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subject: Taking Stock as Collateral for the Special Estate Tax Lien Under Section 6324A

This memorandum responds to your questions regarding the Service's acceptance of stock as collateral for the lien under Internal Revenue Code section 6324A. Before addressing the issues, the memorandum discusses the statutory provisions of sections 6166 and 6324A, as well as the pertinent legislative history. Although most of the discussion in this memorandum focuses on stock in a closely held corporation, the principles are equally applicable to interests in a limited liability company and/or a partnership. This advice may not be used or cited as precedent.

ISSUES

1. Whether, and under what circumstances, stock in a closely held corporation meets the requirements of section 6324A as property which may be pledged in support of the election by the estate under section 6166(k)(2), and related Treas.Regs. §§ 20.6324A-1 and 301.6324A-1?

2. What criteria should the Service use in making a determination of adequacy as related to section 6324A(b)(1)(A)?

3. What requirements may the Service impose on an estate which has pledged stock as collateral in order to determine whether there has been a disposition of interest or withdrawal of funds from the business that would trigger the acceleration of payment under section 6166(g)(1)?

4. In what manner should the Service secure its interest in the stock pledged as collateral?

5. The recording of the section 6324A lien divests the section 6324(a) lien only with respect to the property designated in the section 6324A lien agreement. Are there steps which the Service could and should take to protect its interest in the remainder of the property of the gross estate?

6. Whether, given the complexities involved, full audits should be required of all estate tax returns when estates propose using closely held stock as security under section 6324A?

7. What is the proper procedure that must be followed in determining whether the stock or closely-held entity interest proffered by taxpayer adequately secures the government interest for deferral of payment?

8. What is the proper procedure for denying or terminating a section 6166 election when the Service has determined that the property initially proffered as collateral is insufficient?

9. May, and should, the Service review the continuing sufficiency of collateral securing a section 6324A lien agreement that is already in place and where payment is being made during the section 6166 deferral period? If yes, is the procedure for determining continuing sufficiency or terminating the section 6166 election and accelerating tax due the same as the procedure in Issue 8?

BACKGROUND

In 1976 Congress redesignated section 6166 as section 6166A [1]/ and created new sections 6166 and 6324A to provide relief from estate taxes to estates of decedents whose assets consisted primarily of a closely held family business. Congress was aware that estates consisting primarily of a closely held business did not have the cash needed to pay the estate taxes that became due shortly after the decedent's death. These estates had liquidity problems because a substantial portion of the assets of these estates consisted of an interest in the closely held business or other illiquid assets. The executor was often forced to sell a decedent's interest in the closely held business in order to pay the estate tax. The sale would create financial turmoil for the business. Without the sale, however, it could take several years for these closely held businesses to regain their financial strength to generate enough cash to pay estate taxes after the loss of one of its principal owners. Congress wanted to reduce the harshness of the existing system that required estates with closely held businesses to sell the business interests or assets in order to pay the estate tax.

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[1] / Congress repealed section 6166A in 1981.

Congress modified the law so that certain estates with closely held businesses would have an opportunity to take advantage of the extended payment provisions under section 6166 to pay their taxes. [2]/ Generally speaking, an estate tax return is due nine months after the decedent's death and payment of the estate tax is required to be made with the return. Under section 6166, an executor may elect to defer the payment of the taxes for five years and pay the balance of interest and tax due in installments over a period of ten years where the estate consists largely of interest in a closely held business.

Prior to 1976, estates with closely held businesses did not always take advantage of the installment payment method promulgated by section 6166 because estates making the section 6166 election may be required to provide a bond pursuant to section 6165. The executor found it financially difficult to obtain a bond to satisfy this requirement. Alternatively, if the executor did not get a bond, the executor remained personally liable for the tax for the entire length of the deferral period, which was an unfavorable alternative for most executors, particularly if the executor was not a beneficiary or heir. I.R.C. § 2204. As a result, many executors did not make the section 6166 election even though the estate met the statutory requirements for the deferral of the estate tax. Consequently in 1976, Congress enacted section 6324A to make it easier for the estates with closely held businesses to make an election under section 6166. In lieu of a bond, section 6324A allows the executor to grant the Service a special lien by providing collateral as security for payment of the deferred taxes under section 6166. If the special lien is provided, the executor is no longer personally liable for the deferred tax under section 2204. The special estate tax lien under section 6324A is in lieu of the general estate tax lien of section 6324.

Although the executor may make an election to provide collateral to secure the payment of the deferred taxes, the special section 6324A tax lien comes into existence only after three statutory requirements are met. First, the collateral must be expected to survive the deferral period. I.R.C. § 6324A(b)(1)(A). Second, the collateral must be identified in the agreement. I.R.C. § 6324A(b)(1)(B). Third, the value of the collateral must be sufficient to pay the estate tax liability plus the aggregate amount of interest payable over the first four years of the deferral period. I.R.C. § 6324A(b)(2). The Service determines whether such provisions have been met.

Congress recognized that the value of the collateral offered by the estate might decline over the deferral period. Consequently, Congress allowed the Service to demand

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[2] / Section 6166(a) provides that if the value of an interest in a closely held business which is included in determining the gross estate of a decedent 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 2 to 10 installments. The tax that may be deferred is the tax that is attributable to the interests in a closely held business. Section 6166(b)(1)(C) states that such interest may be stock in a corporation carrying a trade of business.

additional collateral in such situations. I.R.C. § 6324A(d)(5). The estate's failure to provide additional collateral would permit the Service to accelerate payment of the full liability. Id. Implicitly, Congress placed the burden of monitoring the value of the collateral on the Service.

ANALYSIS

> Issue 1. Whether, and under what circumstances, stock in a closely held corporation meets the requirements of section 6324A as property which may be pledged in support of the election by the estate under section 6166(k)(2), and related Treas. Regs. §§ 20.6324A-1 and 301.6324A-1?

Section 6324A(c)(1)(A) provides that the collateral offered to secure the lien may be an interest in "real and other property." Stock in a closely held corporation qualifies as "other property." Although stock in a closely held corporation may be offered as collateral to secure the section 6324A lien, the Service may accept the stock only when the three statutory requirements in section 6324A(b)(1) and (2) are met.

First, the stock in a closely held corporation must be expected to survive the deferral period. This means that the corporation must survive the deferral period and retain value. To determine whether a corporation will survive the deferral period, the Service should first value the business, i.e., the closely held corporation, based on the relevant financial information provided by the estate. It is incumbent upon the estate to provide the Service with all relevant financial information, including appraisals, annual reports, and any other relevant financial document, in order for the Service to adequately value the closely held business. IRM § 4.48.4. provides guidelines for valuing a business. Professional judgment should be used to select the best valuation method. Using the results from its valuation, the Service must then judge whether the business can be expected to survive the deferral period. There is a risk that the Service may err in its conclusion, but Congress intended that the Service bear such a risk. Comm. On Ways and Means, 94th Cong., Background Materials on Federal Estate and Gift Taxation 302, (Comm. Print 1969) ("[t]he Government will not only permit the deferral of taxes, but will bear part of the risk that the illiquid asset may decline in value during the deferral period"). If Congress had intended that the Service be assured payment, Congress would have required that a bond be provided to the Service for deferred estate taxes.

Second, the stock in the closely held corporation must be identified in the written agreement described under section 6324A(b)(1)(B). Specifically, the executor must file a written agreement showing that all of the persons having an interest in the collateral, agree to the creation of the special lien.[3] I.R.C. § 6324A(c)(1). The agreement must be binding on all parties that have any interest on the collateral. Id. Further details concerning the specific requirements of the written agreement can be found in Treas. Reg. § 301.6324A-1(b).

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[3] Note that the Service is not a party to this agreement.

Third, the value of the stock as of the agreement date must be sufficient to pay the deferred taxes plus the required interest. Revenue Ruling 59-60, 1959-1 C.B. 237 provides guidance as to the valuation of stock of closely held corporations. Specifically, the valuation of stock of closely held corporations will require consideration of all available financial data that is provided by the estate, as well as all relevant factors affecting the fair market value. Because a determination of the fair market value depends upon the circumstances in each case, a general formula will not exist for the many different valuation situations arising in the valuation of such stock.

If the three requirements under section 6324A are met, the section 6324A special lien arises and the collateral must be accepted by the Service. The Service does not have the authority to reject collateral proffered by the estate on the grounds that it would be burdensome for the Service to make the economic or business calculations to determine the value. Nor does the Service have the authority to reject collateral proffered by the estate because the Service would prefer other collateral. Congress gave the Service a very limited role in the creation of the section 6324A special lien: the Service determines whether the statutory requirements have been met.

Even when the statutory requirements under section 6324A have been met, we understand that some Service employees would prefer not to take stock as collateral because of the risks: some of the concern stems from the fact that the stock may become worthless. For example, if the closely held business were to sell or transfer its assets and distribute all of the funds, the stock would have little value. In another instance, the business could encumber its assets and thereby reduce the value of the stock. The company could also become bankrupt or close down the business causing the stock to have no value. Furthermore, there is concern that the stock may become worthless due to bad management decisions, economic downturns, or shareholder/management chicanery.

These concerns, as well as others are legitimate. Taking stock as collateral is a risky endeavor. Nevertheless, section 6324A and its legislative history, illustrate that Congress was aware of that risk. By enacting section 6324A(d)(5), and giving the Service the authority to demand additional collateral when the initial collateral declines in value, Congress chose to reduce, rather than eliminate the risks to the Service.

> Issue 2. What criteria should the Service use in determining the adequacy [of stock] as related to section 6324A(b)(1)(A)?

Under section 6324A(b)(1)(A) the Service must determine whether the collateral can be expected to survive the deferral period. In making this determination, the Service may use any generally accepted business criteria. IRM 4.48.4.2.3 and Rev. Rul. 59-60 identify factors to be used in making the determination.

The viability and net worth of the company is reflected in the value of the stock. Whether a stock will retain its value is a factor to be considered in determining whether the company will survive the deferral period.[4]/ The Service should not assume that a stock's failure to retain its value automatically means that a company will not survive the deferral period. Indeed, stock accepted as collateral may decrease in value, requiring the Service to request additional collateral under section 6324A(d)(5).

> Issue 3. What requirements may the Service impose on an estate which has pledged stock as collateral in order to determine whether there has been a disposition of interest or withdrawal of funds from the business that would trigger the acceleration of payment under section 6166(g)(1)?

The Service has statutory rights under section 6324A to determine whether there has been a disposition of interest or withdrawal of funds from the business that would trigger the acceleration of payment under section 6166(g)(1). These rights include requiring all relevant financial information from the estate to continue to monitor the value of the accepted stock as collateral during the deferral period. I.R.C. § 6324A(d)(5). Specifically, the Service could require the estate to provide annual reports or certified financial statements on or before April 15 of each year during the term of the deferral period. If the estate refuses the Service's request for information, the estate runs the risk that the Service may determine that additional collateral is required pursuant section 6324A(d)(5). If the estate refuses to provide additional collateral, the Service may declare an acceleration of all deferred payments under section 6166(g). This may be extremely burdensome to the estate, but it is a result that the estate may have prevented by timely complying with the Service's request for information.

> Issue 4 In what manner should the Service secure its interest in the stock pledged as collateral?

Section 6324A(d)(1) provides that the special estate tax lien "shall not be valid as against any purchaser, holder of a security interest, mechanic's lien, or judgment lien creditor until notice thereof which meets the requirements of section 6323(f) has been filled by the Secretary." Thus, as a first step, the Service should file a Notice of Federal Tax Lien (NFTL), Form 668-J, for the special estate tax lien on the stock. I.R.C. § 6324A(d)(1). The lien arises at the time the executor is discharged from personal liability under section 2204 and continues until the liability for the deferred amount is satisfied or becomes unenforceable by reason of lapse of time. I.R.C. § 6324A(d)(2).

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[4]/For example, a company may have pledged a block of stock to a bank for a loan with the caveat that, if the value of the stock decreased below a certain point, the bank could accelerate the loan and seize all of the company's property. In this situation, there would be a strong link between the value of the stock and the continued viability of the company.

Section 6323(f) states that a NFTL relating to interests in personal or real property must be filed in the office mandated by applicable state law. Stock, in most instances, will be considered personal property by most state law. With respect to personal property, whether tangible or intangible, a NFTL must be filed in the office designated by state law in which the property subject to the lien is situated. I.R.C. §6323(f)(1)(A)(ii). Personal property, whether tangible or intangible, is situated at the residence of the taxpayer at the time the NFTL is filed. I.R.C. § 6323(f)(2). Since the taxpayer in this case is an estate, applicable state law will determine where the NFTL will be filed.

In addition, if stock certificates exist, we recommend that the Service request that the certificates be given to the Service. This would prevent the sale of such certificates to third parties. If the Service fails to obtain possession of the certificates, there is the possibility that third parties may purchase such certificates, incorrectly believing that they have a superpriority in the certificates under section 6323(b)(1)(A). [5]/ At first blush, this assumption seems reasonable. Congress enacted section 6323(b)(1)(A) to allow securities be traded freely on the open markets without purchasers carrying the burden of searching the public record to find previously filed NFTLs. Congress, however, limited the scope of the section 6323(b) superpriorities as against the section 6324A special lien. In section 6324A(d)(3), Congress provided that only three of the superpriorities listed in section 6324(b) would qualify as a superpriority against the special estate tax liens. [6]/ Congress did not provide a superpriority for purchasers of a stock encumbered with the section 6324A special estate tax lien. Accordingly, Congress must have intended that, after the Service filed a NFTL, purchasers of such stock took it encumbered with the special estate tax lien. Nonetheless, to avoid potential litigation is this area, we recommend that the Service request the actual stock certificates.

> Issue 5. The recording of the section 6324A lien divests the 6324(a) lien only with respect to the property designated in the section 6324A lien agreement, are there other steps which the Service may and should take to protect its interest in the remainder of the property of the gross estate?

In answering this question, it is necessary to provide a brief discussion on the three types of tax liens that are generally applicable to the property of a gross estate. The first is the general estate tax lien under section 6324(a), which attaches to all the assets of the gross estate. Unlike a general tax lien which arises under section 6321 when a person liable to pay taxes refuses or neglects to do so after demand, a special estate tax lien under section 6324 attaches at the time of decedent's death before the tax is

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[5]/ Section 6323(b)(1)(A) provides that a previously filed NFTL shall not be valid “as against a purchaser of such security who at the time of the purchase did not have actual notice or knowledge of the existence of such [federal tax] lien.”

[6]/ Section 6324A(d)(3) provides a superpriority for real property tax and special assessment liens, mechanic’s liens for improvements to real property, and real property construction or improvement financing.

determined. See Detroit Bank v. United States, 317 U.S. 329 (1943). The general estate tax lien expires 10 years from the date of death; it cannot be extended. See I.R.C. § 6324(a). In other words, the 10-year period provided for in section 6324(a) is a period of absolute duration and is not a period of limitation that can be tolled merely by the filing of a suit to foreclose the lien. See United States v. Davis, 52 F.3d 781 (8th Cir. 1995) (governments appeal dismissed since it was filed more than 10 years after death).

The second type of tax lien is the section 6324A special estate tax lien on designated collateral. Under section 6324A(d)(4), if a section 6324A lien is placed on the property, then such property is no longer subject to the section 6324(a) general estate tax lien. Section 6324(d)(1) requires that the Service file a NFTL for the special estate tax lien to have priority over a purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor. The section 6324A special estate tax lien arises at the time the executor is discharged from personal liability under section 2204 and continues until the liability for the deferred amount is satisfied or becomes unenforceable by reason of lapse of time. I.R.C. § 6324A(d)(2). Note the gap in coverage between the 10-year general estate tax lien and the section 6324A special estate tax lien.

The third type of lien is the general tax lien arising under section 6321. This lien arises after the estate taxes become due, and then only following assessment, demand, and refusal or neglect to pay. Until the Service files a NFTL for this lien, it would not have priority over a purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor. Accordingly, to protect its interest in the remainder assets of the gross estate more than 10 years after decedent's death, the Service could file a NFTL under section 6321, assuming proper procedures for assessment, demand, and refusal or neglect to pay have been met. Whether the Service should file a NFTL in a particular situation is a business decision to be made by the Service.

> Issue 6 Whether, given the complexities involved, full audits should be required of all estate tax returns when estates propose using closely held stock as security under section § 6324A?

There is no a legal requirement to conduct full audits in such cases. Whether to conduct full audits is a business decision to be made by the Service.

> Issue 7 What is the proper procedure that must be followed in determining whether the stock or closely-held entity interest proffered by taxpayer adequately secures the government interest for deferral of payment?

As discussed in Issue 1, section 6324A provides three statutory requirements to determine the adequacy of the stock or closely-held entity interest proffered by the estate. Initially, the stock or closely held entity interest must be expected to survive the deferral period. I.R.C. § 6324A(b)(1)(A). Secondly, the collateral must be identified in

the agreement. I.R.C. § 6324A(b)(1)(B). And finally, the value of the stock or the closely held entity interest must be sufficient to pay the estate tax liability plus the required interest. I.R.C. § 6324A(b)(2). We interpret these statutory provisions to require an evaluation of the collateral based on the relevant financial information provided by the estate.

Section 6324A does not, however, discuss the proper procedure to follow to make this adequacy determination. The determination of the appropriate procedure to follow is a business decision to be decided by the Service. Notwithstanding, the Service should value the closely held business based on the relevant financial information provided by the estate. IRM § 4.48.4 provides detailed guidelines for valuing a business. Likewise, the Service should value the stock or the entity interest based on the information provided by the estate. Revenue Ruling 59-60, 1959-1 C.B. 237, provides guidance as to the valuation of stock or the entity interest.[7] In addition, the evaluation should also consider all other relevant facts and circumstances of each particular case.

If the Service ultimately decides to reject the stock or the entity interest proffered as collateral, the Service should detail, in writing, the basis for the rejection.

> Issue 8 What is the proper procedure for denying or terminating a section 6166 election when the Service has determined that the property initially proffered as collateral is insufficient?

If the executor of an estate makes an election under section 6166(a) on the estate's Form 706 to extend payment of part or all of the portion of the estate tax which is attributable to a closely held business interest (as defined in section 6166(b)(1), the Service may require that the estate provide a surety bond as security for payment of such taxes under section 6165. I.R.C. §§ 6166(k)(1) and 6165. In lieu of the bond, the executor may elect to provide a lien under section 6324A (Section 6166 Lien). I.R.C. §§ 6166(k)(2) and 6324A(a), 6324A(d)(6). If the value of the property provided to secure the Section 6166 Lien is less than the unpaid portion of the deferred amount and required interest (either when initially offered or some time in the future), the Service may require that the estate provide additional security either in the form of assets to secure the Section 6166 Lien or a surety bond. If within 90 days after notice and demand the estate does not provide the additional security requested, the estate's refusal will be treated as an act accelerating payment of the installments under section 6166(g). I.R.C. §6324A(d)(5).

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[7] Although Revenue Ruling 59-60, 1959-1 C.B. 237, specifically sets forth the proper approach to use in the valuation of closely-held corporate stocks, the general approach, methods, and factors discussed here, are equally applicable to determining the fair market value of business interests of any type. Rev. Rul. 68-609, 1968-2 C.B. 327.

When the Service accelerates the payments of estate tax under section 6166(g), the acceleration is treated as a termination of the section 6166 election. Prior to 1997, estates could only challenge a termination or adverse determination by the Service with respect to section 6166 election by paying the estate tax in full and suing for a refund in either District Court or the Court of Federal Claims. See Smith v. Booth, 823 F.2d 94 (5th Cir. 1987) (district court lacked jurisdiction to issue declaratory judgment as to entitlement to section 6166 election); Rocovich v. U.S., 933 F.2d 991 (Fed. Cir. 1991) (estate could not challenge increased deficiency and/or denial of section 6166 election without full paying liability and interest); Abruzzo v. United States, 24 Cl. Ct. 668 (1991) (under "full payment" rule, jurisdiction was lacking over estate tax refund suit where all installments of deferred estate tax had not been paid). In 1997, however, Congress enacted section 7479, which provides the Tax Court with declaratory judgment jurisdiction with respect to section 6166. Section 7479 provides that in the case of actual controversy involving a determination by the Secretary of (or a failure by the Secretary to make a determination with respect to) "whether an election may be made under section 6166," or "whether the extension of time for payment of tax provided in section 6166(a) has ceased to apply" with respect to an estate, the Tax Court may make a declaration whether such election may be made or whether such extension has ceased to apply. I.R.C. §7479(a). In order to seek relief in the Tax Court, the executor or representative of the estate must file a timely petition and must exhaust administrative remedies, as defined in paragraph 7479(b)(2) and Rev. Proc. 2005-33, §4.01, 2005-24 I.R.B. 1231. I.R.C. §7479(b).

With the enactment of section 7479, the Service created procedures to ensure executors or persons authorized to file on behalf of the estate were aware of their right to petition Tax Court for a declaratory judgment and exhausted administrative remedies prior to petitioning. See Rev. Proc. 2005-33, 2005-24 I.R.B. 1231. When the Service terminates a section 6166 election because the Service is unsecured for a portion of the tax and the executor or a representative of the estate refuses to provide additional security (e.g. because the executor has determined that the property is worth more than the Service believes it is worth), the Service will issue a preliminary determination letter, such as Letter 950, which contains a notice of Appeal rights. Rev. Proc. 2005-33, §4.01(1), 2005-24 I.R.B. 1231. The executor or representative must then request an Appeals conference to exhaust administrative remedies prior to petitioning Tax Court. Id at §4.01(2). If after the Appeals conference the Service still believes the section 6166 election should be terminated, it will issue a final determination letter, such as Letter 3570, which alerts executors or representatives of the estate to their right to petition the Tax Court for a declaratory judgment with respect to whether the estate's section 6166 election has ceased to apply. Id at §4.01(2)(c). Upon issuance of a final determination letter by the Service, the executor or estate's representative may petition Tax Court for a declaratory judgment under section 7479. Id at §3.05.

Issue 9 May, and should, the Service review the continuing sufficiency of collateral securing a 6324A lien agreement that is already in place and where payment is being made during the 6166 deferral period? If yes, is the procedure for determining continuing sufficiency or terminating the 6166 election and accelerating tax due the same as the procedure in Issue 8?

Section 6324A(d)(5) permits the Service to review the continuing sufficiency of collateral securing a 6324A lien agreement. Specifically, the Service has the implicit right to monitor the value of the collateral to determine whether the value has become less than the amount of the unpaid portion of the deferred amount and the required interest amount. I.R.C. § 6324A(d)(5). If the value of the collateral is less, the Service is permitted to ask for additional collateral from the estate. Id. If the estate refuses to provide additional collateral upon notice and demand pursuant to the provisions of section 6324A(d)(5), the Service may declare an acceleration of all deferred payments under section 6166(g). Id. The procedure for acceleration of all deferred payments or termination of the 6166 election under these circumstances is the same as the process described under Issue 8.

The decision of whether to monitor and the procedure for monitoring the sufficiency of collateral is a business decision to be determined by the Service. Nevertheless, we strongly recommend that the Service monitor the sufficiency of the collateral securing a 6324A tax lien agreement during the deferral period. For example, the Service could require the estate to provide annual reports or certified financial statements on or before April 15 of each year during the term of the deferral period. This information would assist the Service to determine whether the stock has maintained its value or whether it should request additional collateral because the value has decreased.

If you have questions regarding the foregoing, please contact Najah J. Shariff at (202) 622-7284 if you have any further questions. We look forward to assisting you in any matters arising from the conclusions.