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Untaxingly Yours

Planning to Fail vs Failing to Plan

By Brian T. Whitlock

Recently while speaking to a law school class on the topic of Succession Planning for Family Business, I was asked why I did not include Code Sec. 303, 2032A, or 6166 in the discussion. These provisions permit the estate of a decedent the ability to pay federal estate taxes related to a farm or family business over an extended period of time, at reduced valuations, and at reduced interest rates. I must confess that I was a little surprised by the question; not because I am unfamiliar with the provisions, but because they are not typically what I think of as tools that planners should aspire to use.

I acknowledge that all three provisions provide genuine *post-mortem* benefits for the heirs of closely held business owners and farmers, but these provisions both acknowledge and accept failure. My approach to business succession planning is probably cliché, but it is similar to the words spoken by actor, Ed Harris, who portrayed Chief Flight Director, Gene Kranz, in the 1995 Academy Award-winning film, Apollo 13, directed by Ron Howard:

> "We've never lost an American in space; we're sure as hell not going to lose one on my watch! Failure is not an option."

In my personal view, business succession planning should have a similar focus. Failure should not be an acceptable option. Estate planners, generally, and Business Succession planners, specifically, should focus on avoiding all the transfer tax that you possibly can, during the client's life. Anything less than that is acknowledging and planning for failure.

Nevertheless, out of a sense of obligation to provide a response to the questioner, this article will focus on the results of failure, and how best to utilize those provisions of the Code designed to help tax practitioners and their clients to cope with the payment of the federal estate tax that results when clients fail to adequately plan for the tax-free transfer of wealth to the next generation.

Special Use Valuation

The estate tax is assessed upon the relative value of a person's net worth that passes at death. The larger the value of the assets included in the gross estate, the larger the potential estate tax. Congress has generally recognized that American farms and closely held businesses are an important component of the U.S. Economy. According to an article published by Forbes Advisor in December of 2022,[1]

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which cited statistics published by the U.S. Small Business Administration Office of Advocacy and the Bureau of Labor Statistics, 99.9% of businesses across the United States are small businesses,[2] and 46.4% of all workers living in the United States are employed by small businesses.[3]

Code Sec. 2032A permits the administrator of an estate, who is filing Internal Revenue Service (IRS) Form 706 and calculating the potential estate tax due, to elect to value real property includible in a decedent's estate that is used for farming or for closely held business use on the basis of the property's actual use, rather than on the traditional basis of "highest or best" use, if certain conditions are met.

Congress enacted this provision in order to avoid forcing the family of the deceased to liquidate the business or farm merely to pay the estate tax burden. The maximum amount by which the value of qualifying real property could be reduced under the special use valuation provisions from 1983 to 1998 was originally limited to $750,000. Over the years since 1998, the maximum valuation reduction has been increased from time to time by statutory provisions that have sought to adjust the amount for inflation. The current inflation adjustment language can be found in the Tax Cuts and Jobs Act of 2017. As a result of the current inflation adjustment language, the Code Sec. 2032A Special Use Valuation maximum amount for the estates of decedents dying in 2023 is $1,310,000.[4] At a 40% estate tax rate, this is equivalent to a maximum savings of $524,000 of Federal Estate Tax.

Redemptions to Pay Taxes and Expenses

In my 40-plus years of experience, I have found that most farmers and closely held business owners tend to be illiquid. The best investment that they made was not in banks or marketable securities, but it was in themselves or their alter ego, their business. This lack of liquidity generally leaves the administrator of the estate and the heirs in a difficult position at the time of death. The estate is without sufficient liquid resources in hand to pay estate taxes and expenses of administration. The only available source of funding is the business. The challenge becomes finding the most tax-efficient way for the estate and/or family to get cash out of the business.

Logic might suggest that the answer is easy. Under Code Sec. 1014, the stock of the deceased shareholder has just received a basis adjustment to fair market value as of the decedent's death. If the family sells stock back to the company at a new high basis that is equal to fair market value, then they can receive the necessary cash for little or no gain. This type of sale or exchange is referred to as a stock redemption.

Code Sec. 302 generally deals with the tax treatment of stock redemptions. Under the terms of this provision, if the redemption is "substantially disproportionate" (in other words not equivalent to a dividend) then it will be treated like a sale or an exchange. If the transfer is equivalent to a dividend, then the distribution of cash for the stock will be taxed as a distribution of the corporation's Accumulated Adjustments Account (AAA), if it is currently an S Corporation, followed by a distribution of the corporation's Accumulated Earnings and Profits (AEP), if it was at any time it was a C Corporation, followed by a distribution of its Previously Tax Income (PTI), old S Corporation earnings of a current C Corporation, and finally, its Other Adjustments Account (OAA), if it was an S Corporation at any time. Only after all of these layers of corporate earnings have been stripped away, would the estate be able to recover its basis by offsetting its stock basis against any remaining redemption proceeds.

In order to qualify as substantially disproportionate, the redemption must reduce the estate's combined voting power in all outstanding classes of stock of the corporation after the redemption below 80%. This percentage reduction in ownership can be difficult to achieve when all the equity of the corporation is owned within a single family, because of the family attributions rules. Under Code Sec. 302, stock owned by other family members will be deemed to be owned "attributed to" the redeeming shareholder. An estate might only be able to qualify under Code Sec. 302, if its ownership was completely redeemed.[5]

Code Sec. 303 provides a workaround for redemptions involving the estates of qualifying deceased shareholders. If the redemption takes place within three years and 90 days of the due date of the estate tax return, within 60 days of the final determination of the tax by the Tax Court, or within the time permitted for deferred payment under Code Sec. 6166, under the qualifications of Code Sec. 303(b)(2), then sale or exchange treatment is available to an estate, provided that the value of all the stock in the redeeming corporation that is included in the decedent's gross estate is more than 35% of the value of the adjusted gross estate.[6] If the estate qualifies, then under the terms of Code Sec. 303(a), the redeeming party[7] may treat the portion of the proceeds that is equal to the death taxes,[8] plus any interest imposed on such taxes as a result of the decedent's death, and plus the funeral and administration expenses allowable, as deductions from the gross estate.

C Corporation Accumulations of Earnings in Anticipation of Redemptions

Corporations that are subject to income tax under Sub Chapter C of the Internal Revenue Code are also subject to certain penalty taxes[9] if they unreasonably accumulate earnings after tax. The policy rationale underpinning these penalty taxes is that the government would prefer that corporations pay dividends rather than accumulate earnings.

Code Sec. 531 imposes a penalty tax of 20% on "accumulated taxable income"[10] (*i.e.*, earnings that are accumulated beyond the reasonable needs of the business). Reasonable business needs might include plans for the future acquisition of machinery and equipment, investing in a real estate to be occupied by the business, and expansion of product lines or business, just to name a few examples.

Rather than requiring a business to borrow funds in order to meet a redemption request under Code Sec. 303, Code Sec. 537 specifically permits a business to accumulate earnings while a shareholder is alive in anticipation of the need to satisfy a *post-mortem* request. As we will see, however, even this provision is a catch-22 of sorts. The business is permitted under Code Sec. 537 to accumulate cash to meet future Code Sec. 303 redemption requests in order to pay estate taxes. However, if the estate redeems stock under Code Sec. 303, it will lose the benefit of Code Sec. 6166 tax deferral on the portion of the stock redeemed and the estate could risk the complete loss of Code Sec. 6166 if too much stock is redeemed.

Deferrals of Tax Payments

Estate tax returns required to be filed under Code Sec. 6018(a) must be filed within nine months after the death of the taxpayer.[11] As a general rule, Code Sec. 6151(a) sets the time for paying any given tax as the same date that the tax return is due.

Under Code Sec. 6165, an automatic six-month extension of the time to file a tax return may be requested. However, this automatic extension of the time to file does not also automatically extend the time to pay the tax.

Code Sec. 6161 permits the IRS to extend the time for paying various taxes that are either imposed on the original return as filed or on deficiency notices arising out of an IRS examination. Under Code Sec. 6161, the time to pay the amount of the estate tax reported on the IRS Form 706 return, as filed by the taxpayer, may be extended for up to a year if the taxpayer can show an "undue hardship." Undue hardship means more than financial inconvenience. The taxpayer must be able to show that a substantial financial loss will result in the taxpayer from making the tax payment on the required due date in order to qualify for the extension. The extension, if granted, will extend the time for the payment of the tax without a penalty, but it will still require the estate to pay the IRS interest at the standard interest rates applicable to deficiencies.

If the estate tax payment arises not with the original return but as a result of a deficiency notice that is subsequently issued by the Internal Revenue, then the IRS has the discretion under Code Sec. 6161 to extend the time for payment of the estate tax attributable to the deficiency up to four years after the assessment is made, upon a showing that the taxpayer would suffer undue hardship (*i.e.*, as substantial financial loss).

Although the statute speaks in terms of a 12-month extension for taxes due with the return and up to four years with taxes due to a deficiency notice, the Regulations stretch the envelope even further. Reg. §1.6161-1 provides for an undue hardship extension of up to 10 years. In order to request that extended period, an application for an extension of time for payment of tax is made on Form 1127 and must be accompanied or supported by evidence showing the undue hardship that would result to the taxpayer if the extension were refused. A statement of assets and liabilities of the taxpayer and an itemized statement showing all receipts and disbursements for each of the three months immediately preceding the due date of the tax are required and must accompany the application. The application will not be considered unless it is filed before the date required for payment of the tax or any installment payment of the tax, or on or before the date or dates for payment in any prior extension granted. As a condition to the granting of an extension, the taxpayer will usually be required to furnish security satisfactory to the IRS for the payment of the tax, or any part or installment thereof, on or before the date or dates prescribed for payment in the extension. This extension parallels the extension available under Code Sec. 6166 without requiring that a portion of the estate consists of a qualifying business interest.

Reduced Interest Rates on Tax Attributable to Qualifying Business Interests

Code Sec. 6166 provides our final estate tax deferral option. If a decedent's estate qualifies, the estate is the recipient of not just a deferral of the principal portion of the tax, but the estate will also qualify for a reduced interest rate throughout the entire deferral period.

In order to qualify for Code Sec. 6166, more than 35% of the deceased taxpayer's adjusted gross estate must consist

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of an interest in a farm or other closely held business. If the estate holds a qualifying business interest, the administrator of the estate may elect to defer payments of tax attributable to the qualifying business interest for five years (paying interest only during the first five years), and thereafter the estate must pay the estate tax in equal installments over the next 10 years. In total, the deferral period stretches 14 years. For the purpose of computing the 35% rule, the adjusted gross estate consists of the gross estate minus any debts, administrative expenses, claims, and losses allowable as deductions under either Code Sec. 2053 or 2054.

A closely held business interest will include all sole proprietorships and single-member limited liability companies, and certain partnerships, and corporations. For an interest in a partnership or corporation to be considered an interest in a closely held business, either at least 20% in value of the voting equity must be included in the gross estate of the decedent, or the corporation must have no more than 45 equity holders. In addition, in order to be considered a qualified business interest, the closely held business must be engaged in or carrying on a trade or business at the time of the decedent's death. The IRS has interpreted that language to require a decedent (or his or her agent) to be actively involved in the management of the business.

The Code Sec. 6166 deferral may be either partially or completely terminated, and the balance of the estate tax liability will be immediately due, if:

(1) More than 50% of the value of the decedent's interest (measured as of his or her death) is later withdrawn from the closely held business;
(2) At least 50% of a decedent's interest in the closely held business is distributed, sold, exchanged, or otherwise disposed of;
(3) Certain stock redemptions under Code Sec. 303 occur;
(4) The decedent's estate has undistributed net income after its fourth taxable year; or
(5) The estate fails to make a timely installment payment of estate tax or interest. The payment of the balance of the Code Sec. 6166 tax will not be accelerated, however, if a payment of interest and principal is made within six months of the due date.

The second portion of the benefit under Code Sec. 6166 is that a reduced interest rate of 2% applies to the portion of the tax that relates to a portion of the value of the qualified business interest that is included in the gross estate. Similar to Code Sec. 2032A, the maximum amount that is eligible for the 2% interest rate indexed for inflation, for 2023 the maximum value of the business that is eligible for the reduced rate is $1,750,000.[12] If we assume that the estate is in a 40% estate tax bracket, then the estate tax on $1,750,000 is $700,000. The reduced 2% rate would only apply to $700,000 of estate tax. The interest rate on the remaining balance of the amount extended is equal to 45% of the interest rate charged by the IRS on underpayments of tax.

Turning Lemons into Lemonade

Sophisticated estate planners generally view the Federal Estate and Gift Taxes to be discretionary taxes. Where taxpayers are willing to actively engage in planning, transfer strategies can be employed to greatly reduce, if not completely eliminate, the estate tax.

Where clients fail to either plan or fail to act on the plans that their advisors have suggested, we are left with our provisions of last resort. Under these provisions (Code Secs. 303, 2032A, 6161, and 6166), we try to manage the process of paying the resulting taxes in the most efficient and cost-effective manner.

ENDNOTES

1 Kelly Main and Cassie Bottorff, Small Business Statistics of 2023—Forbes Advisor, *www.forbes.com/advisor/business/small-business-statistics*.
2 The Small Business Administration defines a "small business" as any entity employing fewer than 500 employees.
3 Do not be misled by the fact that this number is less than 50%. Over 15% of the U.S. workforce is currently employed by federal, state, and local governmental units. This means that less than 39% of the workforce is employed by large businesses, with over 500 employees.
4 Rev. Proc. 2022-38, IRB 2022-45, 445, October 19, 2022.
5 Code Sec. 302(b)(3) provides an exception to the family attribution rules if the seller of the shares that are completely redeemed and the redeemed shareholder does not reacquire and equity interest in the business for at least 10 years.
6 For purposes of the 35% requirement, stock of two or more corporations shall be treated as stock of a single corporation if more than 20% in value of the outstanding stock of each such corporation is included in determining the value of the decedent's gross estate. In addition, a surviving spouse's community property interest in stock may be considered in determining the value of the decedent's gross estate for purposes of applying the 20% rule.
7 The redeeming party will generally be the estate, but the estate need not be the legal owner of the stock. If the stock was includable in the gross estate due to a general power of appointment, then the stock may still qualify for Code Sec. 303 treatment as a sale or exchange.
8 Federal and State estate taxes, Federal and State Generation skipping taxes, and inheritance taxes all fall within the definition of covered taxes.
9 Code Sec. 531, *et. seq.* (the Accumulated Earnings Tax) and Code Sec. 541 *et. seq.* (the Personal Holding Company Tax).
10 Code Sec. 535 defines the term accumulated taxable income as the taxable income of the corporation subject to various adjustments defined in Code Sec. 535(b), minus the dividends paid deduction (as defined in Code Sec. 561) and the accumulated earnings credit (as defined in Code Sec. 535(c)).
11 The filing date is set by statute, Code Sec. 6075.
12 Rev. Proc. 2022-38, IRB 2022-45, 445.

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