Is your estate liquid enough to cover estate taxes?

In estate planning, as in business, cash is king. You may have invested a great deal of effort in designing a plan that provides financial security for your family, motivates your children to excel and provides for a smooth transition of your business to the next generation. But unless your plan also provides sufficient liquidity to pay federal and state estate taxes and other expenses, it may be at risk.

If the bulk of your wealth is tied up in a closely held business, for example, it may be difficult for your heirs to pay estate taxes without being forced to sell the business. In addition, your family may need funds to keep the business going after your death.

Liquidity tools

For many people, the primary source of liquidity is life insurance, which creates a quick source of cash that your heirs receive income-tax-free. To maximize the value of a life insurance policy, it's important to plan carefully.

First, consider setting up an irrevocable life insurance trust “(ILIT”) to purchase and hold the policy, and then contribute funds to the ILIT to cover the premium payments. An ILIT keeps the policy out of your estate and avoids estate taxes on the proceeds, leaving more for your family.

Your contributions to the ILIT generally are treated as taxable gifts. But you can reduce or even eliminate gift tax by using your annual exclusions and lifetime exemption.

If you already own a policy, it's a good idea to remove it from your estate as soon as possible. If you qualify for a new policy at a reasonable price, consider cashing in or terminating your current policy and using an ILIT to purchase a new one.

Otherwise, you can transfer your current policy to an ILIT (subject to gift tax on its cash value). Keep in mind, however, that you must survive for at least three years after the transfer to avoid estate taxes on the proceeds.

Other liquidity tools include:

- Buy-sell agreements, under which the business or its surviving owners purchase some or all of your shares from your heirs — typically, these agreements are funded by one or more life insurance policies;
- IRAs, 401(k) plans and other tax-advantaged retirement plans — but bear in mind that there may be severe income tax consequences from liquidating these assets, and there's the risk that you'll be forced to sell the underlying investments at a time when you'd prefer not to do so; and
- Traditional investments in stocks, bonds and mutual funds — here, too, it's important to consider the investment consequences of a forced sale. In addition, there could be potential income tax consequences.

And of course there are bank accounts, money market funds and shorter-term CDs.

Postmortem strategies

If those liquidity tools fail to meet your family's liquidity needs, there are several postmortem strategies your heirs can use to soften the blow of estate taxes. These include:

Borrowing**.** It may be possible for your representatives to borrow the funds needed to pay taxes and other expenses from a bank, family members or a family business. If the estate's illiquidity makes borrowing necessary, and certain other requirements are met, it may even be able to deduct projected interest payments.

Applying for an extension**.** Estates with liquidity challenges may qualify for extensions as long as 10 years on hardship grounds. Often, an estate can establish hardship by demonstrating that it would be required to sell assets at a loss to pay the taxes when due.

Deferring taxes**.** Your estate can defer taxes attributable to a qualifying closely held business by paying interest for only 5 years and then paying the tax and additional interest in 10 annual installments. This option is available if one or more closely held businesses account for more than 35% of your estate and certain other requirements are met.

Don't delay

Providing liquidity for your estate plan takes time. The earlier you start planning, the greater the chances that you'll succeed. Please ask us for more information in your situation.

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