Legacy Advisors Group

M & A UPDATE®

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Despite Federal Portability, Estate Planning Still Necessary

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Introduction

As of last year, the estate tax was in a "repealed" status. Anyone passing away in 2010, including the late owner of the New York Yankees, George Steinbrenner, was fully exempt from the estate tax. However, as of January 2011, the estate tax has been reenacted and changed. On the federal level, estates valued at $5 million or less will be completely estate tax free. The highest estate tax rate continues to be 35%. In addition, for federal estate tax purposes, marital and bypass trusts used to be required to take advantage of a spouse's exemption in the estate tax. It is no longer required to have a valid marital bypass trust to take advantage of your spouse's exemption. The federal law allows your estate to automatically use a deceased spouse's exemption to reduce your estate taxes when you die. Spouses have a total of $10 million potential between them. This is very important since the law also states that if a deceased spouse does not use the full $5 million dollars the balance rolls over to the surviving spouse.

State Influence

Until now, most large estates only had to consider federal estate tax consequences. What frustrates the seemingly blissful existence of the first paragraph in this report is that there are two sovereign taxing bodies that are entitled to tax estates. One is the federal government; the other is the state of residency in which the deceased taxpayer lived. In response to the high dollar limit on the estate tax exclusion enacted by the federal government for this year, states have responded. As of February 2011, several states have enacted estate taxes that carry lower exemption amounts. Illinois, for example, has imposed a $2,000,000 exemption.

It is in the state level taxes that martial and bypass trusts become relevant again in tax planning. Illinois, for instance does not have portability with the federal estate tax. If you do not have a valid bypass/marital trust, the unused portion of the Illinois estate tax exemption is lost. Further, with only a $2 million dollar exemption, the state will receive estate taxes on some of the money that is exempt from federal estate taxes.

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A CASE STUDY

An S Corporation was allowed to use a lower figure, rather than the sale price, when calculating the tax on built-in gains for the sale of a partnership interest. The built-in gains tax is a tax on an S corporation's gain on disposition of an asset where the gain was accrued while the S corporation was a C corporation. In the first year after conversion from C corporation status to S corporation status, the taxpayer sold a partnership interest for $5.2 million. The taxpayer reported the fair-market-value (FMV) of the partnership interest at $2.6 million, based on a valuation performed prior to the sale. The Tax Court found the sale must be taken into account in the valuation. The Tax Court reasoned the buyer was willing to pay a premium to avoid the exercise of rights of first refusal of the other partners. The Tax Court held the FMV to be $3.7 million.

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For a business person, farmer, or even a well funded retiree's estate, this can spell disaster in the form of a large state estate tax due.

Legal Utility of Trusts

While the tax utility of trusts may have been diminished under the new federal estate tax laws, it is also remarkable that legal utility remains in state estate planning with the use of trusts. Some of the benefits are still present with trusts, i.e., who gets to manage the property and who gets the property in the end. Without effective estate and business succession planning, many businesses are still at risk to succeed to the next generation.

Estate Plan

To best deal with these issues, individuals should have a complete estate plan including a will, living will, health care and property power of attorney, a marital trust, and a bypass trust. Quite simply put, the living will, the healthcare and the property power of attorney documents aid an individual in sorting out issues with their healthcare and property decisions. The will directs the estate as to what to do when a person dies and how they want their affairs handled. The marital and bypass trusts keep and carry the estate tax exemption forward and also provide for control of closely-held entities when a person passes on.

Conclusion

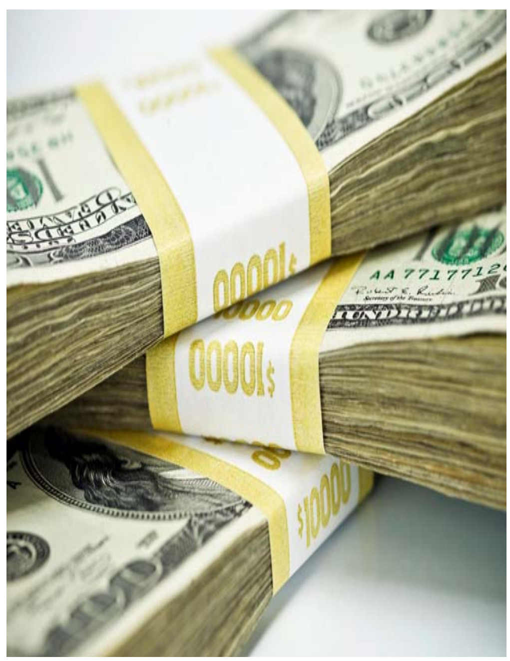
There are factors driving this trend! First, states such as Illinois are running huge deficits. The easiest way to get tax revenues is quite simply to raise taxes, including the estate tax. Even though eleven states currently have their own estate tax separated from that of the federal government, the trend is that more and more states are moving towards uncoupling their estate taxes from that of the federal government.

Combine the trend in the states with control and decision making factors that are always critical and present no matter what the estate tax exemption is. Individuals are always wise to execute marital and bypass trusts as part of their complete estate and business succession plan. If you have a business or any other assets, our advice is to begin estate and business succession planning today. Without a complete plan, your business is at the mercy of the state and federal governments, and those that administer your estate.

What is especially frightening is that your state may still be coupled to the federal exemption. If your spouse passes away and the state subsequently enacts a separate estate tax law, your marital exemption can and will be lost. This could happen at the federal level as well, given the federal estate tax is subject to change in the next two years. Begin planning today!

A CASE STUDY CONTINUED:

Editor's Comment: This case illustrates the importance of using a qualified business valuator. The valuator in this situation saved the taxpayer from paying taxes on $1.5 million. In addition, the case shows how the built-in gains tax can be a concern when converting from a C corporation to an S corporation. Other tax traps and problems can arise when converting from one entity to another, so guidance from The Center's professionals is always advisable.



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Points of Interest

- **…as of January 2011, the estate tax has been reenacted and changed.**
- **In response to the high dollar limit on the estate tax exclusion enacted by the federal government for this year, states have responded. As of February 2011, several states have enacted estate taxes that carry lower exemption amounts.**
- **To best deal with these issues, individuals should have a complete estate plan including a will, living will, health care and property power of attorney, a marital trust, and a bypass trust.**

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Avoid These Business Sale Myths – Part 2

Mike Ertel, CBI/ M&AMI/ CM&AA

The typical business owner will only sell a business once. Understanding the complex process involved will help produce the best results. But don't fall prey to the myths that can derail or seriously affect a potential sale.

Myth #3 – I Know What it is Worth - Some owners will base the company value on what they need for retirement. Others will tell you they want $100,000/year for "sweat equity." Still others utilize industry multiples.

A third party valuation is a good idea for anyone seriously considering the sale of their business. An outside valuation will include a thorough analysis of the business and the market it operates in. This will provide a solid understanding of the company's growth potential, not some vague industry average.

Myth #4 – It's Like Selling a House - Preparing to sell your house may take a few weeks, then you want to get the word out to everyone that the house is on the market. Once you get a satisfactory offer, you sign on the dotted line, turn over the keys and move on.

Selling a company is much more complex. A successful business sale usually requires a great deal of pre-planning, at least a year and maybe as long as three years to drive sales, develop key staff, document the operations and control expenses.

The average house will sell in less than four months, while the average business sale is nine months to a year.

Even after the business is sold, the seller can be expected to put in at least a few months, and possibly years of transition time, helping to make the new owner a success.

Sound sale strategies will bring you the optimum price the market will bear. Go to market with realistic expectations by getting a professional valuation and using a professional business broker or intermediary.

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free, confidential, consultation with us, have them contact me at: mertel@legacyadvisorsgroup.com

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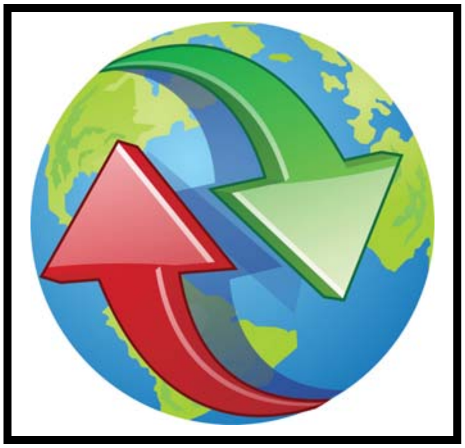

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Frequently Asked Questions…

Q: What should I do if I made a mistake on my tax return that I have already filed?

A: It depends on the kind of mistake that you made. Most mathematical errors are caught in the processing of the tax return itself, thus the IRS will recalculate the 1040 and will send you the proper return based on the recalculation, so you don't have to do anything in that instance. If you did not attach a required schedule, the IRS will contact you and ask for the missing information. If you did not report all your income or did not claim a credit, you should file an amended or corrected return using Form 1040X (PDF), Amended U.S. Individual Income Tax Return.

Q: Why do some companies offer a tax refund in as little as one day, while others do not and is this a good thing?

A: When chain tax preparers offer tax refunds in as little as one day, what they are giving the client is essentially a loan based upon the tax return. The company gives the client the loan in advance of the actual refund, but often for an extremely high fee. My advice is that nobody should take a loan like this as the fees charged are exorbitant for getting your refund just a few weeks quicker. If you want a quick return, file early, don't wait until April 15.

Q: Is it possible to reduce income taxes if I own a business by shifting income elsewhere?

A: Absolutely. Business owners have the advantage of making decisions that ordinarily they would not be able to make to provide them and their families with advantages. One of these advantages is known as income shifting. In this process, you can hire family members to perform labor and receive reasonable compensation for their services. While paying your son $100,000 per year to fold mailers will not be "reasonable compensation" under the IRS's position, there is plenty that can be done to shift income and reduce taxes.