

# Breathing Room

## For Family-Owned Businesses

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*Family-owned businesses are the backbone of our economy. Without adequate planning, however, the death of the founder can put severe financial strain on the business.*



Federal estate taxes may become an overwhelming burden, often totaling as much as 50% of the value of the business. Worse than that, these taxes are due within nine months of the owner's death. For some businesses, there is simply insufficient cash to pay the taxes. As a result, the business must be sold to generate enough cash to pay them.

From the government's standpoint, selling a business for payment of taxes is tantamount to "killing the goose that laid the golden egg." While the government might collect a large, one-time lump-sum estate tax if the business is liquidated, all future taxes (income, sales, payroll, etc.) generated by the business will be lost. In order to collect the estate tax without causing cash flow problems, the government offers favorable payment terms to certain family-owned businesses, which are determined by Internal Revenue Code Section 6166. While Section 6166 is complex and difficult to navigate, this article will attempt to provide a simplified overview and hypothetical example of how the Section might be applied to a family-owned business.

### Rules of Section 6166

An estate that consists of a significant interest in a closely-held business may qualify under Internal Revenue Code Section 6166 to pay its tax over an extended period of time using an installment loan arrangement based on the following parameters:

- This deferral option is available only to U.S. citizens if the value of the interest in a closely-held business accounts for more than 35% of the adjusted gross estate. This is generally defined as the total estate minus certain allowable deductions, such as estate administration costs, debts and mortgages.
- An election must be made within nine months of the date of death to qualify for this extension.
- At the time of the decedent's death, he or she must have been actively involved in the trade or business.
- The estate does not qualify for the extension if the owner had only a passive interest in the business.

*Section 6166 is a valuable financial tool, but it should not be relied upon as the primary strategy to pay estate taxes.*

### Terms of the Loan

Under Section 6166, the estate has up to 14 years to pay the federal estate tax due on the proportional value of the business. The first four years can be payments of interest only, followed by principal and interest payments that can be made in as many as ten equal annual installments.

Interest on the first \$600,000 of tax attributable to the business is figured at a rate of 2%. Interest on the tax due in excess of \$600,000 is taxed at a higher rate; however, because of the current low-interest environment, for 2009 the rate would be approximately 4%. Given the banking industry's unwillingness to loan money during the current recession, it is particularly attractive to have a government-mandated loan program to pay estate taxes.

The chart below reflects an example of a decedent who died with a gross estate valued at \$10 million and a business valued at \$3.2 million. Because the value of the business was 40% of the adjusted gross estate (AGE), 40% of the total estate is eligible to be paid over a 14-year period.

### Example

Total Estate	\$10 million
Adjusted Gross Estate	\$8 million
Value of interest in business	\$3.2 million
% of business interest to AGE	40%
Total estate tax	\$2.5 million
Tax attributed to Business	\$1 million

### Impact of Section 6166

Tax eligible for deferral	\$1 million
Years 1-4 (interest only)	\$20,000 (2% of \$1 million)
Years 5-14 (principal and interest)	\$100,000 principal plus 4.0% interest on the outstanding balance

### Advantage of Section 6166

Few estates (particularly those with a significant interest in a closely held business) have adequate liquid assets to pay the estate taxes in full when they are due (nine months after the date of death). Giving a business the option to pay the taxes on favorable terms over 14 years may make the difference between survival and liquidation to generate adequate cash for payment of taxes.

### Disadvantages of IRC Section 6166

While IRC Section 6166 can be a favorable financing tool, it is not a universal remedy. The taxes are not forgiven or reduced in amount. The estate is simply allowed to pay them over time. Often, it is anticipated that the business will generate enough cash flow to pay the taxes; however, if the business cannot, the taxes will have to be paid from other estate assets or the beneficiaries will need to make installment payments.

Various restrictions may be placed on the business during the 14-year deferral period. The IRS retains a lien on the business. If the business is sold to a non-active family member, the tax deferral may be terminated and the entire tax triggered. The existence of the IRS lien may adversely affect the business' borrowing ability to fund operations or needed expansion. In certain cases, the IRS can even require the estate to post a surety bond, which could be expensive.

During 2009, we have witnessed the effect a recession has on closely-held businesses, forcing many to downsize and some to close their doors. The installment payments under 6166 are still due on a timely basis, whether in times of prosperity or recession. It is not farfetched to assume that generating the cash necessary to make installment payments could accelerate a business into a downward spiral toward bankruptcy.

Section 6166 is a valuable financial tool, but it should not be relied upon as the primary strategy to pay estate taxes. First, the percent age ownership test (35% of the AGE) is not determined until the date of death. Depending on the value of the business and the balance of assets, the estate may not qualify for the extension. Secondly, the favorable loan installment terms apply only to the taxes attributable to the value of the business. The taxes attributable to the non-business assets remain due within nine months of the date of death. In our example above, the total estate taxes were \$2.5 million. Only 40% of these taxes, or \$1 million, were eligible to be deferred. The balance of \$1.5 million must be paid in cash by the nine-month due date.

### Use of Life Insurance

Because it provides cash precisely when it is needed, life insurance is an excellent tool to help meet the nine month deadline for payment of estate taxes attributable to non-business assets.

Life insurance can also be used for the portion of the tax eligible for deferral under Section 6166. By having cash for the taxes, the estate can invest the proceeds while taking advantage of the favorable loan terms of the IRS. As with any

plan, Section 6166 might not be advantageous for everyone. Some disadvantages of this Section may include the following:

- The inability to sell to a non-active family member or outsider
- Unwillingness of lenders to extend credit because of the IRS lien
- An economic downturn leaving the business unable to cash flow the taxes
- Failure of the estate to meet the 35% of AGE test at the time of death

If adherence to Section 6166 rules becomes problematic, the estate has the freedom to terminate the election and simply pay the remaining estate taxes.

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### Establish a Trust

In the example above, the total estate tax was estimated to be \$2.5 million (\$1 million attributable to the business and \$1.5 million attributable to non-business assets). Assume the owners of the business are a healthy 65-year-old husband and wife. They could establish a trust that would create assets to pay all taxes. If the trust purchased a policy worth \$2.5 million on the husband and wife, the annual premium could be approximately \$26,000, or slightly over 1% of the face amount of the policy.

The disadvantage of this strategy is that the husband and wife must "pre-fund" the estate taxes during their lifetimes in the form of annual premium payments. The advantage, however, is that both the estate and the business will be unencumbered by the burden of paying taxes and interest. The chances that the business will continue to be successful after the death of both husband and wife would certainly seem to be enhanced by pre-funding the tax liability.

Life insurance can be an excellent complement to the use of the favorable terms of IRC Section 6166 to pay estate taxes when a closely-held business is a significant part of one's estate. These and other techniques can best be implemented when working jointly with your estate planning attorney and the experts at SilverStone Group.

\*As this article goes to print, Congress is poised to vote on estate tax legislation that could significantly alter IRC Section 6166.

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