B u l l e t i n

Estate Tax Planning and Succession

INTRODUCTION

Every company, regardless of size, will face succession planning issues at some time. Many experts agree that three of the leading causes of unsuccessful succession are: (1) lack of a succession plan; (2) inability of the company to retain key personnel after the owner exits; and (3) an insufficient personal estate plan.

This management bulletin will address the issues and possible strategies related to estate planning and succession. (See Bulletins CP 3, *How to Get Out and Let Others In* and TX 5, *Employee Stock Ownership Plan,* for discussion of other succession issues.)

All property is subject to potential estate tax upon death. This includes property such as:

- Cash
- Real Estate
- Personal Property
- Retirement Plans
- Investments
- Revocable Trusts
- Tangible Assets
- Annuities
- Life Insurance (in some cases)
- Business Interests

Problems arise for small business owners, especially in small family-owned businesses, when the deceased owner fails to understand the size of the estate and potential tax obligation, and therefore the liquidity needs of the business or estate to meet the tax obligation. As reported by the United States Congressional Budget Office (CBO) in its July 2005 paper entitled *Effects of the Federal Estate Tax on Farms and Small Businesses*:

> "…critics argue that the tax may pose a particular hardship for a small business or family farm. If building up such an enterprise results in a taxable estate without enough liquid assets to pay estate taxes, heirs may have to wholly or partially liquidate the business or farm. Purchasing sufficient life insurance might prevent that problem, but the ongoing cost of paying premiums would reduce the cash flow available to invest in the enterprise."

The business owner who plans successfully for estate issues will address techniques to reduce or eliminate estate taxes, and will provide liquidity to avoid the forced sale of the company.

ESTATE TAX – HISTORY AND CURRENT STATUS

Taxation on estates and property transfers at death can be traced back to ancient Egypt, as early as 700 B.C. The first recorded tax was probably levied by Roman Emperor Caesar Augustus nearly 2,000 years ago, the *Vicesina Hereditatium*, a tax on succession and legacies to all but close relatives. (*The Estate Tax: Ninety Years and Counting*, Jacobson, Raub & Johnson). Although there were many different taxes levied on estates at various times in U.S. history, starting with the Stamp Act of 1797, the modern federal estate tax was enacted by the Revenue Act of 1916 to offset a decline in tariff revenues caused by World War I.

In 2001, sweeping changes were made to the estate tax laws. At that time the top estate tax rate of 55% was applied to all estates over $675,000. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) provided for graduated increasing exemption amounts along with graduated reductions in the tax rate, resulting in elimination of the federal estate tax in 2010. However EGTRRA expired in 2011. Congress and the Obama administration agreed on a new federal tax rate of 35% with an exemption on estates valued at less than $5,000,000 through 2012. Without further Congressional action, the rate will increase to 55%, and the exemption will reduce to $1,000,000 in 2013.

Many states also have estate taxes. Consult your tax advisor or attorney for the specifics.

THE LIQUIDITY PROBLEM

An estate will face specific liquidity needs in the immediate and short term. Among those needs are estate administration expenses, state estate taxes, federal estate taxes, and ongoing family income needs. The sources of liquidity for the estate include the liquid assets of the estate (cash, life insurance, CDs, etc), semi-liquid assets (stocks, bonds and annuities) and non-liquid assets (real estate, business interests, etc.). Where the liquid and semi-liquid assets are insufficient to satisfy the liquidity needs of the estate, the business interest or other non-liquid assets will need to be sold. Not only does such a forced sale alter the company succession plans, but the estate is unlikely to receive fair value for the business, and the sale will result in loss of future income to the family.

While the number of family businesses being sold to provide estate tax liquidity is the matter of some controversy, the CBO estimated that in 2000, one-third of family business estates that qualified for the family business exclusion could not pay the estate tax out of reported liquid assets. *(Effects of the Federal Estate Tax on Farms and Small Businesses*, a Congressional Budget Office paper, July, 2005).

STRATEGIES TO ADDRESS LIQUIDITY PROBLEMS

There are two basic strategies to address liquidity issues. First, either reduce the assets in the estate or shift the assets out of the estate. This can be accomplished through the use of trusts and/or gifting. Second, provide liquidity for the estate primarily through the use of life insurance. These strategies are discussed in more detail below.

Trusts

A trust is simply a legal entity that lets you put conditions on how certain assets are distributed upon your death. A trust differs from a will in that while a will deals with all the property distribution in an estate, a trust may only deal with certain property of the estate. Living trusts are set up during the person’s lifetime. Testamentary trusts are set up in a will and go into effect after the person’s death.

Living trusts can be either “revocable” or “irrevocable.”

- A *revocable trust* allows a person to maintain control over the assets and change the terms of the trust at any time.
- An *irrevocable trust* transfers title in the assets to a beneficiary. A person with an irrevocable trust cannot make changes without the beneficiary’s consent, but the appreciated assets may not be subject to estate tax. Life insurance purchased in an irrevocable life insurance trust can allow a person to provide tax free cash for liquidity to heirs by removing the life insurance proceeds from the taxable estate.

Other more complicated types of trusts can provide additional or alternative strategies.

- *Credit shelter trusts* are a mechanism where a person by will bequeaths an amount up to the estate tax exemption, then passing the rest of the estate to a spouse tax free.
- *Generation skipping trusts* allow a person to pass assets tax free to beneficiaries two generations removed (typically grandchildren).

Gifting

Another mechanism that can be used to reduce or transfer assets out of an estate is gifting. Gifts are normally taxed to the recipient at a rate similar to estates. However there is an annual gift tax exemption of $13,000 per individual recipient per year, and a lifetime gift tax exemption of $5,000,000. In certain situations, a planned strategy of gifting can be an effective estate reduction technique, but the gift tax laws are complex and, like all of these strategies, require financial and legal expertise.

Life Insurance

Finally, life insurance can be a cost effective mechanism to provide liquidity for an estate. As mentioned above, an irrevocable life insurance trust is one method. Life insurance is also commonly used to back up buy-sell agreements, providing a company with liquidity to buy a deceased owner's shares from the estate. Again, expert advice is necessary. There are many types of life insurance, and not all types will be effective in providing the type of liquidity desired in specific situations.

CONCLUSION

The estate tax implications for family run businesses are considerable and complex. This complexity is aggravated by the fact that the estate tax laws change often, and state estate tax laws must also be considered. The estate plan as a part of a company’s succession plan must be carefully considered and updated at least every few years. While business owners may be frustrated by the cost of and time needed with lawyers, financial planners and business appraisers, this is unavoidable given the existing tax system and potential implications to succession of the business. Ultimately the business owner is well advised to use the same focus in preserving the business assets as was used in building them.

This bulletin is not intended to provide legal or financial advice. Please consult your attorney and/or financial advisor for specific advice regarding the information in this bulletin.