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Legacy Planning, Once Removed

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May 20, 2026

Once Removed: **Estate Tax Planning for the Family Business**

Episode 57 Summary

In many cases, an estate plan features a prominent asset such as a family business, which many owners hope to pass on to the next generation. But statistics reveal that few family businesses survive to the next generation. One particular obstacle to this succession plan is the estate tax that would be due on the owner's interest upon death. This estate tax liability causes a need for cash that could force a sale of the business.

This episode explores a few strategies that could be used to manage this estate tax liability upon the owner's death. These strategies, if properly planned and implemented, could provide a means of managing, reducing or, perhaps, even eliminating that estate tax liability.

Transcript:

(0:00):

Hello and welcome back.

I'm Steve Murphy, a trust and estates attorney with McGuireWoods LLP. And this is Legacy Planning Once Removed my podcast on taxes, trusts, legacy, family, and everything else on my clients' minds.

For those who are returning, again, welcome back. And for those who are new to the podcast, let me say welcome.

On this podcast, we try to help people with estate planning but also with legacy planning, generally.

So, we have a tagline here.

We like to say: Walk like you leave footprints.

We work with clients to put in place their legacy plan, their succession plan, and in many cases, there's a family business or closely held business that is a particular or prominent part of that plan. I really enjoy working with these kinds of businesses and business owners.

I don't like to use the term small business because often these businesses are of considerable size and revenue.

I prefer to use a term like closely held business or family business, meaning a business that is owned by a small group or perhaps just one or two owners.

Perhaps it's the founder or founders, that first generation owner. And in many cases, these businesses have other third-party owners, like a private equity fund that has invested in the business.

But the key to this closely held business or family business is that there's just a small group of owners, and many times they're members of the same family.

And here are some statistics I just pulled together quickly.

(01:41):

According to some studies, more than 90% of all US businesses are family businesses. There are over 20 million family businesses that account for more than 40% of the nation's private sales and more than 95% of all employers.

And for one study, from 1977 to 1990, 78% of all new jobs created in the United States were created by family businesses.

There are many advantages to these family businesses, to owning them, to working for them. But it's estimated that only 30% of these family businesses pass to the second generation, 12% pass to the third generation, and only 3% reach the fourth generation.

These statistics are really staggering for that business owner who wants to continue to pass the business on to further generations.

And there are numerous challenges along the way, as we'll see in this episode and some future episodes.

This episode will talk about one particular challenge: estate taxes.

In these discussions about succession planning, especially for these closely held businesses, tax planning often takes center stage—and this is for good reason.

We know from other episodes that when the federal estate tax applies, it applies at a rate of 40%, and many states have state estate taxes as well.

John Thune is a senator from South Dakota, and a few years ago, he introduced a bill to repeal the federal estate tax altogether.

And he has this to say about the estate tax. I'm going to quote from his website, so you'll see some references to South Dakota, but obviously, it applies to any business.

He says this: "The federal estate tax, commonly referred to as the death tax, imposes a tax rate as high as 40% on a family estate during the transfer of ownership upon the death of a loved one.

Many of these families are the owners of South Dakota ranches, farms, and businesses who have scrimped, saved, and built job-creating businesses, all with the hope and promise of passing their success on to the next generation.

(04:10):

I believe that repeal of the destructive death tax is critical to keeping family farms and businesses intact across South Dakota."

Now, I just quote that to summarize how some people approach this issue of taxes and closely held businesses, which could include farms, ranches, and other operating businesses.

And we know this is a summary by a politician, but this is a significant problem, the plan for this kind of tax.

We know from some other episodes; the estate tax generally must be paid within nine months of the death of a loved one.

This is a particular challenge for these owners of closely held businesses. That cash needs to be provided, and in many cases, that causes a liquidity crunch.

Sometimes the fear is that the family will have to sell the business at a fire sale just to generate the cash to pay those taxes.

Well, there are at least four particular strategies to address this taxation, this liquidity crunch. So here they are, just brief summaries in no particular order.

First, this is a technical one, but my clients actually are most interested in this one. It has to do with deferral of estate tax under a section called Section 6166 of the Internal Revenue Code.

For estates that have a significant ownership interest in a closely held business, this allows the estate to defer the estate tax for five years. Then in year five, the estate has to start paying the estate tax in 10 installments with a favorable interest rate.

So, if you're doing the math, that means it's essentially a 14-year Runway to pay that estate tax. But there are various tests that have to be satisfied to qualify for this deferral, and this is one area where advisors can really help.

(06:18):

In many cases, the estate doesn't yet qualify for Section 6166. So, during the individual's lifetime, the advisors can see this coming and can maybe restructure the ownership to make sure that the estate can make this important election.

And then there are other important rules about Section 6166. After an owner's death, the election has to be properly and timely made, and the payments have to be made on time. And if not, then this deferral is lost and the tax is due immediately.

This might sound obvious, but there are numerous cases where families have engaged in fights after someone's passing, or perhaps there's just uncertainty about these concerns.

That may result in any number of problems for the family. But in this case, there are numerous cases where this kind of uncertainty or fighting has meant that the family has overlooked this important deferral, and they've lost this ability to defer the estate tax.

The second way to provide some liquidity is to borrow the funds. The estate, like any other individual or entity, could borrow the funds from a bank or a third party. Then they have the cash to pay the tax without selling the family business.

And then the estate or the beneficiaries can pay back the loan over time. But many estates or companies might have a challenge taking out such a loan, or it might be based on really high interest rates or other challenging terms.

But there's one technique that can provide a particular advantage for tax purposes. This is called a Gragan loan. It's based on a tax court case that approved of a technique.

Fully structured and properly administered, then the estate can actually take a deduction for the interest it will have to pay on the loan, and this can actually result in considerable tax savings.

But again, it's important that the estate qualify for this kind of tax deduction on the loan. So, this is another issue where an advisor can help with before the death of the business owner to make sure the structure would meet the requirements for certain kinds of loans. It's life insurance.

(08:37):

In many cases, when there's a liquidity problem upon someone's death, that is a common solution.

Just take out some life insurance policies—it's a relatively simple approach.

So, imagine this: upon the death of the business owner, there might be estate tax due, but there's also an influx of cash from the insurance policy.

That can be used to pay the estate tax, it can be used to purchase assets from the estate, so the estate has cash to pay the estate tax, or it can just be used to make up for the lost capital from the payment of the tax.

But there's a few pitfalls with ownership of life insurance in this way. But there's a particular challenge.

If that policy is owned by or controlled by an individual, then the proceeds are included in that individual's estate for estate tax purposes. That triggers additional tax.

So, imagine a business owner dies with a \$10 million life insurance policy.

If that owner controls the life insurance policy in the relevant way during his lifetime, then that could trigger an additional tax of 40% of \$4 million.

So, the estate might anticipate receiving \$10 million of cash to help with estate tax, but that triggers additional tax.

They only have \$6 million net.

So as an alternative, some people like to explore, well, maybe the policy could be owned by the business.

(10:05):

Well, the challenge is that if the business owns a life insurance policy on an owner's life, then that typically increases the value of the business, again, triggering more estate tax.

The US Supreme Court recently and unanimously held that in a recent case called **Connelly versus United States**, and I'll put the full citation in the show notes.

So, what is the solution? Well, often the solution is to have the life insurance policy owned by a third party, and especially it can be owned by an irrevocable trust.

This is a common technique called an irrevocable life insurance trust or ILIT. The idea is the ILIT would own the life insurance policy, and so those proceeds would not be included in the owner's estate for estate tax purposes, be available perhaps to purchase assets from the estate, so the family

business doesn't have to be sold to third parties to generate. And actually, lots of trusts can own life insurance.

So an ILIT is not just one kind of trust. Rather, it's more like a trust could have life insurance elements. So, consider that type of strategy as you're thinking about liquidity planning.

And then last, the fourth group of how to address this liability might be to use some of the other strategies we've talked about on these episodes of giving away some interest in the company during life, so that in that case, those interests of the company are not included in the owner's estate for estate tax purposes.

But those types of gifts bring with it a whole host of other issues, and I've discussed those in other episodes.

(11:48):

But that issue foreshadows some of the challenges of overall succession planning for a business, for ownership, and management after that individual's death. And we'll talk about that.

So, it is true that estate taxes remain a challenge for succession planning for a family business. There are a few strategies available, but still, estate taxes remain an obstacle to that succession plan. And given that estate tax remains an issue, in many cases, the values and amounts of tax due are significant, and again, would typically be due soon after the owner's death.

And this makes for a bumpy ride upon the death of an owner.

But again, there could be strategies available to make sure the plane can land safely. But in the next episode, I'll talk about what we estate planners consider potentially a larger threat to the succession plan of the business.

I mentioned estate taxes might provide for a bumpy landing at the owner's death, but this next concept could be what leads the business to crash and burn.

If you're considering what to do with that closely held business, estate planning attorney and other advisors, they can help you analyze the structure and put in place a plan to meet your needs and avoid some of these pitfalls.

I'm Steve Murphy, and this has been Legacy Planning, Once Removed, my podcast on thoughtful estate planning.

Thanks for listening, and until next time, walk like you leave footprints.