Legacy ADVISORS GROUP

M & A UPDATE®

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Understanding Gift and Estate Tax Laws as Part of Business Succession

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Introduction

As part four in our series on business succession, it is important for the business owner to have a good understanding of the estate and gift tax, commonly known as the “Death Tax”, but officially called the Unified Transfer Tax. We all know that when money or value is passed from one generation to the next or one party to the next, tax consequences can occur. For instance, if a father gives a gift of $200,000 to his son to buy a home, there is a tax consequence for this money changing hands. The same is true if a business owner transfers a business to a son or daughter. However, in each scenario, the tax consequence may not be seen for many years to come, if ever (read below). In the recent decade, the threat of gift and estate taxes has been alleviated to some extent by automatic inflation indexing and changes in the laws which give rise to estate and gift taxes.

Tax Credit (currently $5,000,000 per person)

The Tax Credit is one part of what is called the “Unified Credit”, because, the taxable lifetime gift exemption and the estate tax exemption is actually 1 (one) credit exemption, totaling $5,000,000. This was not true for nearly a decade, but is now back with us.

Because of multiple changes in the tax laws over the past decade, the estate tax exemption has increased dramatically. In 2002 and 2003, the estate tax exemption was $1,000,000. In 2004 and 2005, the estate tax exemption was $1,500,000. On January 1, 2006 the estate tax exemption was $2,000,000 and remained at that level until December 31, 2008. Then in 2009, the estate tax exemption was $3,500,000 per person. In 2010, it was unlimited, but slated to go back to $1,000,000 in 2011. Because Congress acted in time, the current exemption is $5,000,000 for 2011 and 2012. To further alter the law, the concept of portability was introduced, which allows married couples to use unused portions of their deceased spouse’s exemption in order to somewhat simplify estate planning. Additionally however, states have enacted their own estate tax exemption amounts and they vary by state, making the state level

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A CASE STUDY

The Tax Court has ruled that transfers of stock into an FLP were indirect gifts to children. In the present case, a couple created two Family Limited Partnership interests. The ownership interest of the FLP was split between the husband, wife, and children.

When the husband transferred a large volume of stock to the FLP in exchange for a portion of the FLP, the exchange was merely seen as lacking economic effect, and therefore was a gift and not an effective exchange of property.

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another concern for those in business. It is important to know your state exemption and not just plan for the federal exemption.

The Increasing Annual Gift Tax Exclusion (currently $13,000 annually)

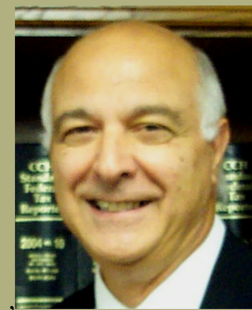
A taxable gift is the amount that the value of the gift exceeds the annual exclusion amount year by year. Taxable gifts are subject to $5,000,000 in lifetime exemptions. This means that if a person gives taxable gifts in a lifetime of over $5,000,000, that person will be required to begin paying taxes on such gifts. It is important to point out that since the $5,000,000 taxable gift exemption is simultaneously the estate tax exemption; a taxable gift amount simultaneously reduces the estate tax exemption dollar for dollar. To illustrate the change the annual gift tax exclusion has endured: in 2004 and 2005, the annual gift tax exclusion was $11,000. In 2006, the annual exclusion for the gift tax was increased to $12,000. This amount lasted until December 31, 2008. Since 2009, the exclusion was raised to 13,0000. The benefit of this is that now business owners can give away more value to a descendant than in past and not be subject to any taxes.

The Lifetime Gift Tax Exemption

Again, it is important to point out that the Lifetime Gift Tax Exemption and Estate Tax Exemption are one credit totaling $5,000,000 (not $10,000,000). As mentioned above, "Taxable gifts are subject to $5,000,000 in lifetime exemptions." This means that if you gave a gift to anyone exceeding $13,000 in any one year, the gift would trigger the need for the donor to file a gift tax return and reduce his or her lifetime gift exemption by the amount over the gift. This does not mean the person giving the gift should not file a tax return if the gift is under $13,000. In such situations of gifting stock in closely-held companies or gifts of real estate it is cheap and beneficial to file a gift tax return, thus starting the statute of limitations and setting the value. The donor of the gift is generally the responsible party required to file and pay the gift taxes if any are due. There are only a small number of situations where the donee is responsible for the taxes.

Conclusion

There are two points expressed herein that are important to business succession planning: 1) Estate and gift taxes have the potential to affect 5% of all estates in the U.S. With proper planning this 5% can be decreased to 2% of all estates. 2) The laws and are constantly in a state of flux. This is critical knowledge if you own a business and / or are involved in the ownership of real estate. Contact the professionals at The Center if you have any questions regarding estate and gift tax planning.



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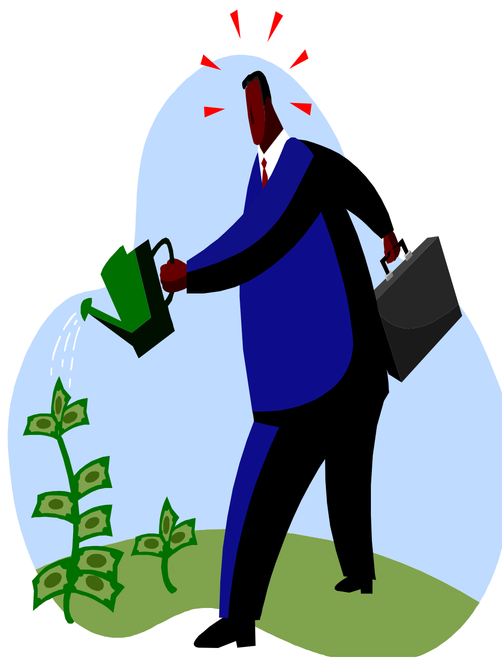
Points of Interest

- **As part four in our series on business succession, it is important for the business owner to have a good understanding of the estate and gift tax.**
- **. . . the concept of portability was introduced, which allows married couples to use unused portions of their deceased spouse's exemption in order to somewhat simplify estate planning.**
- **Estate and gift taxes have the potential to affect 5% of all estates in the United States.**



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A CASE STUDY CONTINUED:

Editor's Comment: Corporate records are critical. Here, the family lacked corporate records beyond annual tax returns. Without the substantiation of corporate records, the transactions were dubious. This type of transaction occurs everyday and is effective for estate and tax planning. Had this couple maintained records and obeyed corporate formalities, the IRS Tax Court would have likely ruled in their favor. Remember, if you want to obtain tax benefits from a transaction, complete all aspects of the requirements necessary to accomplish the overall objective. Work with tax professionals, not general practitioners to be sure you are fully complying with the tax laws.

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Avoid the Major Pitfalls in Selling A Business
No. 2 - Not Understanding the Selling Process

Selling a business is something that most business owners will only attempt once in their career. With an estimated 70% - 90% of their total net worth tied up in their business, they can't afford to make a costly mistake, but their success in running their own business generally doesn't prepare them to handle one of the largest and most crucial financial transaction in their life.

This is the second in a series of articles exploring some of the common pitfalls in selling a business.

Major Pitfall No. 2 -- Not Understanding the Selling Process

Since most business owners only experience the selling process once, so it is understandable that they are not familiar with the number of steps involved; nor how to deal with the issues that frequently arise at each step. Not knowing how to deal with these issues -- and/or not having a trusted, professional, M&A Intermediary for advice and direction -- will put the seller at a severe disadvantage in negotiations and reduces the likelihood of ending up with the best deal possible.

Experienced M&A advisors can perform or contribute to a wide variety of tasks, which, when successfully executed, will maximize the seller's return on the sale. Such tasks include: deciding when, where, how and to whom to market the business, and how best to promote its potential; determining what price to ask, or deciding when to go to market without an asking price; screening prospective buyers; maintaining and ensuring confidentiality throughout the process; developing financing alternatives for the buyer; working with the seller's CPA, attorney and financial planner to assist in structuring the deal to minimize tax liability and maximize seller proceeds; and so on.

Business owners frequently realize the need for confidentiality, but have difficulty traveling the right path between not revealing anything at all and revealing too much too soon. Another common mistake is to assume that since a buyer has signed a non-disclosure agreement, it is now "safe" to reveal anything and everything the buyer may ask about. While all prospective buyers must sign a Non-Disclosure Agreement (NDA) before being provided even basic information about the business, and experienced M&A advisor will assist in determining early on which prospects are likely to be serious prospects and which are unlikely to ever make an offer, and limit the release of confidential information accordingly.

Even with a signed NDA from the buyer in hand, an experienced M&A advisor will stage the release of confidential information – such as interviews with key customers and managers, etc. -- until it becomes clearer that the buyer is committed to making an acceptable offer.

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 directly, and in strictest confidence, at 813.299.7862, or via e-mail at mertel@legacymandaadvisorsgroup.com

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Frequently Asked Questions…

Q: In 2013, what happens to the Estate and Gift Tax?

A: In the event Congress does not act on the Estate and Gift tax exemption, the levels will revert back to $1,000,000 each. While it is likely Congress will act, the consequence of being unprepared could be an issue in many estates.

Q: How do you determine whether a worker is an employee or independent contractor?

A: Primarily, you look to the control that you have over the employee. If you generally control the worker and methods the worker uses to perform their tasks, they tend to be classified as an employee. If the worker has a fair degree of autonomy on the job, autonomy with finances, and less relationship with the principal, generally these workers can be classified as independent contractors.

Q: I am an S Corporation owner, and I have recently sold business assets that have been held for over a year. How do I report the sale of these assets?

A: While instinctively the owner would want to file a Schedule 1040 D and take the loss as a personal loss, this would be the wrong course of action. The sale of business assets is filed on Form 4797, which carries different results that are better for the taxpayer.