

Special Edition

Successor Planning Part 7

Last week, I discussed the continuing process of transferring the business from one generation to the next or selling to a 3rd party. I also discussed the components of capital gains and estate taxes which are part of the process of planning an exit strategy.

I reviewed the various types of trusts that were available and I provided a brief overview on each of the trusts. I indicated that;

- As you're developing "your" exit strategy and planning to sell your business;
- You must have competent advisors.
- You must utilize those advisors in their various capacities to make the transition, not only smooth but successful.

This week, I want to focus on shrinking your estate. Just as there are ways to review succession planning, there are many ways to "trim" your taxable estate. One way is to reduce your interest in your company. How do you do that? You give away assets!

The key to reducing estate taxes is to limit the appreciated assets that are included in your estate for tax purposes. Under the unlimited marital deduction, you can give as much as you want to your spouse with no gift tax due. At your death, you can leave as much as you want to your spouse with no estate tax obligation as well.

However, those laws are continually changing, so again, it's very important to have an expert in estate taxes work closely with you.

In order to qualify for the marital deduction, your spouse must be a US citizen. Each year, without reducing your lifetime exemption, you are allowed to gift \$10,000 of assets to any number of recipients per year - \$20,000 if you are married.

Company stock may be the most appreciable asset you own, and therefore, may be the best asset to gift during your lifetime. For example; assume your business is worth \$500,000 to date; it is likely to be worth \$1MM in 3 years. By giving away the stock today, you will keep the future appreciation at \$500,000 out of your taxable estate.

However, it's important to remember, gifts in excess of \$10,000 per person or \$20,000 per married couple per year, will be subject to a gift tax. You need to weigh this against the benefit scheme by reducing your taxable estate. To avoid taxes, you can hire your child and gift them stock. As long as your successors work for your company, you might as well give them part of their compensation in stock. Over the years, they will build up a sizeable holding.

Assuming this is the way that you choose to reduce your estate, your corporation will earn a full deduction on the value of the shares. Your successor will owe tax, but it's better for them to pay the minimum income tax than the estate tax to acquire the shares. Furthermore, this strategy removes future stock price appreciation from your estate. Another way is to issue stock options;

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- Non-qualified stock options are taxed when exercised.
- Incentive stock options are not taxed until shares are disposed of.

Either way, stock options give you a way to sell at today's prices, yet have your successors buy later, when they can better afford it.

Should you gift restricted stock? Restricted stock is normally issued or acquired privately and is exempt from registration. When a transfer is made conditions can be set that restrict or delay the length of time before sale, or the amount that can be sold at all. **The benefit?; you transfer the stock now, but there is no tax imposed until the restrictions expire.**

There are other ways to protect assets of the estate, which need to be considered during your successor planning process;

- There are family limited partnerships.
- **A family limited partnership allows parents to contribute certain kinds of properties they own in return for general limited partnership units, the latter which they can give to their children at significantly discounted values.**
- It also reduces the size of the estate and its future growth.

Family limited partnerships also provide tax shelters that reduce estate taxes and cut income taxes for the family.

Typically, an FLP is formed by the parent or owner acting as the FLP's general partner. As the one making all the investments and management decisions, you contribute assets and then make gifts of limited partnership interest to your children, thereby transferring and reducing exposure for estate taxes.

An attractive advantage is that the FLP interest can also be gifted away at discounted values because they have limited marketability and represent minority ownership. For example; you and your spouse can jointly make annual transfers of \$20,000 to each child without any gift tax consequences. A good example of this was the FLP that was formed by the Walton family. At the time of Sam Walton's death in April of 1992, Walton owned just 10% of the family Wal-Mart stock.

An FLP also provides asset protection. The assets that are held by the limited partners are sure to become creditors. However, there is one disadvantage of FLP's. **The general partner remains liable for the partnerships obligations.** The usual approach is to set up a corporation to be the general partner, but that means complying with capitalization and paperwork requirements.

Because of that flaw, many people prefer the Limited Liability Companies or Family LLC's.

One liquidity strategy is to utilize insurance. Insurance can be a way to insure that liquidity is there, should the heirs need to get cash out of the business. It's no secret that many business owners use life insurance to finance a future payment of estate taxes. **However, it's important to understand that if life insurance proceeds are included in your estate, they will be subject to estate taxes.** How do you solve this problem?

One solution is to set up a life insurance trust, where by the trust – not you, owns the policy. There are many rules that apply to these irrevocable arrangements so, again, it's important that you have a competent advisor.

Another type of policy that is frequently utilized to help pay estate taxes is Second To Die or Survivorship Life Insurance. These policies cover a couple and pay nothing when the first spouse dies. Upon the death of a second spouse, the proceeds are paid, usually to the couple's children. Leaving your business to your spouse and having your children hold the survivor policy; can set up your children to inherit the business upon your spouse's death, using the proceeds from the policy to pay estate taxes at that time.

Still another type of life insurance policy with the estate plan implications is "Split Dollar" insurance. In most split dollar arrangements, the premiums are paid by the company, which also has access to the cash, in the policy. The company will collect enough out of the death benefit to recoup its cost. **Life insurance proceeds can then provide the cash to fund buy/sell agreements,** which often are necessary to keep the company whole after the owner's death.

Next week, I will discuss "easing out of the business".

QUOTE OF THE WEEK: "There is enough in the world for everyone's need, but not enough for everyone's greed."