



Life insurance and the real estate owner: Why most are candidates for IRC Section 6166 tax deferrals

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Why are most real estate owners' prime candidates for Internal Revenue Code (IRC) Section 6166 deferral of their estate taxes? Most successful real estate owners are astute people, who have accumulated wealth over their lifetimes. The typical real estate owner is usually woefully underfunded, when it comes to having adequate life insurance, to pay Uncle Sam for federal and state estate taxes upon their death. More often than not, a lifetime of building up a portfolio of real estate has to be partially dismantled to pay estate taxes, due to the lack of proper planning.

Unless the estate tax owner is flush with cash, or has adequate life insurance, the family of the deceased real estate owner will be hit with a tremendous federal and state estate tax bill nine months after the decedent's death. The executor/executrix of an estate may request an extension of time to pay. In typical situations, where the personal representative does not have adequate cash to pay the estate tax, the Internal Revenue Service (IRS) allows the estate, under IRC section 6166, to pay the tax in installments under certain circumstances. One of these circumstances is IRC section 6166, which allows an illiquid estate that consists of closely held business interests of the decedent, with the potential to avoid selling off assets, while marshalling cash to pay the estate tax, in annual installments, over a period of time not to exceed ten years. An election is available to defer the first annual installment payment for a period not to exceed five years. During this deferment period interest is payable annually at a statutory nominal rate.

Only the estate tax attributable to the closely held business of the decedent, which must be at least 35% of the value of the adjusted gross estate, will qualify for deferred installment payments. The decedent's interest must be in a business that is closely held. This requirement is satisfied if the decedent is a sole proprietor; a partner in a partnership with no more than 45 partners, or where at least 20% of the capital interest in the partnership is owned by the decedent. Another requirement is that the trade or business must be active, as compared to a passive investor. Most real estate owners that are considered "real estate professionals" are therefore active.

With proper estate planning, via numerous legal structures and discounts, along with adequate life insurance, an estate can avoid being forced to use the 14-year installment plan and associated costs. However, many real estate owners often use any excess available cash to either upgrade their existing property or acquire additional real estate. There are options available that may give an estate the necessary liquidity to pay the estate taxes, without forcing the sale of any property.

Premium financing is a strategy that can help obtain a needed life insurance death benefit. Typical premium financing is a fair market loan arrangement between a lender and an irrevocable life insurance trust (ILIT), where the lender loans the premiums for a life insurance policy on a person's life to the ILIT. The gift to the ILIT is equal to the amount of the loan interest, not the entire policy premiums. Therefore, one is able to acquire the death benefit needed with little or no gift tax impact.

Real estate assets do not have to be liquidated to pay premiums or estate taxes, while maintaining real estate assets in their portfolio.

Premium financing can be used with proper estate tax planning, when an individual wishes to obtain a large amount of life insurance for purposes of estate tax liquidity. If the life insurance policy is held outside of the estate, typically in a trust, premium financing can provide gift tax leveraging because you will not have to gift the premiums. If the loan interest is paid annually, you will have the option to use the annual and lifetime gift tax exemption to reduce the taxes due on the annual loan interest gifts.

There are many advantages for using premium financing. However, there are other factors that one must take into consideration with this strategy. Too many real estate owners, who have acquired and built an empire, often fail to take advantage of numerous estate tax and life insurance planning opportunities that can leave their life's work to the next generation fully intact.

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