business requirement
  - 45-Owner Test
  - 20% Test
  - 35% Test

Section 6166: Example 7



* Managed by Management Company

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Section 6166: Example 7 (cont.)

- Holdco LLC / Propco LLC
  - Trade or business requirement
  - 45-Owner Test
  - 20% Test
  - 35% Test
    - If Propco cash account is a passive asset, value of decedent's 6166 property is $6.92MM, or 34.6% of gross estate
    - If cash account is a reasonable reserve for business purposes, 6166 property is worth $7.4MM, 37% of gross estate

Section 6166: Example 7 (cont.)

- Pre-mortem planning:
  - Increase decedent's ownership of Management Company to at least 20%
  - Remove Holdco LLC from structure if feasible
  - Be mindful of 35% Test when planning for lifetime gifts of decedent's Propco interest
  - Remember to exclude value of passive assets from closely-held business interests

Graegin Loans: Background

- The term comes from the Tax Court case *Estate of Graegin v. Comm'r*, T.C. Memo 1988-477
- A Graegin loan is a loan incurred by an estate to cover those costs, including estate tax payments and expected expenses, for which it otherwise lacks liquidity
- Interest expected to be paid over the lifetime of the loan may be deducted for estate tax purposes if the loan meets certain requirements

Graegin Loans: Benefits

- Estate tax deduction for interest expected to be paid over the lifetime of the loan
- Avoids the need for a fire sale of assets to pay the estate's expenses
- Illiquid assets do not need to be closely-held business interests or meet the requirements of Section 6166
- Greater flexibility than under Section 6166 for terms and timing of repayment of interest and principal

Estate of Graegin v. Comm'r

- Estate consisted primarily of nonprobate assets and included a revocable trust holding stock in a family-owned company
- To avoid selling the stock, the executor borrowed from a wholly owned subsidiary of the company in exchange for an unsecured promissory note bearing interest at the prime rate
- Under the terms of the note, principal and interest were due in a single balloon payment 15 years after the note was executed and prepayment was prohibited

Estate of Graegin v. Comm'r (cont.)

- Court allowed deduction of all interest payable over the loan's lifetime as a reasonable and necessary administration expense under Section 2053 based on the following considerations:
  - Testimony of son who was co-executor of estate, co-trustee of trust for surviving spouse, President of both company and subsidiary, and a member of the Board of Directors of both companies;
  - Reasonableness of loan terms;
  - Approval of expense by state probate court;
  - Existence of unrelated 3% shareholder in family business;
  - Estate's lack of liquidity; and
  - Estate's need to borrow money to avoid forced sale

Graegin Loans: Requirements

- Loan must be a bona fide debt
- Interest expense must be actually and necessarily incurred by the estate
- No possibility of prepayment

Graegin Loans: Bona Fide Debt Requirement

- Loan must be bona fide and contracted for adequate and full consideration in money or money's worth
  - Was there a genuine intention to create a debt with a reasonable expectation of repayment?
  - Was a true debtor-credit relationship actually created based on this intention?
- Factors that weigh on these questions:
  - Presence of a third party in the loan structure (but courts have approved loans from a trust or family entity to the estate where the same parties were ultimately on both sides of the loan)
  - Debtor's expected income over term of loan
  - Adherence to loan terms

Graegin Loans: "Actually & Necessarily" Requirement

- Interest expense must be actually and necessarily incurred by the estate
  - Loan not necessary where estate has sufficient liquidity to pay estate tax and meet other anticipated expenses
  - Estate's ability to pay expenses by liquidating assets does not alone make interest expense unnecessary
    - Unclear whether publicly traded securities should be regarded as liquid assets for these purposes
    - Loans where the estate or beneficiaries could have compelled the distribution of that amount to the estate are not actually and necessarily incurred

Graegin Loans: "Actually & Necessarily" Requirement (cont.)

- Terms of the loan are relevant:
  - Principal amount may take into account a reasonable reserve to cover the costs of estate administration, litigation, and potential upward adjustments to estate tax due
  - Timing of payments (amortized, interest-only, or single balloon payment) and maturity date
  - Interest rate (AFR most conservative for an intra-family loan, but courts and the IRS have approved significantly higher rates in some circumstances)
- Estate's ability to qualify for Section 6166 deferral does not alone make interest expense unnecessary
- Courts have repeatedly refused to question the judgment of a fiduciary not shown to have acted other than in the best interests of the estate

Graegin Loans: No Possibility of Prepayment Requirement

- There can be no possibility of prepayment of a Graegin loan
- Also advisable to include an acceleration provision of all interest through the maturity date upon default

Graegin Loans: Example 1

- Estate holds $10M liquid assets and $40M of illiquid assets, and is subject to Washington and federal estate tax of $21M
- Estate's illiquid assets include a minority interest in a company that the executor expects will require cash inflows of $5M during the estate administration period
- Estate is also subject to litigation by one of the decedent's children. The executor expects that defending against this claim will be a significant expense.
- Executor borrows $17M from a third-party lender and offers estate assets as security. The loan pays interest at a rate of 6%. Loan repayments will be amortized over 20 years and the loan cannot be prepaid.
- If the loan meets the Graegin loan requirements, the estate receives a $12.6M deduction, generating an estate tax savings of $6.6M

Graegin Loans: Example 1 (cont.)

- The structure of this $17M loan can have a large impact on the amount of the deduction and corresponding estate tax savings:

	Interest Deduction	Estate Tax Savings
20-year amortized loan	$12.6M	$6.6M
Interest-only with balloon payment after 20 years	$20.4M	$10.6M
Interest added to principal with single balloon payment after 20 years	$37.5M	$19.5M

- The IRS or Washington DOR may argue that a structure producing more interest was not necessarily incurred
- Estate tax savings may be outweighed by the burden of making loan payments

Graegin Loans: Example 2

- Same facts as Example 1, but the estate borrows $17M from a family trust established by the decedent during life. The loan is unsecured and pays interest at a rate of 8%. The beneficiaries of the estate and the family trust are identical.
- Family trust funds the loan by taking out a secured loan from a third-party lender at a rate of 6%
- Interest paid by the estate is deductible for estate tax purposes, but is paid to a trust benefitting the family. Depending on the structure of the two loans, the (deductible) interest paid by the estate to the family trust may greatly exceed the amount paid by the trust to the third-party lender.
- Family trust has interest income

Section 6166 or Graegin Loan?

Section 6166	Graegin Loan
Estate must hold closely-held business interests	Estate can hold any sort of assets, generally illiquid assets present
Closely-held business interests must be ≥ 35% of adjusted gross estate	No equivalent requirements
No liquidity requirements	Estate must lack liquidity to pay estate tax and expected expenses
Deferral extends up to 14 years at most	Loan can extend beyond 14 years
Repayment terms fixed by statute	Repayment terms flexible
Automatically granted if estate satisfies requirements	Subject to challenge on audit
Significant restrictions on estate administration	Note must be repaid according to its terms

- Estates can qualify for both 6166 deferral and a Graegin loan

Section 6161 Deferral

- IRS may, for reasonable cause, extend the time of payment for part or all of an estate tax liability (including a Section 6166 installment payment) for a reasonable period not to exceed 10 years from the date such tax is due, in increments of up to 12 months
- IRS has discretion to grant or refuse deferral requests
- Interest is payable on the deferred tax and is deductible for estate tax purposes when paid
- Reasonable cause includes:
  - Executor requires time to marshal assets of estate
  - Estate illiquid, cannot borrow to fund estate tax payment at prevailing rates, and/or does not qualify for Section 6166 deferral
  - Asset of the estate subject to or must be obtained by litigation
- IRS may require bond up to twice the amount of tax due

Section 6161 Deferral (cont.)

- Request for deferral must be made on or before the date on which the tax is due, and must:
  - Be in writing
  - State the period for which the extension is requested
  - Include a declaration that it is made under penalties of perjury
  - Be supported by evidence showing reasonable cause
- Requests are generally made on Form 4768

Planning Considerations

- **Lifetime gifting:** Gifts of closely-held business interests may jeopardize the estate's ability to qualify for Section 6166. Gifts of other assets may increase the likelihood that the estate will qualify.
- **Restructuring of closely-held business holdings:** Consider restructuring where feasible so that decedent directly owns interests in 6166 property to avoid having to make the 6166(b)(7) or –(b)(8) elections
- **Creating Trusts and Family Entities:** Trusts and family entities created during life may be used to maximize the benefit of a Graegin loan

Estate Administration Considerations

- **Section 6166:**
  - Be thoughtful regarding dispositions or withdrawals of Section 6166 property and undistributed net income of closely-held businesses during the principal repayment period
  - Interest on deferred tax deductible on the Washington estate tax return when paid
  - Graegin loan interest deductions may help the estate satisfy the 35% Test
- **Graegin Loans:** Be sure the loan is structured properly and administered according to its terms
- **Section 6161:** When all else fails (and perhaps as a protective measure), request Section 6161 deferral

Questions?

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