

Section 6166 – Deferring Estate Taxes

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, there may be concerns about heirs being forced to sell the business or its assets to pay estate taxes. For these reasons, a business owner may be considering the costs and benefits of using Internal Revenue Code (IRC) Section 6166 – the temporary deferral of certain estate taxes and paying them on an installment basis.

How It Works

The installment election under §6166 is available to the estate of a U.S. citizen or legal resident, where the value of interest in the closely-held business accounts for more than 35% of the adjusted gross estate.¹ 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.

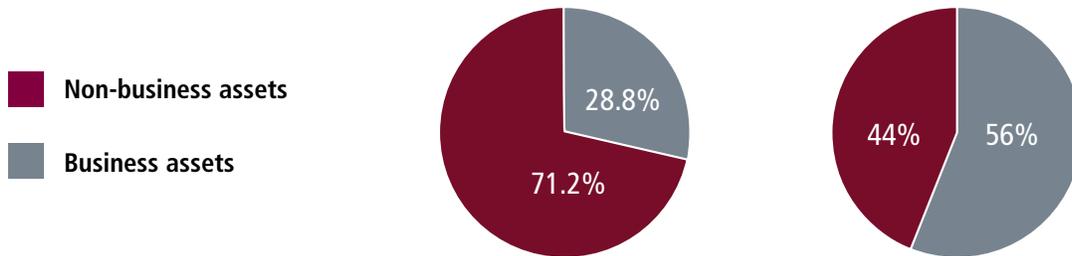
Generally, a business interest is defined under IRC §6166(b) as (1) an interest as a sole proprietor; (2) a partnership interest if 20% or more of the total capital interest in such a partnership is included or the partnership had 45 or fewer partners; or (3) stock in a corporation if 20% or more of the voting stock is included or the corporation had 45 or fewer shareholders. These rules also require that the business interest be an “active” interest; consequently, passive ownership interests would not qualify for deferral.²

Under Section 6166, the estate would elect to defer payment of estate taxes that are due on the proportional value of the business in relation to the overall estate value. The election can push back tax payments for up to 5 years³ (although interest is due starting in year one), 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 years⁴ to pay the required estate tax. A portion of the estate tax⁵ owed 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.⁶

To secure its interest in the estate tax liability, the government may require the estate to provide a surety bond or agree to an extended estate tax lien.

HYPOTHETICAL CASE EXAMPLE

	DOES NOT QUALIFY FOR ESTATE TAX DEFERRAL	MAY QUALIFY FOR ESTATE TAX DEFERRAL
Value of Gross Estate	\$9 million	\$11 million
Value of Decedent's Closely Held Business	\$2.3 million	\$5.88 million
Deduction for Debts, Funeral and Administrative Expenses	\$1 million	\$500,000
Adjusted Gross Estate	\$8 million	\$10.5 million



IRC Section 6166 allows estate taxes to be deferred if the interest in a closely held business exceeds 35% of the decedent’s gross estate and the business qualifies as an active trade or business.

Benefits of 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.

Where Does Life Insurance Fit In?

As mentioned above, 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 immediate estate tax burden that it would not be able to defer under §6166. Moreover, with a bond or lien placed on the estate, the IRS 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.

Life insurance provides 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.

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

Additional Benefits

- 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. Gifts made within 3 years of death will be considered for the 35% of adjusted gross estate test.⁷
- When considering tax deferral under §6166, the implications for using other planning options, including an Installment Sale of the Business to a Defective Trust,⁸ 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.

Conclusion

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 standalone source of liquidity without the limitations that apply to §6166.

¹ Due to the variety of possible circumstances, special rules apply to a business’ 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. The “adjusted gross estate” is calculated by taking the gross estate (including the valuation of the business) and subtracting certain deductions such as debts, funeral expenses, and administration costs. See IRC sec 6166(b)(6).

² 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.

³ Deferment applies only to estate tax due. Interest on that tax must be paid annually. See IRC §6166(f).

⁴ The first installment payment is required to be paid before the end of the 5th year after the 6166 election has been made on the estate tax return. After the first installment payment, the estate must make a subsequent payment each year for up to 9 years (for a total of 10 installments). As such, the total possible payment period is 14 (not 15) years. IRC §6166(a)(3) and (f).

⁵ This is the tax on the indexed value of \$1,480,000 for deaths in 2016, less the applicable credit amount.

⁶ The rate charged on balances owed to the IRS. For individuals and small corporations, it is the short-term applicable federal rate (AFR) for the first month of the previous quarter (rounded to the nearest full percent) plus three percentage points. This rate changes quarterly.

⁷ IRC §2035(c).

⁸ 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.

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