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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PA:APJP:B02

PLR-157800-04

Date:

April 11, 2005

LEGEND

Decedent:

Corporation:

Date 1:

Date 2:

Date 3:

a:

b:

c:

d:

e:

f:

g:

h:

i:

Dear \_\_\_\_\_ :

This letter responds to your request for a ruling dated November 2, 2004, regarding three issues. First, you asked whether the retention of "S" stock by a trust during the 6166 extension period will disqualify Corporation's "S" status. Next, you asked whether the interest rate remains constant during the payment period. Finally, you asked whether, under the facts described below, the provisions of section 6166(b)(7) are necessary to qualify for the 20% ownership test of section 6166(b).

### FACTS

Decedent died on Date 1. As of the date of death, Decedent, through her grantor trust (Trust), dated Date 2, owned a voting shares of Corporation, which constitutes b percent of Corporation. Corporation is a family-owned "S" corporation. Corporation has c shareholders, one of whom is Decedent's brother who owns d percent of Corporation (e shares).

Decedent's gross estate is estimated to be valued at \$f, of which \$g is attributable to Corporation stock. Decedent plans to elect, under section 645, to treat Trust as part of the estate. Likewise, Decedent plans to elect to pay the estate tax affiliated with Corporation in installments pursuant to section 6166.

The governing document for Trust provides that upon Decedent's death and after satisfaction of debts, expenses, and gifts, Trust is to be distributed outright, or if under the age of 25, in trust, to Decedent's nieces and grandnephews (Beneficiaries).

### RULINGS REQUESTED

On the basis of the above facts and representations, the following rulings have been requested:

1. Whether the retention of "S" stock by Trust during the extended period over which the estate tax may be paid under section 6166 will disqualify Corporation's "S" status.
2. Whether the interest rate under section 6601(j)(1)(B), 6601(a), and 6166(b)(7) changes periodically or is determined as of the due date of an estate tax return and remains constant throughout the period which the tax is being paid under section 6166.
3. Whether the election to use the provisions of section 6166(b)(7) is necessary to qualify for the 20% stock ownership test of section 6166(B)(1)(C)(i), and if so, whether it increases the gross estate only for purposes of qualifying under the 20% rule and not for gross estate tax purposes.

## RELEVANT AUTHORITIES

Section 1361(a)(1) provides that the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

Section 1361(b)(1) provides that the term “small business corporation” means a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in section 1361(c)(2), or an organization described in section 1361(c)(6) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1361(c)(2)(A)(iii) provides that a permitted S corporation shareholder includes a trust with respect to stock transferred to it pursuant to terms of a will but only for the 2-year period beginning on the day on which such stock is transferred to it.

Section 1.1361-1(h)(1)(iv) of the Income Tax Regulations provides that a testamentary trust is a trust (other than a qualified subpart E trust, an electing QSST, or an ESBT) to which S corporation stock is transferred pursuant to the terms of an electing trust as defined in section 1.645-1(b)(2) during the election period as defined in section 1.645-1(b)(6), or deemed to be distributed at the close of the last day of the election period pursuant to section 1.645-1(h)(1), but in each case only for the 2-year period beginning on the day the stock is transferred or deemed distributed to the trust.

Section 1361(c)(2)(A)(v) provides that a permitted S corporation shareholder includes an electing small business trust (ESBT).

Section 1361(e)(1)(A) provides that an ESBT is any trust if (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in section 170(c)(2), (3), (4), or (5), or (IV) an organization described in section 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary; (ii) no interest in such trust was acquired by purchase; and (iii) an election under section 1361(e) applies to such trust. Section 1.1361-1(m) provides the requirements for filing an ESBT election.

Section 645(a) provides that, if both the executor (if any) of an estate and the trustee of a qualified revocable trust (QRT) elect, the QRT shall be treated and taxed as part of the related estate (and not as a separate trust) for all taxable years of the estate ending after the decedent’s death and before the applicable date.

Section 645(b)(1) provides that a QRT is any trust (or portion thereof) which was treated under section 676 as owned by the decedent by reason of a power in the grantor (determined without regard to section 672(e)).

Section 1.645-1(b)(2) provides that an electing trust is a QRT for which a valid section 645 election has been made. Section 1.645-1(b)(6) defines the section 645 election period as the period of time during which an electing trust is treated and taxed as part of the related estate.

Section 1.645-1(e) provides that, if there is an executor, an electing trust is treated, during the election period, as part of the related estate, for all purposes of Subtitle A of the Internal Revenue Code, including the subchapter S shareholder requirements of section 1361(b)(1).

Section 645(b)(2) provides that the applicable date, if a Form 706 is required to be filed by the estate, is the date that is 6 months after the date of final determination of liability for the estate tax.

Section 1.645-1(f)(2)(ii) provides that solely for purposes of determining the applicable date under section 645, the date of final determination of liability is the earliest of the following--(A) the date that is six months after the issuance by the Internal Revenue Service of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within 12 months after the issuance of the letter; (B) the date of a final disposition of a claim for refund that resolves the liability for the estate tax, unless suit is instituted within six months after the final disposition of the claim; (C) the date of execution of a settlement agreement with the Internal Revenue Service that determines the liability for the estate tax; (D) the date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or a petition for certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of court; or (E) the date of expiration of the period of limitations for assessment of the estate tax provided in section 6501.

Section 1.645-1(h)(i) provides that on the close of the last day of the election period, the electing trust is deemed to be distributed to a new trust in a distribution to which to which sections 661 and 662 apply.

Section 1.641(b)-3(b) provides that a trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable period of time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust.

Rev. Rul. 76-23, 1976-1 C.B. 264, holds that when the sole purpose for retaining stock in an S corporation in an estate of a deceased shareholder is to facilitate the payment of the estate tax under § 6166 of the Code, the administration of the estate will not be considered unreasonably prolonged, and the estate will continue to be an eligible S corporation shareholder for the period during which the estate complies with the provisions of section 6166.

Section 6166(a)(1) provides, in part, that if the value of an interest in a closely held business, which is included in determining the gross estate of a decedent who was (at the date of his death) a citizen or resident of the United States, exceeds 35 percent of the adjusted gross estate, the executor may elect to pay part or all of the tax imposed by section 2001 in two or more (but not exceeding ten) equal installments.

Section 6166(b)(1)(C) of the Code provides, in relevant part, that the term “interest in a closely held business” means 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 45 or fewer shareholders.

Section 6166(b)(2)(D) of the Code provides, in part, that all stock held by the decedent or by any member of his family (within the meaning of section 267(c)(4)) shall be treated as owned by the decedent. Section 267(c)(4) states that “the family of an individual shall include only his brothers and sisters (whether by whole or half blood), spouse, ancestors, and lineal descendants.

The attribution rules in section 6166(b)(2) apply for purposes of determining whether a corporation has 45 or fewer shareholders within the meaning of section 6166(b)(1). The attribution rules do not apply for purposes of the 35% test of section 6166(a)(1), the 20% test in section 6166(b)(1)(B)(i) and 6166(b)(1)(C)(i), or the formula used in determining the maximum amount of tax that may be paid in installments set forth in section 6166(a)(2).

Section 6166(b)(7) provides that for purposes of section 6166(b)(1)(C)(i) any nonreadily-tradable stock treated as owned by the decedent after the application of section 6166(b)(2), will be treated as included in determining the value of the decedent’s gross estate.

Section 6166(b)(7)(B) defines “nonreadily-tradable stock” as stock for which, at the time of a decedent’s death, there was no market on a stock exchange or on an over-the-counter market.

To obtain the benefits of section 6166(b)(7), the executor must specifically elect its application. Note, however, that if elected the payment period for the estate tax due cannot exceed 10 years and the special interest provision in section 6601(j) will not apply.

Section 6601(a) requires that a taxpayer pay interest if any amount is not paid “on or before the last date prescribed for payment” at the underpayment rate established under section 6621. Section 6621(a)(2) provides that the underpayment rate is the Federal short-term rate plus 3 percentage points. The Secretary determines the Federal short-term rate the first month in each calendar quarter. I.R.C. § 6621(b)(1).

Section 6601(j) provides that if the time for payment of the Chapter 11 tax of the Code has been extended pursuant to section 6166, interest is charged at a different rate. The amount of the tax that is the “2-percent portion” is charged at a rate of 2 percent, and the remainder of the tax is charged at a rate equal to 45 percent of the annual rate provided by section 6601(a). I.R.C. § 6601(j)(A) and (B).

## Analysis

### **Issue 1**

Provided that a valid section 645 election is, or has been, made for Trust, Trust will be treated as part of Decedent’s estate and a permitted shareholder of Corporation during the section 645 election period. Decedent’s estate will be treated as the shareholder of Corporation with respect to the stock of Corporation held by Trust for purposes of sections 1361, 1366, 1367, and 1368. The section 6166 election will not affect the date on which Trust’s section 645 election period terminates.

Upon the termination of the section 645 election period, as provided by section 1.645-1(h)(i) and section 1.1361-1(h)(iv), Trust will be treated as having been distributed to a new trust (New Trust) that qualifies as a testamentary trust. New Trust will continue to be a permitted shareholder of Corporation for the two year period beginning on the day following the termination of the section 645 election period. With respect to Corporation stock held by New Trust during the period that Corporation is treated as a testamentary trust, Decedent’s estate will be treated as the shareholder of Corporation for purposes of section 1361 and New Trust will be treated as the shareholder of Corporation for purposes of sections 1366, 1367, and 1368. See Treas. Reg. § 1.1361-1(h)(3)(ii)(B).

Additionally, New Trust may elect ESBT treatment at any time during the two year period that New Trust is treated as a testamentary trust or the 16 day and two month period beginning on the date after the end of the two year period. If an ESBT election is not made for New Trust effective on or before the end of the two year period that New Trust is treated as a testamentary trust, New Trust will cease to be a permitted shareholder of Corporation at the end of the two year period. If an ESBT election is made for New Trust, Beneficiaries will be treated as the shareholders of Corporation stock held by New Trust for purposes of section 1361, and New Trust will be taxed as provided in section 641(c).

Further, provided that the sole purpose for retaining Corporation stock in Trust and New Trust is to facilitate the payment of the estate tax under section 6166, the administration of Trust and New Trust following the death of Decedent will not be considered unreasonably prolonged for purposes of section 1.641(b)-(3)(b).

### **Issue 2**

As stated above, section 6601(j) provides that if the time for payment of the Chapter 11 tax of the Code has been extended pursuant to section 6166, interest is charged at a different rate. The amount of the tax that is the “2-percent portion” is charged at a rate of 2 percent, and the remainder of the tax is charged at a rate equal to 45 percent of the annual rate provided by section 6601(a). I.R.C. § 6601(j)(A) and (B).

The 2-percent portion is the lesser of: the amount of the Chapter 11 tax being extended under section 6166; or the amount of tax determined under section 2001(c) that is equal to the sum of \$1,000,000.00 and the applicable section 2010(c) exclusion amount, reduced by the section 2010(c) credit. I.R.C. § 6601(j)(A)(i) and (ii). When determining the 2-percent amount, the \$1,000,000.00 is increased by the cost-of-living adjustment determined under section 1(f)(3). I.R.C. § 6601(j)(3). For an estate of a decedent who died in calendar year Date 3, the 2-percent portion is \$h instead of \$1,000,000.00. See Section 3.32 of Rev. Proc. 2003-85, 2003-2 C.B. 1184.

Aside from the interest rate reduction pursuant to section 6601(j)(1)(B), there is no authority that limits the interest rate the estate will pay on outstanding Chapter 11 tax that exceeds the 2-percent portion. Absent an express limitation on the interest rate in the Code, the estate is liable for 45 percent of the interest rate charged in section 6621(a)(2). Accordingly, when the Federal short-term rate changes in a quarter, the interest rate on Chapter 11 tax that exceeds the 2-percent portion will change to reflect the new interest rate.

### Issue 3

To qualify for section 6166 treatment, the value of an interest in a closely held business, which is included in determining the gross estate of a decedent must exceed 35 percent of the adjusted gross estate. I.R.C. § 6166(a). An interest in a corporation carrying on a trade or business is considered an interest in a closely held business if (i) 20 percent or more of the voting stock of the corporation is included in determining the gross estate or (ii) the corporation had 45 or fewer shareholders. I.R.C. § 6166(b)(1)(C). In this case, there are c shareholders, thus the only way the estate can qualify for section 6166 treatment is if it meets the 20 percent test.

Decedent meets the 20 percent test because, pursuant to section 6166(b)(2)(D), her brother’s e shares may be attributed to her. Those shares represent d percent of the voting stock of Corporation. That amount, coupled with Decedent’s b percent, will be included in determining the value of the gross estate. I.R.C. § 6166(b)(7). Because that amount (i percent) exceeds 20 percent, Decedent is deemed to have an interest in a closely held business for purposes of section 6166(b)(1)(C)(i). The d percent, however, will not be included in determining the tax due.

But for the attribution rules of section 6166(b)(2)(D), Decedent’s estate would not qualify for section 6166 treatment. Because, however, the attribution rules are necessary to qualify for the minimum threshold (20% or more of the value of voting stock),

Decedent's estate is limited to the treatment in section 6166(b)(7) and will therefore have 10 years to pay the estate tax. Further, the estate is not entitled to the favorable interest rate. See I.R.C. § 6166(b)(7)(A)(iii).

### CONCLUSIONS

Based on the information provided and the representations made, we conclude as follows:

1. Provided that a valid section 645 election is, or has been, made for Trust, Trust will be treated as part of Decedent's estate and a permitted shareholder of Corporation during the section 645 election period. Decedent's estate will be treated as the shareholder of Corporation with respect to the stock of Corporation held by Trust for purposes of sections 1361, 1366, 1367, and 1368. The section 6166 election will not affect the date on which Trust's section 645 election period terminates.
2. The interest rate under section 6601(j)(1)(B), 6601(a), and 6166(b)(7) changes periodically throughout the period which the tax is being paid under section 6166.
3. The estate qualifies for an extension of time for payment of the estate taxes attributable to Corporation pursuant to section 6166(b)(7). The d percent of attributed ownership will not be included in determining the amount of tax due.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent. A copy of this letter ruling should be attached to Decedent's federal estate tax return.

If you have any questions, please contact 202-622-4940.

Sincerely,  
Charles A. Hall  
Senior Technician Reviewer  
CC:PA:APJP:B02