

Section 6166: Estate tax relief for family businesses

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Fewer people currently are subject to transfer taxes than ever before. But gift, estate and generation-skipping transfer taxes continue to place a burden on families with significant amounts of wealth tied up in illiquid closely held businesses, including farms.

Fortunately, Internal Revenue Code Section 6166 provides some relief, allowing the estates of family business owners to defer estate taxes and pay them in installments if certain requirements are met.

Section 6166 benefits

For families with substantial closely held business interests, an election to defer estate taxes under Section 6166 can help them avoid having to sell business assets to pay estate taxes. It allows an estate to pay interest only (at modest rates) for four years and then to stretch out estate tax payments over 10 years in equal annual installments. The goal is to enable the estate to pay the taxes out of business earnings or otherwise to buy enough time to raise the necessary funds without disrupting business operations.

Be aware that deferral isn't available for the entire estate tax liability. Rather, it's limited to the amount of tax attributable to qualifying closely held business interests.

Section 6166 requirements

Estate tax deferral is available if (1) the deceased was a U.S. citizen or resident who owned a closely held business at the time of his or her death; (2) the value of the deceased's interest in the business exceeds 35% of his or her adjusted gross estate; and (3) the estate's executor or other personal representative makes a Section 6166 election on a timely filed estate tax return.

To qualify as a "closely held business," an entity must conduct an *active* trade or business at the time of the deceased's death (and only assets used to conduct that trade or business count for purposes of the 35% threshold). Merely managing investment assets isn't enough.

In addition, a closely held business must be structured as:

- A sole proprietorship;
- A partnership (including certain limited liability companies taxed as partnerships), provided either (1) 20% or more of the entity's total capital interest is included in the deceased's estate, or (2) the entity has a maximum of 45 partners; or
- A corporation, provided either (1) 20% or more of the corporation's voting stock is included in the deceased's estate, or (2) the corporation has a maximum of 45 shareholders.

Several special rules make it easier to satisfy Section 6166's requirements. For example, if an estate holds interests in multiple closely held businesses, and owns at least 20% of each business, it may combine them and treat them as a single closely held business for purposes of the 35% threshold. In addition, Section 6166 treats stock and partnership interests held by certain family members as owned by the deceased.

On the other hand, the interests owned by corporations, partnerships, estates and trusts are attributed to the underlying shareholders, partners or beneficiaries. This can make it harder to stay under the 45-partner/shareholder limit.

Please contact us with questions.

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The Law Office of Eugene Gorrin, LLC
17 Watchung Avenue, Suite 204
Chatham, NJ 07928
973.701.9300
egorrin@gorrinlaw.com
www.gorrinlaw.com