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Don't Let Estate Taxes Force the Sale of Your Family Business

Create a Plan to Minimize Estate Taxes While Increasing Liquidity

Many family business owners spend years nurturing their companies with the goal of providing a livelihood for their heirs. However, too often their estates lack the cash to pay estate taxes and other expenses, which can force the eventual sale of the business. If you're concerned that your heirs will face this predicament, you may benefit from considering Internal Revenue Code Section 6166, which allows a portion of estate tax to be deferred.

The 35% Test

If you're an owner of a closely held business and a citizen or resident of the United States at the time of your death, your estate can potentially qualify for Sec. 6166 treatment. The test is whether the value of the interest in your business exceeds 35% of your adjusted gross estate.

There are a few rules to consider when applying the 35% test. If you're a sole proprietorship, only the assets used in the company are considered when valuing the business. And the value of passive assets held by your business can not be included in the valuation.

If you have multiple companies, you must have owned at least 20% of each to combine the businesses for the 35% test. There's also a general rule that businesses with more than 45 owners won't qualify, although there are exceptions.

The Nuts and Bolts

If your estate qualifies for Sec. 6166 treatment, your heirs can pay the estate tax in two or more (but not exceeding 10) equal installments over 10 years. In addition, they can defer payment of the first tax installment for up to five years beyond the date it would have ordinarily been due. During the deferral period, interest must be paid annually. The first principal installment is due at the same time that the last interest-only payment is due.

A special interest rate of 2% is available on the first \$1 million in taxable value, which is adjusted annually for inflation. (For 2013, the deferral amount is \$1.43 million.) Interest on any balance of the tax is assessed at 45% of the annual interest rate charged on the underpayment of tax. With interest rates so low, as of this writing the special 2% rate is actually higher than the rate on the excess, which is currently a mere 1.35%.

Sec. 6166 does not apply to the entire amount owed on the estate. The amount of estate tax that may be paid in installments is the proportional amount attributable to the business's value as compared to the amount of your adjusted gross estate. The remaining estate tax is due nine months after your death.

Real estate qualifies as long as there's been active management of the property — that is, if those assets are more than passive real estate investments.

The Negatives

To minimize taxes and maximize cash flow, you should assure that your heirs understand the potential disadvantages of tax deferral under Sec. 6166. First, keep an eye on tax liens. To ensure that installment payments are made, the IRS will place a tax lien on your family business, and your estate will remain open and unresolved during the installment period. The greater the debt, the more likely it will adversely affect the company's credit and hinder its ability to raise funds.

Nonbusiness interest is another hotspot with the IRS. Deferred payments can't be used to cover federal estate taxes for such interests. Your estate will need enough cash to pay for administrative expenses and accounting and legal fees for 14 years. It also will need sufficient liquidity to cover cash bequests, state death taxes, additional federal estate taxes, and interest and principal for the deferred estate tax.

If a scheduled payment is missed, the IRS can demand immediate payment of all unpaid taxes. Even if your estate pays the installments on time, there are certain circumstances under which the deferral is lost and the balance due will be accelerated. For instance, the full balance will become due if the business is sold to someone who isn't considered a "qualified" heir.

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If you have any questions, please feel free to contact your Seiler professional at (650) 365-4646 or email info@seiler.com. We would be happy to discuss appropriate courses of action for your particular circumstance.

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Silicon Valley Office

Three Lagoon Drive, Suite 400
Redwood City, CA 94065
Main: 650.365.4646
info@seiler.com

San Francisco Office

220 Montgomery Street, Suite 300
San Francisco, CA 94104
Main: 415.392.2123
info@seiler.com

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