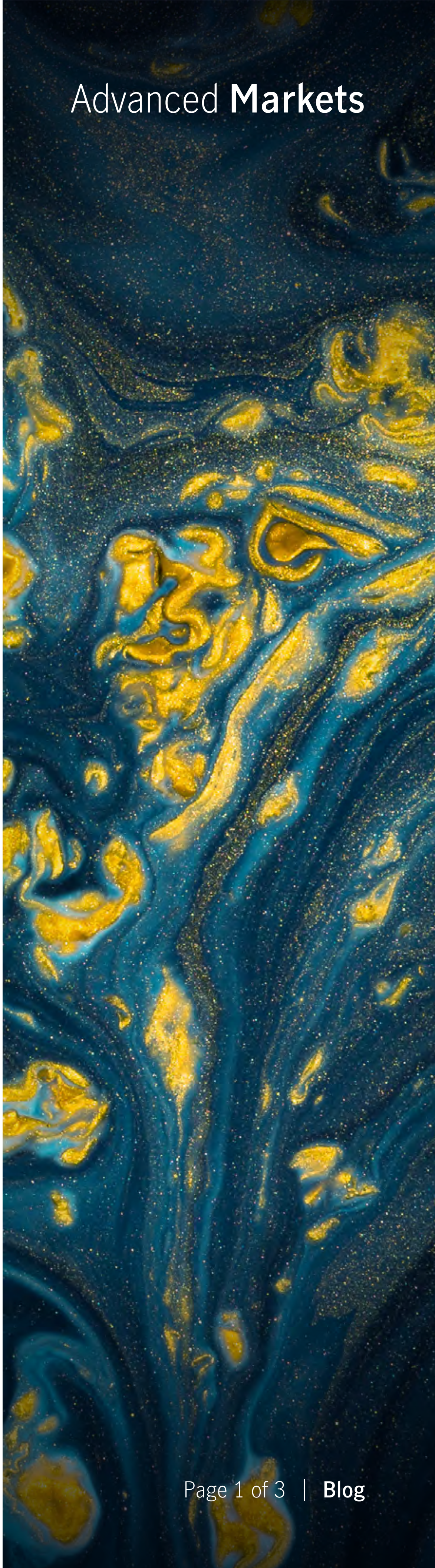

"Show me the money"

The need for liquidity at the intersection of estate and business planning

The insurance and financial planning industry has a propensity to separate "estate planning" from "business succession planning." However, these two concepts are not mutually exclusive and must be considered in tandem for most high-net-worth clients. As net worth increases, so does the probability that families have business equity. Similarly, as a family's wealth increases, so does the portion of wealth attributable to business interests.[1] While the push for high-net-worth clients to engage in estate planning is increasing – in part due to the looming sunset of our historically high lifetime exemptions – it is imperative that such planning takes a wholistic view that encompasses business succession planning as well. For a discussion on the lifetime exemption sunset read: *Consider acting now before estate exemptions go down*.

For business owners and clients who may face estate tax liabilities, there are two sides to planning:

1. Estate tax reduction techniques often utilize tax-free lifetime gift and estate transfer tax exemptions, exclusions and deductions written into the tax code, charitable contributions, and allocation of the unlimited marital deduction, as well as the potential for sales and transfers to trusts of appreciating property to provide an estate value freeze. These are often referred to as "use it or lose it" planning opportunities.

2. Estate tax payment techniques provide options to pay any estate tax liability. The estate tax return and any estate taxes owed are due within 9 months of death—this requires liquidity, often before the estate is settled. Where business ownership represents a large portion of a high-net-worth client's estate, finding the liquidity to pay estate taxes may require the heirs to sell the business or its assets. Additionally, without adequate liquidity to pay taxes, the business may be burdened with debt and may not survive for the next generation. For business owners, the option to elect §6166 can delay the immediate liquidity need, which can benefit both the estate and the business.

Section 6166 offers a statutory government loan to defer the estate taxes owed on the business portion of the estate,[2] and allow payment of those taxes on an installment basis over 14 years at a discounted interest rate (currently 2%)[3] on a portion of the installment note. For estates where an active interest in a closely held business makes up over 35% of the estate, this may be a viable option for heirs to delay the payment of estate taxes and take advantage of the preferred 2% interest rate.

A §6166 election may be an extremely beneficial tool for heirs to defer the liquidity need and continue managing the business; however, there are also limitations to §6166 that must be considered. Additionally, the restrictive qualifications for a §6166 election must be met "at the time of death,"[4] which makes it almost impossible to plan for. For example, a client's health may prevent them from being active in the business prior to death, or a change in the value of the business or the client's other assets may impact the 35% threshold.

The statute also includes payment acceleration triggers as well as the potential requirement of a surety bond or lien against the business and its assets, both of which can inhibit the day-to-day operation of the business. Making a §6166 election also results in the government looking over the heirs' shoulders as they run the business. Lastly, keep in mind that the §6166 election only defers the estate tax owed on the business portion of the estate; liquidity to pay the government note, as well as any additional estate taxes due, will still be required.

Now, consider proactive planning as part of the overall estate and business succession plan. With the use of a life insurance policy held in an irrevocable trust, the beneficiaries may receive cash from the policy death benefit when they need it most. This can be used to pay estate taxes on the non-business portion of the estate, or on all assets, giving beneficiaries more flexibility. Life insurance death benefits are payable to the beneficiary regardless of estate qualification under §6166 and regardless of changes in disposition of the business over time. The liquidity provided by life insurance may also allow the flexibility to work in combination with, or as an alternative to, the government plan, or can be reinvested, with the potential returns used to eliminate the future liquidity needs to fund ongoing §6166 installment payments.

Estate liquidity planning through the use of life insurance may result in the payment of estate taxes on all assets at a potentially lower cost than the government plan alone provides. Life insurance can provide a competitive rate of return on death benefit and may provide cost-efficiency with respect to future liquidity needs. Consider as well, that gifts of assets to an irrevocable life insurance trust may reduce the size of the taxable estate. When gifts are made from personal estate assets, this may alternatively increase the proportion of business assets that comprise the estate, making a §6166 election an option for the heirs.

Beyond functioning as an estate tax liquidity opportunity, life insurance may also be used for other business-focused estate planning purposes such as equalizing inheritances and facilitating buy-sell arrangements. If the client shares business ownership with additional owners, the life insurance may provide cash available for the heirs to purchase additional interests or may ensure that the heirs receive a fixed and fair price for the business interests. In the case of business succession where there are multiple heirs that may or may not be active in the business, life insurance benefits may help provide the estate liquidity to ensure that each family member is treated fairly between heirs who may inherit the business and other members who may receive an equivalent value from the estate.

Ultimately, when it comes to planning for estate taxes as part of an overall estate and business succession plan, it's not a "this or that" approach. In the end, the use of life insurance as a proactive planning approach does not forsake the heirs' ability to still utilize a §6166 installment election but may provide them needed flexibility to meet estate obligations while managing the client's legacy for future generations.

1. Small Business Facts: The Importance of Business Ownership to Wealth, U.S. Small Business Administration Office of Advocacy, Brian Headd, August 2021. (https://advocacy.sba.gov/2021/08/17/small-business-facts-the-importance-of-business-ownership-to-wealth/)
2. 26 U.S.C. §6166 – Extension of time for payment of estate tax where estate consists largely of interest in closely held business.
3. 26 U.S.C. §6601(j)
4. 26 U.S.C. §6166(b)(2)

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Loans and withdrawals will reduce the death benefit and the cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Withdrawals in excess of the cost basis (premiums paid) will be subject to tax and certain withdrawals within the first 15 years may be subject to recapture tax. Additionally, policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59½. Withdrawals are available after the first policy year.

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 tax). Failure to do so could result in adverse tax treatment of trust proceeds. There can be costs associated with drafting a trust.

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