THE ESTATE PLANNER

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ESTATE TAX RELIEF FOR FAMILY BUSINESSES

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Sec. 6166

Estate tax relief for family businesses

Now that the gift, estate and generation-skipping transfer (GST) tax exemptions have more than doubled to an inflation-adjusted $11.18 million for 2018 ($22.36 million for married couples), fewer people are subject to transfer taxes than ever before. But these taxes continue to place a burden on families with significant amounts of wealth tied up in illiquid closely held businesses.

Fortunately, Internal Revenue Code Section 6166 provides some relief, allowing the estates of family business owners to defer estate taxes and pay them in installments if certain requirements are met.

Sec. 6166 benefits

For families with substantial closely held business interests, an election to defer estate taxes under Sec. 6166 can help them avoid having to sell business assets to pay estate taxes. It allows an estate to pay interest only (at modest rates) for four years and then to stretch out estate tax payments over 10 years in equal annual installments. The goal is to enable the estate to pay the taxes out of business earnings or otherwise to buy enough time to raise the necessary funds without disrupting business operations.

Be aware that deferral isn't available for the entire estate tax liability. Rather, it's limited to the amount of tax attributable to qualifying closely held business interests. For example, if the value of an interest in a closely held business were equal to 60% of the adjusted gross estate, 60% of the tax would be eligible for deferral. The remaining 40% would be payable within nine months after the decedent's death.

Sec. 6166 requirements

Estate tax deferral is available if 1) the deceased was a U.S. citizen or resident who owned a closely held business at the time of his or her death, 2) the value of the deceased's interest in the business exceeds 35% of his or her adjusted gross estate, and 3) the estate's executor or other personal representative makes a Sec. 6166 election on a timely filed estate tax return. Typically, the estate is required to provide security for future tax payments by furnishing a bond or allowing a tax lien to be filed against the business or other assets.

To qualify as a "closely held business," an entity must conduct an *active* trade or business at the

Does Sec. 6166 apply to real estate businesses?

When an entity owns rental real estate, the line between active business and passive investment can be blurred. To determine whether an entity is an active business entitled to the estate tax deferral benefits of Section 6166, the IRS examines several factors, including 1) the amount of time the deceased or his or her employees, including the entity's employees, devote to the business, 2) whether the entity maintains an office with regular business hours, 3) the extent to which the deceased or his or her employees provide services beyond the mere furnishing of leased premises (for example, landscaping or grounds care), and 4) the extent to which the deceased or his or her employees arrange, perform or supervise repairs and maintenance and handle tenant repair requests or complaints.

IRS guidance recognizes, however, that real estate businesses often engage third parties to handle day-to-day real estate activities. But using independent contractors doesn't prevent an entity from qualifying as an active trade or business, so long as its activities go beyond "merely holding investment property."

time of the deceased's death (and only assets used to conduct that trade or business count for purposes of the 35% threshold). Merely managing investment assets isn't enough. Distinguishing between an entity that conducts an active business and one that holds passive investments can be a challenge, particularly when it owns rental real estate. (See "Does Sec. 6166 apply to real estate businesses?" above.)

In addition to conducting an active trade or business, a closely held business must be structured as:

- A sole proprietorship,
- A partnership (including certain limited liability companies taxed as partnerships), provided either 1) 20% or more of the entity's total capital interest is included in the deceased's estate, or 2) the entity has a maximum of 45 partners, or
- A corporation, provided either 1) 20% or more of the corporation's voting stock is included in the deceased's estate, or 2) the corporation has a maximum of 45 shareholders.

Several special rules make it easier to satisfy Sec. 6166's requirements. For example, if an estate holds interests in multiple closely held businesses, and owns at least 20% of each business, it may combine them and treat them as a single closely held business for purposes of the 35% threshold. In addition, the section treats stock and partnership interests held by certain family members as owned by the deceased. That means the estate can count interests held by the deceased's spouse, siblings, ancestors and lineal descendants toward the 35% and 20% thresholds.

On the other hand, the interests owned by corporations, partnerships, estates and trusts are attributed to the underlying shareholders, partners or beneficiaries. This can make it harder to stay under the 45 partner/shareholder limit.

Softening the blow of estate taxes

If you own a family business, it pays to investigate whether your estate will qualify for an estate tax deferral under Sec. 6166. The ability to pay the tax over time can help your family avoid a forced sale of business assets.

Put pen to paper

A letter of instruction and a mission statement add clarity to an estate plan

If you've ever experienced the death of a loved one, you know what an upsetting and sometimes confusing time the aftermath can be. Legally binding documents, such as a will or living trust, spell out your final wishes. But including a letter of instruction and a mission statement in your estate plan can go even further to help your family through a difficult period.

Letter of instruction

Begin your letter of instruction by stating the location of your will or living trust. Then create an inventory of all your assets and include their location, any account numbers and relevant contact information. This may include, but isn't necessarily limited to, the following items:

- Checking and savings accounts,
- Retirement plans and IRAs,
- Health and accident insurance plans,
- Business insurance,
- Life and disability income insurance,
- Records of Social Security and VA benefits,
- Stocks, bonds, mutual funds and other investments,
- Safe deposit boxes and vaults and their contents,
- Information on real estate holdings,
- Information on credit cards, loans and debts,
- Social Security number and birth certificate,
- Passports and other identification papers,
- Copies of tax returns,
- Any divorce or citizenship papers, and
- Any tangible assets not readily found.

The contact information should include the names, phone numbers and addresses (including emails) of the professionals handling your financial accounts and paperwork, such as an attorney, CPA, banker, life insurance agent and stockbroker. Also, list the beneficiaries of retirement plans, IRAs and insurance policies and their contact information.

And don't forget the location of the items and any passwords, PINs or other information needed: Your heirs can't access a safe without the key or combination, nor will they be able to access your information online.

Remember that a letter of instruction is more than just a listing of assets and their locations. Typically, it will include other items of a personal nature, such as funeral, burial or cremation arrangements and accounting of fees paid for cemetery plots or mausoleums. Also important to add are the names,

addresses and telephone numbers of people and organizations to be notified upon death, and specific instructions for handling personal and financial affairs after you're gone.

A letter of instruction is more than just a listing of assets and their locations.

The letter can expand on instructions in a living will or other health care directive. For example, it might provide additional details about the decision for being taken off life support systems. It may also cover charitable contributions you wish to be made after death or how property should be donated to charity.

Mission statement

Many people today are moving away from a rules-based approach to estate planning and embracing a principles-based approach. Rather than conditioning a child's inheritance on a rigid list of "acceptable" behaviors, for example, a principles-based approach allows greater flexibility for trustees and others to make decisions based on the values you wish to promote.

A family mission statement can be an invaluable tool for defining and communicating these principles and values. Because each family is different, there's no cookie-cutter formula for drafting this document. The most important thing is for the statement to define your family's shared values, whatever they may be.

Articulate your wishes through clear writing

Lending your voice in the form of a letter of intention or a mission statement can be a source of comfort and clarification to grieving loved ones after your death. As with your other estate planning documents, be sure to review your letter or mission statement periodically and make revisions as necessary.

Asset protection

A hybrid DAPT offers the best of both worlds

The Tax Cuts and Jobs Act reduces or eliminates federal gift and estate taxes for most people (at least until 2026). One benefit of this change is that it allows you to focus your estate planning efforts on asset protection and other wealth-preservation strategies, rather than tax minimization.

If you're concerned about personal liability, you might consider an asset protection trust to shield your hard-earned wealth against frivolous creditors' claims and lawsuits. Foreign asset protection trusts offer the greatest protection, although they can be complex and expensive. Another option is to establish a domestic asset protection trust (DAPT) in one of the 17 states that currently offer them. (You don't necessarily have to live in one of those states.)

The benefit of a DAPT is that it offers creditor protection even if you're a beneficiary of the trust. But there's also some risk: Although many experts believe they'll hold up in court, DAPTs are relatively untested, so there's some uncertainty over their

ability to repel creditors' claims. A "hybrid DAPT" offers the best of both worlds. Initially, you're not named as a beneficiary of the trust, which virtually eliminates the risk described above. But if you need access to the funds down the road, the trustee or trust protector can add you as a beneficiary, converting the trust into a DAPT.

Do you need this trust type?

Before you consider a hybrid DAPT, determine whether you need such a trust at all. The most effective asset protection strategy is to place assets beyond the grasp of creditors by transferring them to your spouse, children or other family members, either outright or in trust, without retaining any control. If the transfer isn't designed to defraud known creditors, your creditors won't be able to reach the assets. And even though you've given up control, you'll have indirect access to the assets through your spouse or children (provided your relationship with them remains strong).

If, however, you want to retain access to the assets in the future, without relying on your spouse or children, a DAPT may be the answer. Ordinarily, a self-settled trust — that is, one that names you, the settlor, as a beneficiary — isn't protected against creditors' claims. DAPT statutes create an exception to this rule. They provide varying levels of asset protection even though you have access to the trust assets as a discretionary beneficiary.

A hybrid DAPT is initially set up as a third-party trust — that is, it benefits your spouse and children or other family members, but not you.

What are the risks?

DAPTs have existed for years, yet they're rarely tested in court, so there's some uncertainty over their effectiveness. Many experts believe that, if you live in a state with a DAPT statute, a properly designed and funded DAPT will provide protection against creditors' claims. But there's less certainty about the effectiveness of such trusts established by nonresidents.

How does a hybrid DAPT work?

A hybrid DAPT is initially set up as a third-party trust — that is, it benefits your spouse and children or other family members, but not you. Because you're not named as a beneficiary, the trust isn't a self-settled trust, so it avoids the uncertainty associated with regular DAPTs. There's little doubt that a properly structured third-party trust avoids creditors' claims. If, however, you need access to the trust assets in the future, the trustee or trust protector has the authority to add additional beneficiaries, including you. If that happens, the hybrid account is converted into a regular DAPT subject to the previously discussed risks.

A flexible tool

The hybrid DAPT can add flexibility while offering maximum asset protection (short of an offshore trust). It also minimizes the risks associated with DAPTs, while retaining the ability to convert to a DAPT should the need arise. Talk with your estate planning advisor to assess whether a hybrid DAPT is right for you.

ESTATE PLANNING RED FLAG

Your charitable gifts are unrestricted

If philanthropy is an important part of your legacy, consider taking steps to ensure that your donations are used to fulfill your intended charitable purposes. Outright gifts can be risky, especially large donations that will benefit a charity over a long period of time.

Even if a charity is financially sound when you make a gift, there are no guarantees it won't suffer financial distress, file for bankruptcy protection or even cease operations down the road. The last thing you want is for a charity to use your gifts to pay off its creditors or for some other purpose unrelated to the mission that inspired you to give in the first place.

One way to help preserve your charitable legacy is to place restrictions on the use of your gifts. For example, you might limit the use of your funds to assisting a specific constituency or funding medical research. These restrictions can be documented in your will or charitable trust or in a written gift or endowment fund agreement.

Depending on applicable federal and state law and other factors, carefully designed restrictions can prevent your funds from being used to satisfy creditors in the event of the charity's bankruptcy. If these restrictions are successful, the funds will continue to be used according to your charitable intent, either by the original charity (in the case of a Chapter 11 reorganization) or by an alternate charity (in the case of a Chapter 7 liquidation).

In addition to restricting your gifts, it's a good idea to research the charities you're considering, to ensure they're financially stable and use their funds efficiently and effectively. One powerful research tool is the IRS's Tax Exempt Organization Search (TEOS). (You can find the link by searching for "TEOS" at irs.gov.) TEOS provides access to information about charitable organizations, including newly filed tax returns (Form 990), IRS determination letters and eligibility to receive tax-deductible contributions.

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