Managing Estate Taxes: How to Protect the Family Business from Liquidation

Transitioning a family business upon the death of an owner or a significant stakeholder is never easy. When illness or tragedy strikes suddenly, there may be no opportunity to figure out succession planning for a business. Grappling with how to pay estate taxes on a closely held business can add complexity and stress to an already fraught process.

However, with proper planning, a family or the partners in a closely held business can avoid having to liquidate assets or sell shares to pay estate taxes. Insurance arrangements, operating agreements that include buy-sell provisions, and gifting strategies all have the potential to ensure that a family business remains in the family and that they can pay any associated taxes. **Enlisting the help of a Certified Tax Coach** will ensure you are prepared for estate taxes and the transition of the business to beneficiaries.

When there is an absence of proper planning, what can be done? What happens when beneficiaries inherit a business and want to keep it family-owned or closely held but the business is not liquid enough to pay the estate taxes within the required nine months? This is where **Internal Revenue Code § 6166** comes to the rescue.

OVERVIEW OF THE TAX CODE: EXTENSIONS FOR PAYING ESTATE TAXES

In general, IRC § 6166 gives the executor of a decedent (the person who has passed away) with “an interest in a closely held business” **five years to defer payment of the estate taxes** and allows for **up to tens years’ worth of installment payments**. However, not every closely held business qualifies for relief under this provision.

First, the decedent must be a citizen or resident of the US. Second, the value of the decedent’s interest in the business must amount to more than 35% of their adjusted gross estate.

Additionally, at the time immediately before the decedent’s death, the interest must fit one of these three categories:

- As a proprietor in a trade or business carried on as a proprietorship;
- As a partner in a partnership carrying on a trade or business—in this case, 20% or more of the total capital interest in the partnership must be included in the gross estate or the partnership must have 45 or fewer partners; or
- As stock in a corporation carrying on a trade or business—in this case, 20% of the value of the voting stock of the corporation must be included in the gross estate or the corporation must have 45 or fewer shareholders.

Under this code section, **community property** or interests held by a husband and wife as **joint tenants**, **tenants by the entirety**, or **tenants in common** are treated as one shareholder:

- "Community property" refers to the assets that come into marriage through any means other than inheritance or gift, which are then treated as assets of the "marital community"—not all states recognize community property, so this is subject to state law.
- "Joint tenants" is an arrangement where when one tenant dies, the other is automatically entitled to the entire property regardless of the decedent's will.
- "Tenants by the entirety" is a type of joint ownership that means when a spouse dies, the surviving spouse automatically owns the entire property.
- "Tenants in common" occurs when two or more people share ownership rights in a property, and when one owner dies, their share passes to the estate, which can then leave the property to any beneficiary they would like.

Lastly, the tax code provides clear attribution rules, which establish the legal owners of a business interest in order to prevent tax evasion or fraud. IRC §274 states that "all stock and all partnership interests held by the decedent or by any member of his family… shall be treated as owned by the decedent."

QUALIFYING FOR ESTATE TAX DEFERRAL

IRC § 6166 does not allow an estate to defer all of its estate taxes. Only those estate taxes related to the decedent's business interest qualify. Consequently, the maximum deferral amount is limited. For the specific math, taxpayers can refer to IRC § 2001—which covers the imposition and rate of estate tax—and the equations below:

Calculating Max §6166 Deferral

x = Max §6166 Deferral

$$\frac{x}{(\S2001\ \text{tax} - \text{credits})} = \frac{\text{CLOSELY HELD AMT}}{\text{ADJ GROSS ESTATE}}$$

$$\frac{x}{(\text{final } \S2001\ \text{tax})} = \text{\% RATIO}$$

$$\text{solving for } x = \text{\% RATIO}\,(\text{final } \S2001\ \text{tax})$$

To calculate the adjusted gross estate, taxpayers must take the value of the estate and reduce it by any deductions allowed under IRC §2053 or §2054, including debts, funeral expenses, administration costs, and mortgages. The amount allowed as a deduction is a "facts and circumstances" determination that will be evaluated based on the date the estate tax return is filed.

These deductions can be an important factor for qualifying the estate for the deferral. Take the requirement that the business interest must equal more than 35% of the decedent's estate. If the decedent dies with a $33M gross estate and only $11M is an interest in a closely held business, this falls short of that 35% threshold, so the estate would not qualify for estate tax deferral. However, if the estate qualifies for deductions—let's say they total $2M—the adjusted gross estate is now $31M, and the $11M interest now represents over 35% of the estate. The taxpaying beneficiaries would now qualify for a deferral under §6166.

Taxpayers should note that charitable and marital deductions cannot be used to calculate the adjusted gross estate in order to qualify for a §6166 tax deferral.

MAKING THE ELECTION

For a taxpayer to defer estate taxes, the election must be made on a timely filed estate tax return. If the return is on time, the election can be applied to the tax calculated as owed and to certain deficiencies (if the amount of tax reported is different than the amount the IRS determines is actually owed). If no election is made, the taxpayer can still pay later deficiencies in installments, but not the tax originally determined to be due.

The election is made by attaching a notice of election containing the following information:

- The decedent's name and taxpayer identification number (TIN);
- The amount of tax to be paid in installments;
- The date of the first installment;
- The number of annual installments, including the first installment;
- The properties shown on the estate tax return which constitute the closely held business interest (identified by schedule and item number); and
- The facts which formed the basis for the executor's conclusion that the estate qualifies for payment of the estate tax in installments.

If information on the planned installments is missing from the notice of election, the election will default to deferring the maximum amount of tax allowed, to be paid in ten equal annual payments. The first payment will be due 5 years after the originally prescribed date of payment.

INTEREST, DEFAULTS, AND ACCELERATED REPAYMENT

Interest. While the IRS will allow the deferral of estate tax payments for up to 15 years (a full deferral of five years plus 10 years for repayment), the deferral is not free. For the first five years of the deferral period, interest must be paid annually on the unpaid portion of the tax. After this, any applicable interest must be paid with the annual installment payments. The amount of interest is determined by the rules outlined in IRC §6601(j) rather than the standard annual rate.

Late Payments and Defaults. If the estate fails to make payments of either the principal tax or the interest owed, “the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the [Treasury] Secretary.” However, if the payment is made within six months of its due date, the estate is subject to a 5% penalty for every month (or fraction of a month) it is late.

Accelerated Repayment. As mentioned above, failure to make a payment on time can accelerate the repayment of the deferred tax. Another action that can result in accelerated repayment is attempting to sell, exchange, or otherwise dispose of 50% or more of the decedent’s interest or distribute “money and other property attributable to such an interest.” Normally, accelerated repayment would not result from selling shares to pay estate tax or expenses that would typically qualify as § 2053 deductions. However, estates cannot delay payment of taxes only to turn around, sell off the decedent’s business interest, and distribute the proceeds. The purpose of the IRC § 6166 provision was to allow closely held businesses to pay estate tax and still remain closely held rather than be forced to liquefy the business. If taxpayers attempt to use this provision to game the system, they will not find a loophole available.

To guard against losing money due to poorly planned payments, defaults, and accelerated repayments, **let a Certified Tax Coach guide you through the tax planning process**.

LEVERAGING A “GRAEGIN LOAN”

In cases where the decedent’s estate cannot meet that 35% test, even after all deductions have been applied, the estate may be able to consider a “Graegin Loan.” A Graegin Loan allows the estate to borrow money from a third-party lender to pay estate taxes and also allows for the immediate deduction of all interest due on the loan. This helps reduce the adjusted gross value of the estate and may help the estate get across that 35% threshold.

Graegin Loans are named after a US Tax Court case that decided that an interest expense did not need to be “actually and necessarily incurred” to be tax deductible. Rather, the interest amount simply needed to be “ascertainable with reasonable certainty and that it will be paid.” Since there is potential for abuse here, taxpayers must be sure that their Graegin Loan meets the facts and circumstances necessary to stand up under scrutiny. The most important elements are that the interest is accurately calculated and will be repaid.

SUMMARY

Succession planning is unfortunately all-too-often neglected or fails to take the full tax consequences into account. For qualifying estates, the § 6166 deferral provision can help ease a sudden financial burden and ensure that a family business does not have to be sold off merely to pay estate taxes. The best strategy to mitigate the effects of estate tax is to engage in proper and thorough succession planning long before the estate becomes an inheritance. To secure a healthy financial future for your estate, **reach out to Certified Tax Planner today**.