



LIQUIDITY FOR THE BUSINESS OWNER'S ESTATE

As the owner of a closely held business, your estate's liquidity could be particularly important to you. If that business represents a large portion of your estate, you 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, you may also be considering how best to create liquidity to help heirs meet the estate tax obligation and other cash needs.

THE SOLUTION

For this reason, you may be considering the costs and benefits of using Internal Revenue Code (IRC) Section 6166. If it qualifies, your estate could elect under this Section to temporarily defer certain estate taxes, and subsequently pay them on an installment basis. You 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 DOES §6166 WORK?

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 business¹ accounts for more than 35%² of the adjusted gross estate. In order to take advantage of estate tax deferral under this Section, your estate would file an election no later than the timely filed estate tax return.

Your estate would elect to defer payment of estate taxes due on the proportional value of the business.³ The election can push back tax payments by up to 5 years⁴ and then enables your estate to pay those taxes in up to ten equal installments after the deferral. Your estate

can therefore acquire up to 14 years⁵ to pay. A portion of the estate tax⁶ 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.⁷

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 and may be a more cost-efficient method of paying estate taxes.
- Life insurance provides your estate the liquidity it needs exactly when it is needed, regardless of whether your estate qualifies for tax deferral under §6166, and can remove uncertainty about how the future tax installments will be paid.
- Life insurance may be a more cost-efficient method of paying estate taxes than the tax deferral provided for under the §6166 election.

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 your other estate assets do not qualify for special treatment under §6166.
- Your estate must qualify for the tax deferral opportunity under §6166. One requirement is that the interest must be in an active trade or business.⁸ Gifts made within 3 years of death will be considered for the 35% of adjusted gross estate test.⁹
- When considering tax deferral under §6166, the implications for using other planning options, including an Installment Sale of the Business to a Defective Trust,¹⁰ must be taken into account.
- Tax deferral under §6166 may require security or a lien against the business or its assets.¹¹
- 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.

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. Deferment 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 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.
9. IRC §2035(c).
10. 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.
11. 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.

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