



## LIQUIDITY FOR THE BUSINESS OWNER'S ESTATE

For the owner of a closely held business, estate liquidity can be a matter of particular importance. If that business represents a large portion of the estate, the client may be concerned about heirs being forced to sell the business or its assets to pay estate taxes. In examining the ways to minimize estate taxes, the client may also be considering how best to create liquidity to help heirs meet the estate tax obligation and other cash needs.

For this reason, the business owner may be considering the costs and benefits of using Internal Revenue Code (IRC) Section 6166. If it qualifies, the business owner's estate could elect under this Section to temporarily defer certain estate taxes, and subsequently pay them on an installment basis. The business owner might also consider how the liquidity available from a life insurance policy can be used in combination with or even as an alternative to the tax deferral option under IRC §6166.

### HOW §6166 WORKS

The installment election under §6166 is available to the estate of a U.S. citizen or legal resident, where the value of the interest in the closely held business<sup>1</sup> accounts for more than 35%<sup>2</sup> of the adjusted gross estate. In order to take advantage of estate tax deferral under this Section, the estate would file an election no later than the timely filed estate tax return.

The estate would elect to defer payment of estate taxes that are due on the proportional value of the business.<sup>3</sup> The election can push back tax payments by up to 5 years,<sup>4</sup> and then enables the estate to pay those taxes in up to ten equal installments after the deferral. The estate can therefore acquire up to 14 years<sup>5</sup> to pay. A

portion of the estate tax<sup>6</sup> incurs interest throughout the installment period at 2% and is known as the "2% portion." Tax exceeding the 2% portion incurs interest at 45% of the current regular tax underpayment rate.<sup>7</sup>

### WHERE LIFE INSURANCE FITS IN

Choosing §6166 has obvious benefits, but certain aspects of the tax deferral and installment option under that Section make life insurance an extremely attractive complement or even an alternative.

Although §6166 helps to temporarily relieve the tax burden that results from ownership of the business, it does not apply to other assets in the estate. This means that the estate could still face an estate tax burden that it would not be able to defer under §6166. The IRS has also begun to emphasize the bond or lien requirements of that Section, which it could seek to exercise against not only the business itself but also against the underlying assets of the business. A surety bond can be prohibitively expensive or may be unavailable, and an IRS lien could affect the business' future ability to borrow. See the February 2008 Edition of Advanced Markets Central Intelligence.<sup>8</sup>

Against this background, life insurance performs some important functions.

First, it is self-completing. It can provide cash when the estate needs it, regardless of whether the estate qualifies under §6166. In particular, the death benefit supplies the liquidity needed to meet ALL estate tax obligations, not only those that qualify for tax deferral and installment payments under §6166.



*Powerful solutions for estate liquidity needs . . .*

Second, even if the estate qualifies for relief under that Section, life insurance can help to relieve future liquidity pressures. There would be no need to identify sources of funding for future estate tax installments.

Third, gifting of premiums during a client's lifetime will reduce the size of the taxable estate.

## **BENEFITS**

### *Tax Deferral Under §6166*

- When a timely election is made under §6166, certain estate taxes may be deferred temporarily up to 5 years, with the balance paid in installments, over a maximum of 14 years.
- Under §6166, a low 2% interest rate applies to a portion of the outstanding tax owed for the duration of the installment period.

### *Life Insurance*

- Cash from the life insurance policy eliminates the need for a forced sale of the business or other assets to meet the estate tax obligation.
- The purchase of a life insurance policy may be a tax-efficient complement to the tax deferral election under §6166.
- Life insurance provides the estate the liquidity it needs exactly when it is needed, regardless of whether the estate qualifies for tax deferral under §6166.
- Life insurance may be a more cost-efficient method of paying estate taxes than the tax deferral provided for under the §6166 election.
- Life insurance eliminates uncertainty about how the future tax installments will be paid.
- Gifted premium payments on the life insurance policy reduce the taxable estate.

## **CONSIDERATIONS**

- A cost-benefit analysis comparing the present value costs of both a §6166 election and the purchase of a life insurance policy should be considered.
- Estate taxes attributable to estate assets other than the business do not qualify for special treatment under §6166.
- The estate must qualify to use the tax deferral opportunity under §6166. One requirement is that the interest must be in an active trade or business.<sup>9</sup> Gifts made within 3 years of death will be considered for the 35% of adjusted gross estate test.<sup>10</sup>
- When considering tax deferral under §6166, the implications for using other planning options, including an Installment Sale of the Business to a Defective Trust,<sup>11</sup> must be taken into account.
- Tax deferral under §6166 may require security or a lien against the business or its assets.
- Interest paid under a §6166 arrangement does not qualify as an administrative expense and is not deductible on either the estate tax return or on the fiduciary income tax returns.
- The right to defer payment can be lost in a number of circumstances, even after installment payments have begun. This could include default on payment of either interest or principal.

## EXAMPLE

The following illustrates the relative cost to the estate in terms of the present value of dollars spent. Four basic options can be considered for a projected year of death against a range of assumed factors, including a given rate of inflation and a given rate of estate tax. In the first of these, assume no prior planning has been done, so estate taxes are payable within 9 months of death. The second option assumes election of §6166 benefits with estate taxes paid over the maximum period. In the third case, estate planning employs the appropriate life insurance policy to pay estate taxes at the time due. The final scenario illustrates combining the benefits of the §6166 election with life insurance.

Case Assumptions:

6166 ELECTION INFORMATION	
Tax Year:	2009
Profit Margin of Business:	10.00%
Underpayment Rate:	8.00%
Valuation Inflation Rate:	3.00%
<b>Gross Estate:</b>	<b>\$8,000,000</b>
Admin. Expenses:	\$0
<b>Taxable Estate</b>	<b>\$8,000,000</b>
Value of Business:	\$4,000,000
Net Federal Estate Tax:	\$3,480,800
Adjusted Gross Estate:	\$8,000,000
35% of Adjusted Gross Estate:	\$2,800,000
<b>Estate Tax Method</b>	<b>2009 Limits</b>
Payments per Year:	Daily
Payment Period	End of Year
Net Present Value Rate	5.00%
Estate Growth Rate	3.00%

Protection SUL-G 08, \$98,467, full pay on Male, age 64, Preferred Non Smoker and Female, age 61, Preferred Non Smoker, \$10,000,000 death benefit. The data shown is taken from an illustration.

**SUMMARY OF OPTIONS: COST ANALYSIS – YEAR 2033**

<b>Option 1. Current Planning (Basic Estate Taxes)</b>		<b>Option 3. Estate Taxes Paid by Life Insurance Only</b>	
<b>Gross Estate:</b>	\$16,262,353	<b>Gross Estate in 2033</b>	\$12,672,305
Admin. Expenses:	\$0	<b>Estate Tax in 2033</b>	<b>\$5,583,337</b>
Taxable Estate:	\$16,262,353	<b>Less: Death Benefit Proceeds in 2033</b>	\$10,000,000
Value of Business:	\$8,131,176	Plus Premiums & Gift Taxes Paid By 2033	\$2,461,684
Adjusted Gross Estate:	\$16,262,353	<b>Total Insurance Gain</b>	<b>(\$1,954,979)</b>
<b>Net Federal Estate Tax in Year 2033:</b>	<b>\$7,198,859</b>	Present Value Cost/(Gain) Today (5.00%)	(\$83,541)
Present Value Cost/(Gain) Today (5.00%)*	\$3,865,169		
<b>Option 2. Estate Taxes with Section 6166 Election</b>		<b>Option 4. Estate Taxes Paid By Section 6166 &amp; Life Insurance</b>	
<b>Estimated Estate Taxes to be Paid</b>	<b>\$7,198,859</b>	<b>Estimated Estate Taxes to be Paid</b>	<b>\$5,583,337</b>
Estate Taxes that Must be Paid Now (a):	\$3,599,429	Estate Taxes that Must be Paid Now (1):	\$2,791,669
Estate Taxes that can be Deferred:	\$3,599,429	Estate Taxes that can be Deferred:	\$2,791,669
Unified Credit	\$1,455,800	Unified Credit	\$1,455,800
“2 Percent” Payment Plus Principal Payment	\$3,599,429	“2 Percent” Payment Plus Principal Payment	\$2,791,669
Total 6166 Cost (b):	\$4,664,293	Total 6166 Cost (2):	\$3,575,258
Total Estate Tax Cost ((a) + (b)):	\$8,263,723	Total Estate Tax Cost ((1) + (2)):	\$6,366,927
<b>PV Cost of Annual Payments in Year 2033:</b>	<b>\$6,858,909</b>	<b>PV Cost of Annual Payments in Year 2033:</b>	<b>\$5,285,570</b>
Present Value Cost/(Gain) Today (5.00%)*	\$3,682,645	<b>Less: Death Benefit Proceeds in 2033</b>	\$10,000,000
<b>Pre-Tax Income Rate Needed to Meet 6166 Payments = 20.24%</b>		Plus Premiums & Gift Taxes Paid By 2033	\$2,461,684
		<b>Total Insurance &amp; 6166 Gain</b>	<b>(\$2,252,746)</b>
		Present Value Cost/(Gain) Today (5.00%)	\$4,391

\* Grossed up by 45% Estate Tax Rate.

The data shown is taken from a hypothetical calculation. It assumes a hypothetical rate of return and may not be used to project or predict investment results.

In non-survivorship or single life situations, consider John Hancock’s Protection UL-G 09 (Form 08PROULG). Features including low cost guarantees may be available with this product that might offer advantages when comparing relative present value costs to the estate.

**SUMMARY**

Liquidity to meet the estate tax burden can present a challenge when a large portion of the client’s estate consists of an interest in a closely held business. Having the option to defer some estate taxes and then pay it in installments through a §6166 arrangement can be useful in the right conditions. Its benefits can be considerably enhanced when used in combination with life insurance, which can also provide an excellent stand-alone source of liquidity without the limitations that apply to §6166.



1. §6166(b)(1) defines this interest (in all cases in an entity carrying on a trade or business) as (1) an interest as a sole proprietor; (2) a partnership interest if either 20% or more of the total capital interest in such a partnership is included or the partnership had 45 or fewer partners; or (3) stock in a corporation if either 20% or more of the voting stock is included or the corporation had 45 or fewer shareholders. Passive ownership interests do not qualify—the level of activity of the deceased owner distinguishes an active business that qualifies for the election from non-qualifying passive ownership. See Rev-Rul 75-365, and Private Letter Ruling 9128024.
2. Due to the variety of possible circumstances, special rules apply to valuation, including where the business is a sole proprietorship, or when combination of ownership in more than one business is permissible, or when the business is a farm.
3. The §6166 election will apply only to the tax owed on the value of the closely held business in proportion to the value of the entire adjusted gross estate.
4. Deferral applies only to estate tax due. Interest on that tax must be paid annually. See IRC §6166(f).
5. Since the first installment of tax is due at the same time as the last installment of interest, the total possible payment period is 14 (not 15) years. IRC §6166(a)(3) and (f).
6. This is the tax on the indexed value of \$1 million in 1998, or the first \$1.33 million for deaths in 2009, less the applicable credit amount.
7. The rate charged on balances owed to the IRS. For individuals and small corporations, it is the short-term applicable federal rate (AFR) plus three percentage points. This rate changes quarterly.
8. The IRS determines on a case-by-case basis whether a surety bond from the estate or a special lien under provisions of §6324A is needed and appropriate. See *Estate of Roski v. Commissioner*, 128 T.C. 113 Dec 56,896, and Notice 2007-90. Formal regulations from the IRS are still pending.
9. The IRS views the level of the interest-holder's activity as the significant factor in determining if the tax deferral benefits of §6166 are available to the estate.
10. IRC §2035(c).
11. Trusts should be drafted by an attorney familiar with such matters in order to take into account income and estate tax laws (including the generation-skipping transfer tax). Failure to do so could result in adverse tax treatment of trust proceeds.

This material does not constitute tax, legal or accounting advice and neither John Hancock nor any of its agents, employees or registered representatives are in the business of offering such advice. It was not intended or written for use and cannot be used by any taxpayer for the purpose of avoiding any IRS penalty. It was written to support the marketing of the transactions or topics it addresses. Comments on taxation are based on John Hancock's understanding of current tax law, which is subject to change. Anyone interested in these transactions or topics should seek advice based on his or her particular circumstances from independent professional advisors.

Insurance policies and/or associated riders and features may not be available in all states.

Guaranteed product features are dependent upon minimum premium requirements and the claims-paying ability of the issuer.

Insurance products are issued by John Hancock Life Insurance Company (U.S.A.), Boston, MA 02116 (not licensed in New York) and John Hancock Life Insurance Company of New York, Valhalla, NY 10595.

© 2009 John Hancock. All rights reserved. [www.jhsalesnet.com](http://www.jhsalesnet.com)

IM1484 01/09 MLINY01060910469



INSURANCE PRODUCTS:		
Not FDIC Insured	Not Bank Guaranteed	May Lose Value
Not a Deposit	Not Insured by Any Government Agency	