Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Denice Huber
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(Small Business/Self-Employed)

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subject:

Disclosure Statement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Issues

I. What wording would need to be added to the Agreement to Special Lien ("**ASL**") signed by the to secure the government's interests in the four business entities offered as collateral under section 6324A of the Internal Revenue Code of 1986, as amended?

II. Would the partnership and LLC agreements require amendments in order to allow the to pledge the interests?

III. Would the partners and members that are not heirs of the need to sign the security agreements and consent to the pledging their interest in the entities?

IV. Provide an agreement that would be enforceable as a contract to pledge the interests of the in the partnership and LLCs.

Conclusions

I. The ASL does not require additional wording. **However, please see our comments regarding question IV.**

II. The agreements do not require amendment. However, documentation showing that the partnership and LLCs approved the security agreements should be obtained. Furthermore, in this instance, the appropriate agreement is a security agreement rather than a pledge agreement.

III. Other partners or members, as applicable, need not sign the security agreement, but may need to approve the security agreement due to provisions of the applicable organizational agreement.

IV. An agreement based on the ASL is attached as Exhibit A. **However, if it is possible to revise the Collateral to be offered, an alternative agreement is attached as Exhibit B.**

Facts

The ("**Taxpayer**") elected to defer its estate tax liability for ten (or more) years under section 6166.[1] It also elected to grant the Internal Revenue Service ("**IRS**" or "**Service**") a lien on specific property pursuant to section 6324A. The Taxpayer has consented to the imposition of a lien on certain partnership and LLC interests. Due to the nature of the property, Technical Services is concerned that, despite the filing of a notice of federal tax lien, that the value of the interests could be impaired or the assets could be transferred outright. You have asked us to advise regarding securing the Service's interest in the partnership and LLC interests. The agreement that is the subject of this memorandum is in addition to, and not in lieu of, the lien agreement described under § 6324A.

Law & Analysis

Section 6166 allows estates to defer payment of estate tax attributable to interests in a closely-held business for up to five years, provided that the interest on any unpaid portion of the tax is paid annually during that period. I.R.C. § 6166(a), (f). The estate must pay the balance of interest and tax due in as many as ten equal

[1] Unless otherwise stated, "Code" or "section" shall refer to the Internal Revenue Code of 1986, as amended.

installments with no more than a year between installments. I.R.C. § 6166(a). For purposes of this memorandum, we assume that the Service properly granted the section 6166 election. See Rev. Proc. 79-55; I.R.M. §§ 4.25.1.4.9(4), (13).

Where the Service agrees to defer the estate tax, the Service may require a bond from the estate as security. I.R.C. § 6165. Alternatively, the Service may not require a bond if the Service obtains a section 6324A special lien pursuant to an agreement under section 6324A(c).[2]

Where the Service accepts Collateral, any person with an interest in the Collateral must sign an agreement with the Service. I.R.C. § 6324A(c) (hereinafter referred to as "6324A lien agreement"). The 6324A lien agreement is governed by Federal law, and perfection and priority rules can be found in section 6324A(d). The fair market value of the property required by the Service may not exceed the sum of the deferred amount and the required interest amount, as defined in Treas. Reg. § 20.6324A-1(e)(1) and (e)(2). I.R.C. § 6324A(b)(2); Treas. Reg. § 20.6324A-1(b)(2). However, the parties to the agreement referred to in section 6324A(c) may voluntarily designate property having a fair market value in excess of that sum. Treas. Reg. § 20-6324A-1(b)(2).

The Service is interested in entering into the proposed Security Agreement in order to secure the Service's interest in the property to supplement the 6324A lien agreement. The Security Agreement is not specifically authorized by the Code, and as such is governed by state law.

The Security Agreement, as a contract between the Service and the estate, is governed at least in part by state law. Under California law, the Service is receiving a security interest in property and the Service must take the proper steps under California law with regard to that security interest.

Under California law, a security interest becomes enforceable only if it has attached. A security interest attaches if: 1) The debtor has rights in the property being offered as security, Ca. Comm. Code § 9203(b)(2); 2) the secured party gives value for

[2] An open question is whether a section 6324A lien extinguishes the general estate tax lien, created by § 6324(a). The Service's position is that the general estate tax lien continues to attach all estate property *except* the property subject to the section 6324A lien. See I.R.C. § 6324A(d)(4); see also Treas. Reg. §§ 20.6324A-1, 301.6324A-1(e); I.R.M. § 5.5.8.1(4)(b). This issue has never been directly addressed by any court. In In re Roth, 301 B.R. 451, 454 (Bankr. W.D. Pa 2003), aff'd, 2004 WL 716743 (April 1, 2004, W.D. Pa.), the Service argued on appeal to the district court that a section 6324A lien on shares of stock displaced the section 6324(a) lien only with respect to those shares of stock. The court held that it need not reach this issue, however, as the other assets the Service was seeking to collect were not assets of the gross estate ever subject to the section 6324A lien. See also Noble v. Soler, 98-1 U.S.T.C. ¶ 60,297 (S.D. Ohio 1997) (court does not reach issue of extent of displacement of section 6324(a) lien because section 6324A lien agreement was never filed). In a bankruptcy case involving section 6324B (which makes the language of section 6324A(d)(4) applicable pursuant to section 6324B(c)(1)), the court again does not directly address this issue, but notes that "[m]oreover, any property against which a Section 6324B lien is filed is divested of the Section 6324 lien regardless of whether the property was Section 2034 to 2042 property." In re Druse, Sr., Ltd., 82 B.R. 1013, 1016 (Bankr. D. Neb. 1988).

the security interest, Ca. Comm. Code § 9203(b)(1); 3) the parties have a security agreement containing a description of the property being offered as security, Ca. Comm. Code § 9203(b)(3); and 4) the debtor authenticates (i.e., signs) the security agreement, Ca. Comm. Code § 9102(7).

Also, the secured party must take additional steps to make the security interest enforceable against third parties. Absent these additional steps, the security interest is only enforceable against the debtor. The process of making the security interest enforceable against third parties is called perfection. Perfection can occur by filing a financing statement against the Collateral, receiving a pledge on the Collateral (i.e., taking possession of the Collateral), or obtaining control over the Collateral. See Law & Practice of Secured Transactions: Working with Article 9 § 3.02.

The appropriate form of perfection varies depending on the Collateral. Most security interests can be perfected by filing. See Ca. Comm. Code § 9310(a).[3] Even though perfection by filing is adequate, where possible, a pledge is often the best form of perfection. "By depriving the debtor of dominion over the collateral, the secured party has alerted the world to the possibility of an encumbrance." Richard F. Duncan et al., Law & Practice of Secured Transactions: Working with Article 9 § 3.02 (2005). A pledge can only be used where the Collateral is in the form of paper, such as money, negotiable instruments, chattel paper, securities and negotiable title documents. See Working with Article 9, at § 3.03[1]. Further, security interests in accounts or general intangibles can be perfected only by filing, and security interests in money or instruments can be perfected only by pledge. Id. Finally, where the Collateral is investment securities, taking control (as well as filing a financing statement or receiving a pledge) is also an appropriate form of perfection. See Working with Article 9, at § 3.03A.

In this case, the Collateral is partnership and LLC interests. Partnership and LLC interests are general intangibles. Ca. Comm. Code § 9102(a)(42).[4] General intangibles can only be perfected by filing. See Working with Article 9, at § 3.03[1]; Lynn A. Soukup, It's a Matter of Collateral, 14 Business Law Today 53 (2005). **Therefore, a security agreement, rather than a pledge agreement, is appropriate.**

The terms of the security agreement should also be consistent with the law and published guidance dealing with section 6324A liens and section 6166 elections. The Security Agreement should not, in any way, affect the Service's remedies under the § 6324A lien agreement, as provided for by various provisions of the Code, most notably § 6166(g).

Section 6166 explains the causes and consequences of a default of a section 6166 deferred payment election. Most generally, if fifty percent or more of the interest in the closely-held business is disposed of or withdrawn, the unpaid balance is due and payable upon notice and demand. I.R.C. § 6166(g)(1). Likewise, failure to make a

[3] See also Law & Practice of Secured Transactions: Working with Article 9 § 3.03[1].
[4] See also, Lynn A. Soukup, "It's a Matter of Collateral," 14 Business Law Today 53.

payment (left uncured for more than six months) renders the unpaid balance due and payable. I.R.C. § 6166(g)(3). In addition, regulations, Revenue Rulings, and other published guidance issued over the years illustrate particular circumstances that either do or do not cause a default under section 6166. See, e.g., Rev. Rul. 89-4 ("The sale of a portion of the assets of a closely-held business to allay impending foreclosure does not constitute a disposition of an interest in the business under § 6166(g), if the proceeds are applied to reduce mortgage debt.").

Rather than create new default terms in the security agreement, the agreement should incorporate the section 6166 default terms. This would allow the Service and the affected taxpayers to refer to the substantial published guidance surrounding section 6166 defaults in order to deal with peculiar fact situations that may develop. As stated recently regarding a related subject, "since the law in this area is not well settled, we recommend that the Service take a conservative approach." CCA 200027046, 2000 WL 33116163.

For some time, we have encouraged the Service to disclose and agree upon all terms and conditions of the section 6166 installment agreement with the estate and other interested persons before approving the election. "We believe, as in any legally enforceable agreement, that all terms and conditions of the section 6166 installment agreement should be disclosed and agreed upon by all interested parties prior to granting the election." CCA 200027046, 2000 WL 33116163.

The following addresses the specific questions posed by the Service.

I. What wording would need to be added to the ASL signed by the to secure the government's interests in the four business entities offered as collateral under section 6324A of the Internal Revenue Code of 1986, as amended ("Code" or "Section")?

The ASL is sufficient as drafted. The Security Agreement attached to this memorandum provides additional terms that secure the Service's interest in the property offered as collateral. **However, please see our comments regarding question IV below.**

II. Would the partnership and LLC agreements require amendments in order to allow the to pledge the interests?

Per the partnership and LLC agreements, the following provisions must be followed regarding creation of the Service's security interests:

- . Section 8 names a managing partner, who has control and supervision over "all things done by the partnership." **The Service should ensure approval by the current managing partner.**

- . Section 8.2. of the agreement restrains transfers or encumbrances of interests unless it has been appropriately approved in writing. **The Service should seek a copy of such writing.**
- . Section 8.2. of the agreement restrains transfers or encumbrances of interests unless it has been appropriately approved in writing. **The Service should seek a copy of such writing.**
- . Section 11.1. of the agreement restrains transfers or encumbrances of interests unless it has been appropriately approved in writing. **The Service should seek a copy of such writing.**

III. Would the partners and members that are not heirs of the need to sign the agreements and consent to the pledging their interest in the entities?

As with the § 6324A lien agreement, any parties who have an interest in the Collateral should sign the security agreement. See I.R.C. § 6324A(c). In this case, the Collateral is certain partnership and LLC interests. Therefore, the owners (or agents of the owners) of those particular interests that constitute the Collateral should sign the Agreement. This could include executors, trustees or beneficiaries.

Other partners or members not a party to the section 6324A agreement, as applicable, need not sign the security agreement, but may need to approve the security agreement due to provisions of the applicable organizational agreement (as stated in the previous section).

IV. Provide an agreement that would be enforceable as a contract to pledge the interests of the in the partnership and LLCs.

As previously explained, the appropriate document is a security agreement; and where the Collateral is intangible property, a pledge agreement is not applicable. Therefore, as requested, a security agreement that offers the partnership and LLC interests as collateral is attached as Exhibit A.

In addition, an alternative agreement is attached as Exhibit B. This alternative agreement has the offer the assets of the partnership and LLC interests as Collateral. If the Service can alter the ASL so that the assets of the partnership or LLC interests are the Collateral this would be preferable. See Roth v. U.S., 93 A.F.T.R.2d 2004-1663 (wherein the Service received security in the form corporate shares, but had no recourse where the shareholder disposed of all of the assets of the corporation and caused the shares to have no value).

The following are the differences between the two agreements:

- In Exhibit A, the introductory paragraph lists the debtors as the owners of the relevant partnership and LLC interests. In Exhibit B, the introductory paragraph lists the debtors as the partnership and LLCs themselves.

- In Exhibit A, the second recital states that the debtors own the partnership and LLC interests. In Exhibit B, the introductory paragraph states that debtors own the real and personal, tangible and intangible property (i.e., the property held by the partnership and the LLCs).
- In Exhibit A, Section 1.1. contains a listing of the partnership and LLC interests that will be the Collateral. In Exhibit B, Section 1.1. requires attachment of a Schedule listing the assets of the partnership and LLCs that will be the Collateral.

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If you have any questions, please call attorney Chong S. Hong at (408) 817-4682.

JEFFREY J. HEINKEL
Associate Area Counsel

By: _____
CHONG S. HONG
General Attorney, Tax
(Small Business/Self-Employed)

Encl: Exhibit A – Draft Security Agreement
Exhibit B – Alternative Draft Security Agreement