Deferring Estate Tax on the Death of a Family Business Owner: Why You Need to Know About Internal Revenue Code Section 6166

By Brett Sovine

We have long extolled the virtues of succession planning for family business owners.1 Conversations on this subject often address the tax, creditor and control advantages of utilizing trusts to pass value in the family business down the family tree while retaining control over business operations at the senior level. Early planning can often relieve the business and the family of stress related to raising liquidity quickly to pay estate taxes on a successful business owned entirely by a founder at her death. Occasionally, though, a family business owner may be unwilling or unable to give or sell a meaningful portion of the ownership of the business to successive generations. Perhaps the founder is reluctant to relinquish ownership of the company she and her spouse have worked so hard to build, or maybe an unexpected death or incapacity makes it legally impossible to proceed with estate planning that is started but incomplete. What can be done to minimize the immediate impact of federal estate tax on the business and family under these circumstances?

The answer may lie in section 6166 of the Internal Revenue Code (IRC), which in certain situations permits the executor of an estate to defer federal estate tax on a closely held business following an owner’s death. If the code’s requirements are met, the executor can elect to defer and spread payment of the estate tax over a period of up to 14 years. In the early years of the deferral period, payments to the Treasury can be made as interest only. Estate tax deferral under this IRC section relates solely to the portion of the decedent’s estate that represents his or her ownership in the company. In addition, it is only available to the extent the decedent’s ownership in the closely held business accounted for at least 20% of the company’s value and more than 35% of the value of his or her adjusted gross estate at the
time of death. If these requirements are met, the executor should consider making the election to defer federal estate tax due on that portion of the estate related to the value of the business.

**Example.** A widower who was actively involved in a successful medical device company he started with his wife a few years earlier, after her retirement as a vascular surgeon, received his wife’s stock in the family company outright following her passing. The husband then died unexpectedly, owning 100% of the business. The company’s value at his death was $20 million, and the total value of his estate was $50 million, the balance of which was made up of mostly real estate, marketable securities and retirement plan accounts. Since the husband owned more than 20% of the business at his death, and the business made up over 35% of the value of his estate, the executor of the husband’s estate could elect to pay the estate tax related to the family business over a period of up to 14 years.

Why might the executor of the estate elect to defer the estate tax in this example? According to the facts, the business had achieved a value of $20 million in just a few years. What if the executor was the decedent’s daughter who is also active in the business, and she felt the company had strong long-term growth prospects if it did not have to be sold or leveraged to pay estate tax currently? How would electing 6166 deferral help, and how does it work?

**Interest and Principal Payments**

An executor of an estate must pay the federal estate tax due on a closely held business ownership interest within nine months of the date of the decedent’s death. Assuming the husband and wife in the earlier example had used up their respective applicable exclusions during life, the estate would have to raise cash to pay federal estate tax of approximately $20 million within nine months of his death.2 If, instead, the executor elected to defer the portion of the estate tax related to the interest in the family business, the estate could defer approximately $8 million (the portion of estate tax due on the business) in tax. This buys the company time to either generate cash to pay the deferred tax or arrange an orderly sale of the business, as it relieves the executor of having to raise such a large pool of capital in a short time.

This is what Congress designed section 6166 deferral to do for family business owners. What happens to the tax liability then? The estate must begin paying interest to the Treasury annually from the date the tax was due (nine months from death) and start paying the principal tax balance no later than the fifth anniversary of the due date. Principal and interest deferral can be continued up until the 14th anniversary of the date the tax was due.

For decedents dying in 2019, the interest rate is 2% on the first $1.55 million in taxes deferred and 2.6% on the balance. This means the annual interest payable by the husband’s estate in the first four years of deferral is $198,700, compared with $8 million due within nine months of his death absent the 6166 deferral election. When the estate begins making principal and income payments to the Treasury in year five, a lien will be placed on all assets that qualified for deferred taxes (that is, the business interest) to secure full payment of the deferred taxes and interest.

**Electing Deferral**

Once the executor has the family business and other estate assets appraised, he or she must elect 6166 deferral for the business interest to ensure it pays the proper amount of tax due for the nonbusiness estate assets, which are ineligible for 6166 tax deferral. This is done on either the application for an extension of time to file an estate tax return or on the return itself. It is important to begin the process of appraising the business as soon as possible because business appraisals are subjective and can take time to prepare. The estate has nine months to obtain an appraisal and, even with the appraisal in hand, bears the risk that the Internal Revenue Service (IRS) may challenge the business’s appraised value on audit, which could ultimately jeopardize the executor’s election. Suppose the IRS successfully challenges the business’s value in the husband’s estate and finds that the company is worth only $10 million. In that case, the value of the family business would not exceed 35% of the decedent’s total estate, which would be reduced by a corresponding amount to $40 million, yielding a ratio of 25%. This is a factor an executor must consider before electing 6166 deferral.

**Active Trade or Business**

To qualify for 6166 estate tax deferral, the business subject to the deferral election must be actively engaged in a trade or business at the time of the decedent’s death. This is an easy test for some businesses and a more difficult analysis for others. Production facilities owned and operated to produce, sell and distribute medical devices are part of an active trade or business. Passive assets owned by an otherwise active trade or business are ineligible for 6166 estate tax deferral, and the line between passive (ineligible for deferral) and active (eligible for deferral) is not always clear. For example, what if the family business in the earlier example also purchased land for future manufacturing facilities but had not yet improved the lots and placed them into production? One could argue that planning for production expansion is an aspect of actively managing a trade or business. What if the medical device company also wholly owned a

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limited liability company (LLC) that owned and operated a California beach resort open to the public? The latter is a different business, but both are active enterprises. What if, instead, the LLC owned land in California held for future residential development? It is possible that the value associated with that part of the business is a passive activity not eligible for 6166 deferral. An industry that often faces scrutiny from the IRS is real estate development. Developers routinely buy and hold land for future development. They also sometimes lease land to third parties for development and maintenance. Can the executor of such a developer’s estate elect 6166 deferral under the theory that real estate speculation and development was the active trade or business engaged in at death? Estates have gone to court to argue over these points with the government. The outcome usually hinges on the amount of time the business owners spent on the trade or business. Was the owner a surgeon who funded land speculation, or did he manage the land himself? Did the owner manage tenants, set rent levels, initiate legal proceedings, perform or oversee maintenance and repairs, and so forth? Who answered calls in the middle of the night from tenants or on weekends from interested buyers? The answers to these questions will ultimately play a crucial role in determining whether deferral is available to the estate made up largely of land held for development.

**Family Attribution**

IRC section 6166 deferral was intended by Congress to benefit all forms of actively owned and managed family businesses; thus, relief extends to businesses owned and operated as sole proprietorships, LLCs, partnerships and corporations. Consistent with the goal of providing estate tax relief to family businesses, the number of owners who can own a business is capped for certain forms of ownership. A corporation electing 6166 deferral cannot have more than 45 shareholders, and a partnership or LLC cannot have more than 45 partners or members, respectively. This is not as high a bar as it may seem, because the IRC permits certain family members to aggregate their ownership not only for the number of owner thresholds, but also for the ownership percentage qualification tests addressed earlier.

**Conclusion**

Many families actively pursue succession planning or the sale of a family business during the life of the founders and successive generations. Succession planning is an ongoing process — never a finished product. However, sometimes life or other familial issues get in the way of a family’s plans, and IRC section 6166 should be considered under the correct circumstances. Some families aggressively plan to utilize 6166 deferral, particularly where a senior generation refuses to transfer ownership in the family business. These families work together to spend down or gift away assets that the business does not need and retain ownership at the senior level to ensure a greater portion of the senior generation’s estate represents ownership in an active trade or business eligible for 6166 deferral. Note that the 2% interest rate on the first $1.55 million in taxes deferred mentioned earlier is fixed, but the 2.6% on the remainder is a variable rate tied to other sections of the IRC. In the current sustained historically low interest rate environment, interest rates are attractive where a senior business owner is elderly or against surrendering his or her interest in the business. That said, because of the nuances of IRC section 6166, careful consideration should be given before relying on 6166 deferral as the definitive succession plan for the family business. If your family owns a family business and you would like to discuss any aspect of succession planning, including how to plan to take advantage of 6166 estate tax deferral, contact the Brown Brothers Harriman Center for Family Business. Learn more at www.bbh.com/familybusiness.

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2 The federal estate tax rate currently is 40%. In this scenario, 40% of the $50 million estate is $20 million. The taxes owed might be more if the decedent lived in a state that still imposes a state estate tax on top of the federal tax.