WP 90X

90 MINUTES OF EXTRAORDINARY EDUCATION

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Welcome to

Making the 6166 Election: What You Don't Know Can Hurt You

Thursday, August 24, 2023| 8:00-9:30am

Available Via Video Conference

NASBA CPE Credit: 1 hour for CPAs

CFP Credit: 1 hour

- Learning Objectives
  - Provide an overview of IRC §6166
  - Define the unintended consequences when utilizing §6166
  - Identify client situations where §6166 should and shouldn't be considered
  - Evaluate various alternative strategies to pay estate taxes
- Q&A
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Estate Tax Overview

- Estate tax applies on the value of an individual's net worth above the available estate tax exemption amount
- 2010: Heirs had a choice of utilizing a $5M exemption and a 35% estate tax rate or $0 exemption, 0% tax rate and modified basis rules

Estate Tax Calculation - Sample

Adam's Assets	$	100,000,000
Less: Applicable Discounts*	$	(25,000,000)
Discounted Value	$	75,000,000
Less: Estate Tax Exemption	$	(12,960,000)
Taxable Estate	$	62,040,000
Estate Taxes @ 40%	$	(24,816,000)

** Applicable discounts of 33% applies to $75M operating business*

- Table above reflects a sample estate tax calculation
- Discounts may apply to certain assets when determining "fair market value"
  - Applies to operating businesses, real estate, etc.
    - Depends on entity structure and character/type of asset
  - Common discounts include minority interest and lack of marketability
    - Typical discounts can range from 15% - 45%
  - Discount availability and amount are determined by a certified valuation expert

§6166 Overview & Analysis

§6166 OVERVIEW

- §6166 allows for an installment payment of the estate taxes owed upon the death of a US citizen
  - Election must be filed no later than the due date for the estate tax return
  - Only applicable where the value of the deceased's ownership in a closely held business interest is more than 35% of the adjusted gross estate value
    - Adjusted gross estate = gross estate value less deductions for expenses, debts, taxes and losses

- Definition of a "business interest"
  - Interest in a sole proprietorship
  - A partnership interest if 20% of more of the total capital interest in such partnership is included or the partnership has 45 or fewer partners
  - Stock in a corporation if 20% of more of the voting stock is included or the corporation had 45 or fewer shareholders
  - Note: Must be an active interest (passive ownership does not qualify)

§6166 Payment Calculation & Terms

- §6166 results in a deferred payment of the estate taxes that are due on the proportional value of the business in relation to the overall adjusted gross estate value
  - Election defers payments of the estate tax for up to 5 years
    - Initial interest payment is due upon filing of the estate tax return
    - Annual interest payments are due for the following years
  - After the interest-only period, the estate can pay the estate tax in up to 10 equal installments
  - Results in the equivalent of a 4-year deferral and 14-year payment period

- §6166 interest throughout the installment period is calculated as follows:
  - 2% interest up to specific dollar amount ($1.64M in 2022; adjusted for inflation)
  - Tax exceeding the 2% interest portion incurs interest at 45% of the current regular tax underpayment rate
    - Currently 3.15% (45% * 7% underpayment rate)

- Deferral is attractive on the surface, but often comes at a significant cost

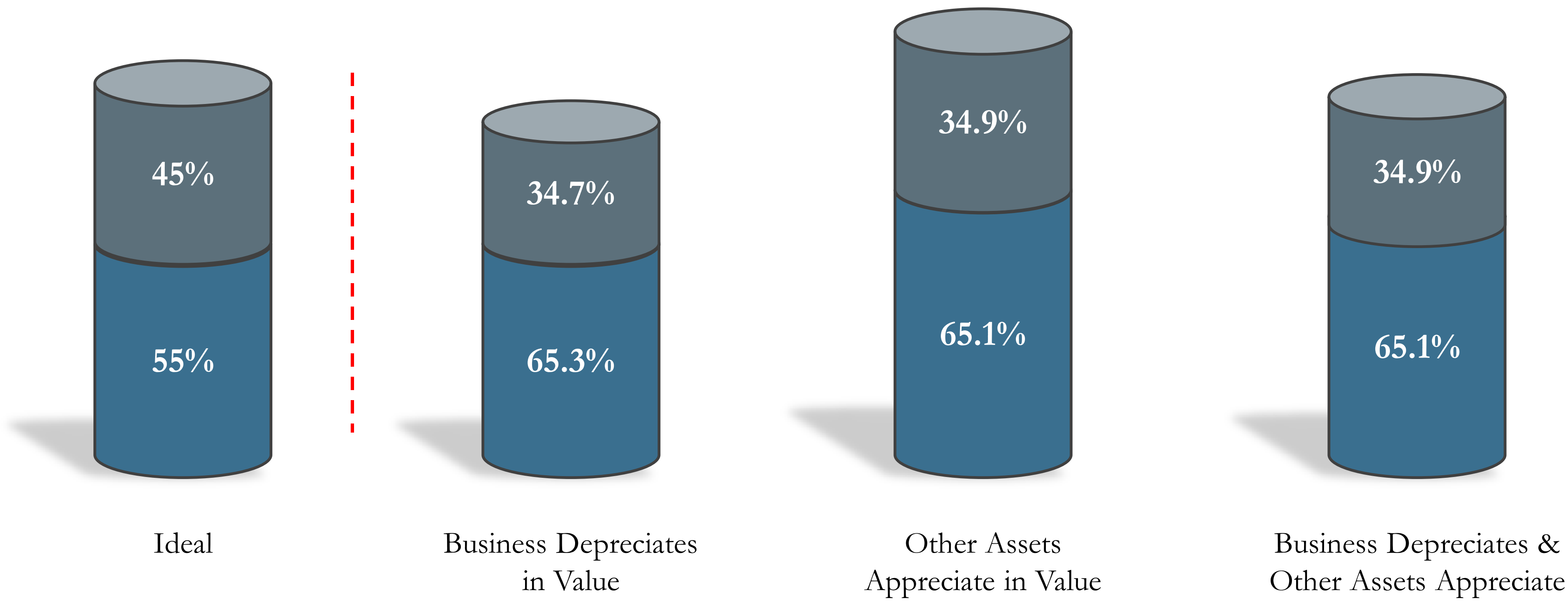
§6166 Valuation Concerns

- Deferral only applies to the proportional share of business value relative to total estate value
  - Estate tax incurred on all other assets is not eligible for a deferral

- The value of the business interest must be 35% or more of the total adjusted estate value
  - This can create a problem in a variety of situations:
    - Use of discounts to determine the value of the business
    - Prior gifting may result in the taxable estate not meeting that requirement
    - Appreciation of assets outside the value of the closely held business may impact this 35% threshold
    - Prior planning – including a buy-sell agreement and other estate planning techniques (i.e. successfully executed GRAT)

- Disincentivizes future estate planning and wealth transfer strategies
  - Where is a safe place to stop?

§6166 Implications on Estate Planning



- Ideal scenario assumes a 45%/55% split between operating business and other assets
- Fluctuation in asset values can eliminate §6166 as a viable option for payment of estate taxes
- Scenarios where an estate will not qualify for §6166 (35% business interest threshold)
  - If business value decreases by 35% (assumes other assets value remains the same)
  - If other assets value increases by 52% (assumes business value remains the same)
  - If business value declines by 20% and other assets increase by 20%

§6166 General Concerns

- Interest payments on installment note are not deductible
  - Interest rate above the 2% portion adjusts annually

- Payments must be made timely
  - Any default will result in immediate acceleration of the entire estate tax balance

- If more than 50% of the business is sold, the loan will be called and the estate tax will be due

§6166 COLLATERAL CONCERNS

- §6166 results in security and/or a lien against the business or its assets
  - Stock in the business can only be acceptable collateral if three requirements are met:
    - Collateral must be expected to survive the deferral period
    - Collateral must be identified in the agreement
      - All parties that have an interest in the collateral must consent to the lien
      - Eliminates any privacy in the Family's planning
    - Value of collateral must be sufficient to pay the deferred taxes plus required interest
  - IRS has the right to monitor the value of the collateral throughout the life of the lien
    - Can request additional collateral if necessary to satisfy the financial requirements
    - If no additional collateral is provided, then the IRS may declare an acceleration of the payments
    - Annual audits may occur to determine the sufficiency of the collateral

§6166 Lien/Creditor Considerations

- IRS will file a Notice of Federal Tax Lien to document the arrangement
  - IRS also has the right to request and possess company stock certificates to ensure the business isn't sold while the lien is outstanding

- IRS has the option to be in 1st position on assets
  - Not subordinated to bank debt – it's their choice and could be subject to change
  - Could throw loans into technical default

- Could have a significant impact on banking, investments, other shareholders, etc.

Case Study

Client Fact Pattern

- Angela is a single female age 52 with an estate value of $177M
  - Business value: $121,000,000
  - Note receivable: $40,000,000
  - Real estate: $5,500,000
  - Liquid assets: $14,600,000
  - Other assets: $49,000
  - Debt: $3,700,000

- Analysis projects an average annual growth rate of 5% on all assets

- Angela has all her estate tax exemption available
  - Assuming a 2.5% annual increase for inflation

- Assumes maintaining a minimum cash balance equal to 5% of her illiquid net worth upon her passing – after all estate taxes are paid

- Angela and her advisors would like to explore all options to solve the ever-growing estate tax issue, including §6166

Estate Tax & Estate Liquidity Calculation			
Angela's Age	52	72	92
Year	2023	2043	2063
Net Worth	$ 177,788,957	$ 454,587,739	$ 1,182,376,631
Less: Estate Tax Exemption*	$ (12,960,000)	$ (10,618,235)	$ (17,399,214)
Taxable Estate	$ 164,828,957	$ 443,969,504	$ 1,164,977,417
Estate Taxes	**$ 65,931,583**	**$ 177,587,802**	**$ 465,990,967**

**Assumes the exemption sunset in 2026 and a 2.50% annual inflation adjustment to the exemption amount*

Estate Liqudity Calculation			
Estate Taxes	$ 65,931,583	$ 177,587,802	$ 465,990,967
Minimum Cash Balance	$ 8,347,302	$ 18,841,283	$ 46,684,937
Gross Liquidity Need	$ 74,278,885	$ 196,429,084	$ 512,675,904
Total Liquid Assets (inside and outside of the estate)	$ 17,694,079	$ 86,947,660	$ 270,698,027
Estate Liquidity Surplus/(Deficit)	**$ (56,584,806)**	**$ (109,481,424)**	**$ (241,977,876)**

Estate Tax Payment Strategies - Cash Flow Projection - Angela's Life Expectancy				
Death Benefit Projected	$ 58,634,864			
Strategy	Bank Debt	Cash Payment	§6166 Payments	Life Insurance
Total Payments	$96,121,562	$58,634,864	$76,653,167	$6,000,000
NPV	$13,390,188	$10,081,016	$9,447,831	$3,902,381
Cost of a Dollar	**$1.64**	**$1.00**	**$1.31**	**$0.10**
NPV @ 4.50% Rate - Cost of a Dollar	**$0.23**	**$0.17**	**$0.16**	**$0.07**
% Increase Relative to Insurance Funding (total payments)	**1602%**	**977%**	**1278%**	
% Increase Relative to Insurance Funding (NPV @ 4.50%)	**343%**	**258%**	**242%**	

- Angela's life expectancy is assumed to be age 91
- Bank debt assumptions: 8% interest rate; 10-year term
- Cash payment assumes the cash balance inside and outside of the estate equals the amount due
  - We don't know when Angela will die!
  - Lost opportunity cost on the cash during lifetime
  - Cash inside estate needs to be "grossed up" to account for estate taxes
- §6166 assumes payments over 14-years as described previously in this presentation
- Life insurance assumes $300,000 in annual cost over 20 years

OTHER PLANNING CONSIDERATIONS

- Philanthropic strategies – Non-business assets
  - Qualified Charity
  - Family Foundation

- Advanced estate planning/wealth transfer strategies
  - Defective Trust Sales
  - Grantor Retained Annuity Trusts (GRATs)
  - Other related strategies

- Strategies above do not create liquidity for estate taxes; they simply reduce/freeze the size of the total estate
  - There is a need to do both

LEARNING OBJECTIVES ACHIEVED

- Learning objectives achieved:
  - ✓ Provide an overview of IRC §6166
  - ✓ Define the unintended consequences when utilizing §6166
  - ✓ Identify client situations where §6166 should and shouldn't be considered
  - ✓ Evaluate various alternative strategies to pay estate taxes


Q&A

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