

¬state planning lawyers and ■posed federal budget for the 2010 fiscal year allocates \$5.5 billion toward the enforcement of federal tax laws, representing a \$400 million increase in the amount allocated for the same purpose in 2009 and a \$737 million increase in the amount allocated for the same purpose in 2008. The increased enforcement actions by the IRS during the 2010 federal fiscal year are being targeted, at least in part, toward the examination of estates of deceased high net worth individuals in an effort to increase tax revenues and ensure that federal estate tax laws are being followed.

Unfortunately, the IRS will bring these enforcement actions in difficult economic times. The federal estate tax is based on a "snapshot" of the values of the assets owned by a decedent as of his or her date of death. The IRS generally may audit an estate up to three years after an executor files the federal estate tax return on behalf of the estate. It is inevitable that in 2010 the IRS will audit the estates of those decedents who died during 2006 and 2007 and whose estate tax returns were filed in 2007 and 2008. The values of these estates as of the decedents' respective dates of death are likely to be higher than their values at the time of audit, given that the "snapshot" of the values of the assets within these estates was taken at or around the height of the most recent economic boom. Given that many of the estates that will be subject to audit by the IRS will contain assets that have substantially decreased in value since the death of the decedent, many estates will find it difficult (if not impossible) to immediately pay any deficiency in the federal estate tax assessed by the IRS in an audit performed in 2010.

Fortunately, the Internal Revenue Code (IRC) anticipates that an estate may have difficulty paying an assessed deficiency and contains a mechanism that provides a potential solution to

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this problem. IRC § 6161(b)(2) provides that the IRS may, for reasonable cause, extend the time for the payment of any deficiency of federal estate tax for a reasonable period not to exceed four years from the payment due date of the deficiency. Although this statute is buried in the provisions of the IRC that address the administration and procedure of tax law, a working knowledge of this statute can have positive implications for tax practitioners and their clients whose central concern is the bottom line of an estate audit. The potential extension of payments under IRC § 6161(b)(2) certainly can make the results of an estate audit more palatable during difficult economic circumstances.

A Discussion of the Text of IRC § 6161(b)(2) and Accompanying Regulations

IRC § 6161(b)(2) is a straightforward section of the Internal Revenue Code, which states that "[u]nder regulations prescribed by the Secretary [of the Treasury], the Secretary may, for reasonable cause, extend the time for the payment of any deficiency of [an estate] tax . . . for a reasonable period not to exceed 4 years from the date otherwise fixed for the payment of the deficiency." An estate requesting an extension under IRC § 6161(b)(2) should do so by filing Form 4768 with the IRS; Part III of this form provides an estate the opportunity to explain why the IRS should grant an extension of time to pay the tax deficiency.

The Meaning of "Reasonable Cause"

To the authors' knowledge, no regulations or published cases discuss the "reasonable cause" standard set forth in IRC § 6161(b)(2). The meaning of this standard, however, is illuminated by 26 C.F.R. § 20.6161-1. This regulation relates to IRC § 6161(a), the statutory section of the IRC that addresses potential extensions of the payment of federal estate taxes that are set forth by an executor on an estate tax return (rather than taxes that are assessed by the IRS in an audit). Although 26 C.F.R. § 20.6161-1 does not state that it applies to IRC § 6161(b)(2), this regulation

provides persuasive authority in that it addresses a standard of law used elsewhere in IRC § 6161. The regulation provides the following examples of scenarios that can give rise to a finding of "reasonable cause" under certain provisions of IRC § 6161:

- an estate with sufficiently liquid assets to pay the estate tax, but these assets are located across several jurisdictions and are not immediately subject to the executor's control;
- an estate substantially comprising assets that consist of rights to receive future payments, and such assets cannot be borrowed against except on terms that would inflict loss on the estate;
- an estate that includes a claim to substantial assets that cannot be collected without litigation, rendering the gross estate unascertainable as of the time the tax is due; and
- an estate that does not have sufficient funds (without borrowing funds at a rate of interest higher than that generally available) with which to pay the entire estate tax when otherwise due, providing for a reasonable allowance for the decedent's dependents and to satisfy claims against the estate that are due and payable, and the executor has made a reasonable effort to convert assets in his possession into cash.

An examination of the history of IRC § 6161 also illuminates the meaning of "reasonable cause" as used in the statute. The "reasonable cause" standard used under IRC § 6161(b)(2) contrasts with the previous statutory standard of "undue hardship." This former standard of "undue hardship," as it was used in the former version of IRC § 6161(b)(2), was replaced by the legislative changes made in the Tax Reform Act of 1976. The "undue hardship" standard, however, continues to be used under IRC § 6161(b)(1) as the standard for extension requests for deficiencies of income and gift taxes, and, as such, 26 C.F.R. § 20.6161-1 includes

a discussion of the meaning of "undue hardship." The discussion of "undue hardship" in 26 C.F.R. § 20.6161-1 provides context in the examination of the examples given to illustrate the meaning of "reasonable cause," thereby assisting practitioners in ascertaining the meaning of the latter of these standards.

Based on 26 C.F.R. § 20.6161-1, undue hardship means "more than an inconvenience" to the taxpayer and requires more than a general statement of hardship or a mere demonstration of reasonable cause. Based on the examples used in this regulation, a sale of property at a price equal to its current fair market value, when a market exists, does not ordinarily result in an undue hardship to the taxpayer. But 26 C.F.R. § 20.6161-1 does indicate that an extension of time should be granted based on undue hardship if the assets in the gross estate that must be liquidated to pay the tax can be sold only at a sacrifice price or in a depressed market. Given that (1) selling assets in a depressed market to pay an estate tax deficiency appears to meet the "undue hardship" standard (based on the examples set forth in 26 C.F.R. § 20.6161-1) and (2) the "undue hardship" standard requires something more than "reasonable cause," then an estate that will have to sell assets that have lost value in a depressed market to pay a tax deficiency may be able to demonstrate reasonable cause for the purposes of obtaining an extension under IRC § 6161(b)(2).

Other Limitations

A potential extension of time under IRC § 6161(b) is not without other limitations. Regardless of whether reasonable cause for an extension under IRC § 6161(b)(2) exists, IRC § 6161(b)(3) prohibits an extension if the deficiency is because of negligence, intentional disregard of rules and regulations, or fraud with the intent to evade tax. Tax practitioners and clients who wish to potentially employ an extension available under IRC § 6161(b), therefore, must analyze the positions taken by an estate when filing the estate tax return and during any subsequent audit to ensure that such positions are being

made carefully and with an effort to minimize the risk that any assessed deficiency is because of negligence, fraud, or the intentional disregard of rules and regulations.

Built-in Protections for the IRS

The IRC includes other statutes designed to protect the IRS in the event that an extension under IRC § 6161 is granted to an estate. IRC § 6165 authorizes the IRS to condition granting an IRC § 6161 extension on receiving a bond from an estate. Section 301.7101-1 of 26 C.F.R. sets forth a non-exhaustive list of the forms of bonds that can be provided by an estate in exchange for



an extension under IRC § 6161. This list of permissible bonds includes the grant of a security interest in various types of estate property (such as real estate, personal property, stocks, and bonds) and having a company or individual agree to serve as a surety. The amount of this bond, however, may not exceed twice the amount of the deficiency for which the extension is being granted.

In addition to providing the IRS the right to demand a bond in return for an extension, the IRC also preserves the right of the IRS to bring a collection action against an estate throughout the term of an extension. IRC § 6503(d) suspends the statute of limitations for the collection of estate tax for the term of an extension granted under IRC § 6161, thereby allowing the IRS to bring a timely action against an estate in the event that a deficiency is not paid in accordance with the terms of an extension.

The Costs and Benefits of Employing IRC § 6161(b)(2)

The most obvious benefit of employing an extension available under IRC § 6161(b)(2) is providing an estate additional time to pay an assessed

deficiency (and in the current economic climate, providing the assets of an estate the opportunity to recover some or all of their date of death values). The IRS, however, requires that an estate pay interest to the IRS throughout the term of an extension obtained under IRC \S 6161(b)(2); the interest rate is a variable rate established in IRC § 6621 and is defined as the federal short-term rate (established on a quarterly basis by the Secretary of the Treasury) plus three percentage points. Fortunately, any interest paid by an estate under an extension granted under IRC § 6161(b)(2) may be tax deductible as an administrative expense under IRC § 2053, potentially resulting in a reduced effective interest rate. In addition, the ongoing administrative and legal fees involved in monitoring such an extension also are likely to be tax deductible under IRC § 2053. If these expenses are incurred, ongoing deductions may be taken throughout the term of the extension, resulting in tax refunds being due to an estate on the filing of amended estate tax returns claiming the additional deductions.

Conclusion

IRC § 6161(b)(2) can be an extremely useful tool for an executor of an estate, particularly if the date of death values of the assets owned by a decedent are substantially greater than the asset values as of the time of an audit and the asset values are projected to increase over the four-year period immediately following the audit. The required showing of "reasonable cause" of why an extension should be granted appears to be relatively minimal, given the examples and language set forth in the regulations related to IRC § 6161. Finally, although such an extension will result in an estate paying interest on an assessed deficiency, any interest paid by an estate (as well as the expenses of monitoring the extension) may be deductible as an administrative expense under IRC § 2053, resulting in a reduced effective interest rate that will be paid by the estate. The obtainable extensions and corresponding low net carrying costs available under IRC § 6161(b)(2) result in this provision of the tax code being a useful tool in difficult economic times.