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AVOIDING ACCELERATION OF INSTALLMENT PAYMENT OF FEDERAL ESTATE TAX

— by Neil E. Harl*

For those who have used installment payment of federal estate tax to defer tax payment over 177 months after death, a major concern is avoiding acceleration of the deferred tax and loss of the four percent interest rate on the first $345,800 of tax less the unified credit. For farm and ranch estates using the deferred payment option, post-death planning is needed to avoid acceleration.

**General rule.** Except for Section 303 stock redemptions, some testamentary transfers by the decedent and certain corporate reorganizations, if 50 percent or more of the decedent's interest in the closely held business is distributed, sold, exchange or otherwise disposed of or is withdrawn from the business, the remaining installments become due. For deaths before 1982, the figure was one-third or more.

For Section 303 redemptions, there must be paid an amount of federal estate tax, including interest, not less than the amount of the distribution and the payment must be made on or before the date prescribed for payment of the first installment that comes due after the date of distribution (or, if earlier, on or before the date that is one-year after the distribution). The mere execution of a stock redemption agreement after death does not, of itself, accelerate the payment of tax.

**Death-time transfers.** For transfers after 1981, the transfer of a decedent's interest upon death of the original heir or upon death of any transferee receiving the interest as a result of the transferor's death does not cause acceleration of payment if each subsequent transferee is a family member of the transferor. Note that this exception applies only to death time transfers and then only to family members.

**Lifetime transfers.** In contrast to the rule on death-time transfers, any lifetime transfer— even to a family member— counts against the 50 percent limit. Thus, an installment sale of land to sons constituted a disposition although the disposition was not large enough to trigger acceleration of tax. And the sale of farmland by one estate beneficiary to another was a disposition.

**Mortgaging property.** Only limited authority exists on the consequences of the mortgaging of property after death. In one ruling, the mortgaging of property was not a disposition where the funds were used to pay the liens on the property and to pay the costs of refinancing. In another ruling, the sale of property to pay off mortgages was not a disposition or withdrawal where the proceeds were applied on the mortgage. In that ruling, it was made clear that proceeds received in excess of the mortgage would be considered a disposition.

In a 1989 ruling, Rev. Rul. 89-4, IRS held that where estate property was sold to pay off the outstanding debt on that and other estate property, both under threat of foreclosure, the sale did not cause acceleration of installment payment of estate tax except to the extent the sale proceeds exceeded the debt payments on the properties. IRS noted that the value of the closely-held business included in the estate would not decrease in such a transaction, except to the extent the sale proceeds were in excess of that needed to pay off the debt against the remaining property.

The sale of corporation property to a shareholder in exchange for discharge of the corporation's debt to the shareholder is viewed as a transaction in the ordinary course of business and not a disposition causing acceleration of installment payment of federal estate tax.

**Filing bankruptcy.** The transfer of property to a bankruptcy estate by an individual under Chapter 7 or 11 bankruptcy is not treated as a disposition for tax purposes including installment payment of federal estate tax. The statute refers to such transfers as not constituting dispositions "for purposes of any provision of this title." Therefore, a mere transfer of assets to the bankruptcy estate should not trigger acceleration of federal estate tax deferred under installment payment rules. The bankruptcy estate steps into the shoes of the bankrupt heir.

Moreover, the transfer of property back to the debtor at the termination of the bankruptcy estate should not be treated as a disposition. Therefore, property not disposed of, which is ultimately returned to the debtor, should not encounter acceleration of federal estate tax that has been deferred. Any disposition otherwise by the trustee in bankruptcy or debtor in possession presumably runs the risk of being treated as a disposition for purposes of acceleration of payment.

For Chapter 12 or 13 filings, or filings under any chapter by partnerships or corporations, no transfer is involved so a mere bankruptcy filing would not seem to cause acceleration.

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Leasing. Cash renting of farmland during the deferral period after death is treated as a disposition.\textsuperscript{20} That result stems from the use of the word "business" throughout the acceleration part of the statute and the belief that the heirs must maintain the property as a closely held business during the period for acceleration.\textsuperscript{21}

The execution of an oil and gas lease apparently does not cause acceleration; however, parcels of land on which farming is discontinued as a result of oil and gas exploration and production activities are considered to be disposed of for purposes of acceleration of tax payment.\textsuperscript{22}

The sale of timber and the leasing of timber land under a 29-year "net lease" has been held to be a disposition.\textsuperscript{23}

Tax-free exchange. Although IRS initially ruled otherwise,\textsuperscript{24} IRS now agrees that the transfer of assets in a tax-free like-kind exchange does not accelerate tax payments.\textsuperscript{25}

Dividend payment. A dividend payment after death is deemed a withdrawal to the extent of earnings and profits accumulated before death.\textsuperscript{26}

Partition of assets. A partition of farmland to separate the business interests of the estate has been held not to constitute a disposition where the assets continued to be used in farming operations and the partition was based on fair market value appraisals.\textsuperscript{27}

Corporate reorganizations. In about two dozen rulings issued to date,\textsuperscript{28} it has been made clear that a mere change in organizational form does not result in acceleration of federal estate tax if it does not materially alter the business.\textsuperscript{29} Thus, reorganizations involving a shift from sole proprietorship to partnership form\textsuperscript{30} or taxable liquidation of a corporation with subsequent formation of a partnership\textsuperscript{31} have not involved a disposition or withdrawal. Likewise, there has been no acceleration on a type D divisive reorganization\textsuperscript{32} of a farm corporation.\textsuperscript{33}

However, issuance of corporate debentures for an equity interest is apparently considered a disposition.\textsuperscript{34} Therefore, careful attention should be given to reorganizations involving the use of debt securities.

Transfers in trust. In general, post-death transfers in accordance with the decedent's will or in the course of estate settlement do not cause acceleration. Thus, one ruling has held that there was no acceleration on funding of marital and family trusts from the estate and subsequent distribution from the marital trust to the surviving spouse was not considered a distribution, either.\textsuperscript{35} In the facts of that ruling, the surviving spouse was empowered by the will to withdraw principal from the trust.

In another ruling, there was no acceleration where the decedent's stock passed at the death of the surviving spouse who held a life estate plus a general power of appointment and failed to exercise the power; the stock was deemed to pass under the decedent's will.\textsuperscript{36}

\begin{footnotes}
\footnotetext{1}{I.R.C. § 6166. See generally 5 Harl, \textit{Agricultural Law} §42.05 (1991).}
\footnotetext{2}{I.R.C. § 6601(j). Interest on additional amounts is due at the regular rate.}
\footnotetext{3}{I.R.C. § 6166(g)(1). See Ltr. Rul. 8730006, April 14, 1987 (sale of undivided interest in farm by two heirs to third heir for cash was disposition causing acceleration); Ltr. Rul. 8806022, Nov.13, 1987 (same).}
\footnotetext{4}{I.R.C. § 6166(g), before amendment by Pub. L. No. 97-34, Sec. 422(a)(1).}
\footnotetext{5}{I.R.C. § 6166(g)(1)(B). See Rev. Rul. 72-188, 1972-1 C.B. 383 (redemption of stock in 10 consecutive years to pay the 10 deferred installments of federal estate tax). See also Ltr. Rul. 8839013, June 27, 1988 (Section 303(a) redemption of estate stock not disposition causing acceleration of installment payment of estate tax).}
\footnotetext{6}{Ltr. Rul. 8504126, Oct. 31, 1984.}
\footnotetext{7}{I.R.C. § 267(c)(4).}
\footnotetext{8}{I.R.C. § 6166(g)(1)(D).
\footnotetext{9}{Id.}
\footnotetext{10}{Ltr. Rul. 8224075, March 17, 1982 (land had been earlier released from lien for mortgage purposes).}
\footnotetext{11}{Ltr. Rul. 8730006, April 14, 1987.}
\footnotetext{12}{Ltr. Rul. 8310346, Dec. 27, 1982.}
\footnotetext{13}{Ltr. Rul. 8441029, July 10, 1984.}
\footnotetext{14}{Id.}
\footnotetext{15}{1989-1 C.B. 298.}
\footnotetext{16}{Ltr. Rul. 8610058, Dec. 10, 1985.}
\footnotetext{17}{I.R.C. § 1398(f)(4).}
\footnotetext{18}{Id.}
\footnotetext{19}{I.R.C. § 1398(f)(2).}
\footnotetext{20}{Ltr. Rul. 8339023, June 24, 1983.}
\footnotetext{21}{See I.R.C. § 6166(g).}
\footnotetext{22}{Ltr. Rul. 8326167, April 1, 1983.}
\footnotetext{23}{Ltr. Rul. 8437043, June 8, 1984 (disposition even if proceeds are reinvested in remaining business interest).}
\footnotetext{24}{Ltr. Rul. 8025095, March 30, 1980.}
\footnotetext{25}{Ltr. Rul. 8034165, no date given; Ltr. Rul. 8248103, Aug. 31, 1982 (same); Ltr. Rul. 8304033, Oct. 22, 1982.}
\footnotetext{26}{Rev. Rul. 75-401, 1975-2 C.B. 473.}
\footnotetext{27}{Ltr. Rul. 8525040, March 25, 1985 (involving community property ownership of assets).}
\footnotetext{28}{See 5 Harl, \textit{supra} note 1, § 42.05, n. 108.}
\footnotetext{29}{Rev. Rul. 66-62, 1966-1 C.B. 272.}
\footnotetext{30}{Ltr. Rul. 8025095, March 30, 1980.}
\footnotetext{31}{Ltr. Rul. 8103066, Oct. 22, 1980.}
\footnotetext{32}{I.R.C. § 368(a)(1)(D).}
\footnotetext{33}{Ltr. Rul. 8942031, July 24, 1989.}
\footnotetext{34}{See Ltr. Rul. 8220119, Feb. 22, 1982.}
\footnotetext{35}{Ltr. Rul. 8334022, May 20, 1983.}
\footnotetext{36}{Ltr. Rul. 8314007, Dec. 17, 1982.}
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