

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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date: October 11, 2007
to: Mary P. Hamilton
Senior Attorney (Boston)
(Small Business/Self Employed)

from: Pamela Fuller
Branch Chief, Branch 3
(Procedure & Administration)

subject: Under what circumstances, if any, is the Internal Revenue Service required to accept collateral offered by taxpayer under I.R.C. § 6324A

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

X	=
Estate	=
Interest	=
LLC	=
City A	=
State A	=
City B	=
City C	=
State B	=
YR1	=
YR6	=
YR7	=
YR9	=
YR10	=
\$a	=
\$b	=

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\$c =
 \$d =
 \$e =
 \$f =
 \$g =
 State A cite =
 State B cite =
 Executors =
 Lawyer =
 Law-Firm =

ISSUES

1. Whether the Internal Revenue Service (“Service”) should accept as collateral for the tax deferred pursuant to an I.R.C. § 6166 election, the taxpayer’s Interest in the LLC, a State A limited liability company.
2. Assuming the Service accepts the Interest in the LLC as collateral, whether the Service should enter into the Pledge and Escrow Agreement (Agreement) proposed by the taxpayer, under which the taxpayer’s attorney would hold the Interest in the LLC in escrow subject to the I.R.C. § 6166 lien. If the Agreement proposed by the taxpayer is inadequate to protect the Service’s interest, what Agreement would be appropriate.
3. What steps should be taken to perfect the Service’s security interest in the Interest in the LLC.

CONCLUSIONS

1. If the three statutory requirements under I.R.C. § 6324A have been met, the I.R.C. § 6324A special lien arises and the Interest in the LLC must be accepted by the Service.
2. I.R.C. § 6324A(c) requires a written agreement protecting the Service’s interest in the collateral securing the I.R.C. § 6324A special lien. The Code, however, does not call for the Service to enter into any additional agreements, nor does it preclude it. Whether to enter into a Pledge or Escrow Agreement in addition to the required I.R.C. § 6324A(c) written agreement is a matter to be determined by the facts and circumstances of each particular case.
3. The Service should file a NFTL for the I.R.C. § 6324A special estate tax lien in the Interest in the LLC with the office of the U.S. District Court in City B, State B. I.R.C. § 6324A(d)(1).

FACTS

The facts you have provided are as follows: X, a resident of City C, State B, died on April 25, YR 6. At the time of his death, X owned an Interest in the LLC. The LLC was organized in YR1 as a limited liability company under the laws of State A. The LLC is the owner of 75% of the real property comprising a retail shopping center located in City

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A, State A. An appraisal dated January 31, YR7 obtained by the decedent's Estate valued the LLC at \$a as of the date of decedent's death. At the time of decedent's death, the LLC was treated as a partnership with 15 or fewer members for federal tax purposes and, as such, is considered a closely held business within the meaning of I.R.C. § 6166(b).

The estate tax return of the Estate reflects a gross estate in the amount of \$b. The value of decedent's Interest in the LLC as reported on schedule f of the estate tax return is \$c as of the date of decedent's death on April 25, YR6. The value of the Interest in the LLC is based on an appraisal obtained by the Estate.¹ The Service has reviewed this appraisal and has also done its own separate analysis. Based on this fact, the Service does not object to the appraisal of the Interest in the LLC in the amount of \$c. The Estate meets the qualifications to make the election under I.R.C. § 6166² to request to pay the federal estate tax attributable to the business interests in installment payments. The Estate timely requested to defer the payments of the estate tax attributable to the business interest in the amount of \$f (which includes accrued statutory additions in the amount of \$g as of May YR10) in ten equal annual installments.

The Executors of the Estate have drafted a written agreement as required under I.R.C. § 6324A(c) consenting to the creation of the special estate tax lien. In lieu of the bond required by I.R.C. § 6165, the Executors have consented to the placement of a 15-year estate tax lien under I.R.C. § 6324A on the Interest in the LLC to secure the payment of the deferred taxes. The Executors are all of the parties who currently have an interest in the Interest in the LLC. The Interest in the LLC has no encumbrances. The Executors, who all reside in State B, have also designated Lawyer of Law-Firm to act as agent for the beneficiaries of the Estate in all dealings with the Service under I.R.C. §§ 6166 or 6324A.

In addition to the I.R.C. § 6324A(c) written agreement described above, the Estate has submitted a proposed Pledge and Escrow Agreement. The basic terms of the Pledge and Escrow Agreement are described below. The parties to the agreement are the Executors and the Service. The recitals to the agreement include the following: (1) decedent owned an Interest in the LLC at the time of his death; (2) the membership interest is "not registered and readily saleable on the open market and which constitutes an interest in a closely held business as defined by Section 6166..." and (3) the Estate and the Service have agreed that the Estate shall pledge the membership interest held

¹ The net value of decedent's interest was \$d. The appraiser applied a 40% discount for "Lack of Control, Marketability & Illiquidity" to arrive at a value of \$e, rounded to \$c.

² I.R.C. § 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 I.R.C. § 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. I.R.C. § 6166(b)(1)(C) states that such interest may be stock in a corporation carrying on a trade of business.

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by the Estate “as and for collateral to secure the payment of the taxes deferred under section 6166.”

The agreements of the parties include the following: (1) the Estate will hold the Interest in the LLC subject to lien created under section 6166, and assigns its intent [sic] to Law-Firm as escrow agent; (2) the Estate will provide annual reports or certified financial statements to the Service on or before April 15 of each year during the term of the agreement; (3) the Estate may substitute other collateral of comparable value, but only with the approval and concurrence of the Service, and the Service may require the Estate to provide additional property if the escrow property decreases in value; (4) in the event of default, this agreement shall terminate upon written notice by the Service; the Service may declare the balance of the obligation due and owing and may undertake collection action; (5) the Estate will remain the owner of the Interest in the LLC and will be entitled to income from the LLC interest and to vote the interest; the Service will not exercise incidents of ownership except after default and delivery of the escrow property to the Service; and (6) the agreement will continue until all federal estate taxes, interest and assessments related thereto are paid in full. Upon termination of the agreement, if all taxes and other amounts are paid in full, and with the written agreement of the Service, the escrow agent shall release the membership interest to the Estate.

LAW AND ANALYSIS

1. Whether the Service should accept as collateral for the tax deferred pursuant to an I.R.C. § 6166 election, the taxpayer’s Interest in the LLC, a State A limited liability company.

Under I.R.C. § 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. I.R.C. § 6324A provides, in relevant part, that in the case of an election under I.R.C. § 6166, if the executor makes an election and files an agreement as described in I.R.C.

§ 6324A(c), the deferred amount, plus interest, penalties and accruals, shall be a lien in favor of the United States on the I.R.C. § 6166 property. A special tax lien is created by I.R.C. § 6324A in lieu of the general estate tax lien of I.R.C. § 6324, and in lieu of the bond required under I.R.C. § 6165. I.R.C. § 6324A(c)(1)(A) provides that the collateral offered to secure the lien may be an interest in “real and other property.” The Interest in the LLC qualifies as “other property.”

Although the Interest in the LLC may be offered as collateral to secure the I.R.C. § 6324A lien, the Service may accept the Interest in the LLC only when three statutory requirements in I.R.C. §§ 6324A(b)(1) and (2), 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). And third, the value of the collateral must be sufficient to pay the estate tax liability plus the aggregate amount

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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.

First, the Interest in the LLC must be expected to survive the deferral period. This means that the closely held business, namely the LLC, must survive the deferral period and retain value. To determine whether the LLC will survive the deferral period, the Service should first value the business, i.e., the LLC. IRM § 4.48.4. provides guidelines for valuing a business. After valuing the business, the Service must then judge whether the LLC 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”).

Second, the Interest in the LLC must be identified in the written agreement described under I.R.C. § 6324A(b)(1)(B). Specifically, the executor must file a written agreement showing that all of the persons having an interest in the collateral, i.e., the Interest in the LLC, 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).

Third, the value of the Interest in the LLC 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 the membership interest in a limited liability company.⁴ The valuation of the membership interest requires consideration of all available financial data, 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 does not exist.

If the three requirements under I.R.C. § 6324A are met, the I.R.C. § 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 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 I.R.C. § 6324A special lien: the Service determines whether the statutory requirements have been met. If the statutory requirements have been met, the special estate tax lien arises under the statute and the Service must accept the Interest in the LLC.

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

⁴ 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.

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In this case, the second requirement of I.R.C. § 6324A has been satisfied in that the Interest in the LLC is identified in the I.R.C. § 6324A(c) written agreement drafted by the Executors. With respect to the first and third statutory requirements, the facts are not as clear. The facts indicate that the Service has conducted an evaluation of the Interest in the LLC. However, the exact nature of the analysis by the Service is not detailed. Assuming that the Service's analysis involved a determination that the Interest in the LLC is expected to survive the deferral period and a determination that the value of the Interest in the LLC is sufficient to pay the deferred taxes plus the required interest, then the statutory requirements under I.R.C. § 6324A have been met and the special estate tax lien arises requiring the Service to accept the Interest in the LLC.

If, however, the Service's evaluation did not involve a determination of the first or third statutory requirement of I.R.C. § 6324A, the Service will need to make such a determination based on the guidelines described above. If the Service concludes that any of the requirements have not been met, the Service has the right to reject the Interest in the LLC as collateral.

2. Assuming the Service accepts the Interest in the LLC as collateral, whether the Service should enter into the Pledge and Escrow Agreement (Agreement) proposed by the taxpayer, under which the taxpayer's attorney would hold the Interest in the LLC in escrow subject to the I.R.C. § 6166 lien. If the Agreement proposed by the taxpayer is inadequate to protect the Service's interest, what Agreement would be appropriate.

I.R.C. § 6324A(c) requires a written agreement protecting the Service's interest in the collateral securing the I.R.C. § 6324A special lien. I.R.C. § 6324A(c) requires all persons having any interest in the collateral securing the I.R.C. § 6324A lien to sign a written agreement consenting to the creation of the special lien. According to I.R.C. § 6324A(c), the Service is not required to be a party to the written agreement. The written agreement must designate a responsible person who shall be the agent for the beneficiaries of the estate and the consenting parties to the lien for all dealings with the Service on matters arising under I.R.C. § 6166 or I.R.C. § 6324A. I.R.C. § 6324A(c)(2). In addition, the regulations require that the written agreement contain a clear description of the collateral subject to the lien, the amount of the lien, the fair market value of the collateral as of the date of decedent's death and date of election under I.R.C. § 6324A, any encumbrances to the collateral, the decedent's name and relevant taxpayer identification information. Treas. Reg. § 301.6324A-1(b). The written agreement is to be attached to the notice in which the I.R.C. § 6324A lien is elected. *Id.* Finally, the written agreement must be in a form that is binding on all of the interested parties. *Id.*

In this case, the Executors of the Estate have executed an I.R.C. § 6324A(c) lien agreement consenting to the creation of the special lien. In lieu of the bond required by I.R.C. § 6165, the Executors have consented to the placement of a 15-year estate tax

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lien under I.R.C. § 6324A on the Interest to secure the payment of the deferred taxes. The value of the Interest is described in the agreement as \$c as of the date of decedent's death, April 25, YR6. The Interest has no encumbrances. The I.R.C. § 6324A(c) lien agreement also states that the Executors are all of the parties who currently have an interest in the Interest in the LLC. We interpret this to mean that there are no other parties with an interest in the Interest in the LLC. Accordingly, no other persons, including the managers of the LLC, are required to sign the I.R.C. § 6324A(c) lien agreement. The Executors have also designated Lawyer of Law-Firm to act as agent for the beneficiaries of the Estate in all dealings with the Service under I.R.C. §§ 6166 or 6324A. The I.R.C. § 6324A(c) lien agreement appears to comply with the statutory requirements under I.R.C. § 6324A and to protect the Service's interest in the collateral securing the special tax lien.

Except for the I.R.C. § 6324A(c) written agreement described above, the Code does not require the Service to enter into any additional agreements, such as a Pledge or Escrow Agreement. Nor does the Code preclude the Service from entering into such types of additional agreements. There is, however, no authority for the Service to substitute the I.R.C. § 6324A(c) written agreement for a Pledge or Escrow Agreement. Whether to enter into a Pledge or Escrow Agreement in addition to the required I.R.C. § 6324A(c) written agreement is a matter to be determined by the facts and circumstances of each particular case. In considering whether to enter into an additional agreement, the Service should determine whether the agreement will provide any additional security to the I.R.C. § 6324A(c) written agreement.

Here, the Estate submitted a proposed Pledge and Escrow Agreement that mainly reiterates what would be contained in the required I.R.C. § 6324A(c) written agreement. However, it also requires the Estate to provide annual reports or certified financial statements to the Service on or before April 15 of each year during the term of the agreement. This would appear to assist the Service in monitoring whether the Interest in the LLC has maintained its value. If the Interest in the LLC were to decrease in value, the Service could request additional collateral pursuant to the provisions of I.R.C. § 6324A(d)(5).

The Pledge and Escrow agreement also states that the Estate will assign its Interest in the LLC to the attorneys for the Executors, the Law-Firm, as escrow agent. Generally, if stock certificates exist, we recommend that the Service take possession of them during the deferment period. This prevents the sale of such certificates to third parties. In the case of a membership interest in a LLC, certificates do not exist for the Service to retain possession. However, the Service could request the Estate to assign the Interest in the LLC to the Service in lieu of the Law-Firm acting as escrow agent. Assignment of the Interest in the LLC to the Service would provide additional security for the government because it would not need to go through a third party in the event that the Estate fails to comply with the terms and conditions of I.R.C. § 6324A.

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3. What steps should be taken to perfect the Service's security interest in the Interest in the LLC.

I.R.C. § 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 filed 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 in the Interest in the LLC. I.R.C. § 6324A(d)(1). The lien arises at the time the executor is discharged from personal liability under I.R.C. § 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).

I.R.C. § 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. The LLC is a State A limited liability company. Under State A law, a membership interest in a limited liability company is personal property, and a member has no interest in the specific limited liability company property. State A cite. However, the taxpayer is a State B estate. In State B, the law is the same, membership interest in a limited liability company is personal property, and a member has no interest in the specific limited liability company property. State B cite. Accordingly, the Interest in the LLC constitutes personal property.

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). The taxpayer in this case is the Estate. Accordingly, the Interest in the LLC is situated at the residence of the Estate at the time the NFTL is filed. The statute does not define residence of the Estate. Our research revealed only an article in BNA Tax Management Portfolios-Estate, Gift, and Trust Series, which states that the residence of the executor or executors will be deemed to be the residence of the taxpayer for purposes of the liens relating to the estate tax. See Estate Tax Payments and Liabilities, 832-1st Tax Management Portfolios (BNA) at A-14 (2007). Nevertheless, because this is an unsettled area of the law, we recommend that you file a NFTL based both on the residence of the executor or executors at the time the NFTL is filed, and based on the residence of the decedent at time of death. In this case, the Executors, who all reside in State B, report their address as c/o the Law-Firm in City B, State B. The decedent resided in City C, State B, at the time of his death. Thus, we look to the law in State B to determine where the NFTL should be filed. State B law requires a lien affecting personal property to be filed with the office of the U.S. District Court for the judicial district in which the taxpayer resides. Rev. Rul. 77-61, 1977-1 C.B. 388. Accordingly, the NFTL must be filed with the office of the U.S. District Court in City B, State B.

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I.R.C. § 6323(f)(3) states that the form and content of the NFTL is to be prescribed by the Service, and such notice shall be valid notwithstanding any other provision of law regarding the form or content of a notice of lien. Therefore, federal law, and not state law, determines the sufficiency of the notice. Treas. Reg. § 301.6323(f)-1(b)(2). For this reason, the description of the collateral to which special lien attaches should state the following:

Interest in the LLC, a State A limited liability company, located in City A, State A.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call _____ at () _____ if you have any further questions.