ESTATE TAX FROM A BUSINESS OWNER'S PERSPECTIVE

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Most business owners are understandably focused on the day-to-day issues involved in operating a business. With the many stresses weighing on a business owner, estate tax is often not at the forefront of issues to be addressed. Federal estate and state inheritance taxes can have significant adverse effects on a family business. Such taxes can take a business owner's heirs by surprise and add a significant burden in the challenging process of dealing with the aftermath of a business owner's death. However, with careful planning, the adverse impact of estate tax can be minimized.

Federal estate tax is imposed on the value of a business owner's estate, to the extent the value of the estate's assets exceeds the federal estate and gift tax exemption. The exemption also applies to lifetime gifts, with gift tax liability when cumulative lifetime gifts exceed the exemption amount. The amount of the federal exemption has changed dramatically in recent years. As recently as 2003, the exemption was $1,000,000. Since then, the exemption has been stepped up at various times, with a $5 million gift/estate tax exemption effective in 2011 and 2012 and a maximum tax rate of 35 percent. The exemption will revert to $1 million in 2013, with a maximum tax rate of 55 percent, unless Congress extends the current exemption or makes it permanent.

In addition to federal estate and gift tax, some states impose an estate or inheritance tax. Oregon's inheritance tax applies to assets exceeding a $1 million exemption, with a maximum 16 percent tax rate. Washington's estate tax applies to assets exceeding a $2 million exemption, with a maximum 19 percent tax rate. Each state has its own set of rules for calculating inheritance/estate tax liability, including some provisions for reduced tax liability for qualifying family businesses with farm and/or natural resource assets.

For many business owners, a significant part of the estate value is tied up in family business assets. With federal estate tax and state inheritance tax generally due within nine months after death, family members can face significant tax liability without sufficient liquid assets to pay the tax. This can place great stress on any business, and can be devastating for a business that is struggling to survive in a weak economy. It is important for family business owners to start planning now for the succession of the business.

An effective business succession plan will include such considerations as transition of management authority, transfer of business ownership, taking steps to reduce estate and inheritance tax liability, and ensuring liquidity to pay taxes. Some of the most powerful planning strategies involve the use of valuation discounts or low interest rates—or a combination of these two concepts to provide tax savings.

When assets are held in a family business entity, such as a corporation or limited liability company (LLC), the value of the ownership interests in the entity can be substantially discounted due to factors such as lack of control and/or lack of marketability. Valuation discounts (sometimes exceeding 40 percent) provide leverage by permitting a larger percentage of interests in the entity to pass to family members (during lifetime and at death) than if the business assets were transferred directly.

In addition to valuation discounts for interests in business entities, other strategies take advantage of the current low interest rate environment. For example, by placing business assets into a "grantor retained annuity trust" ("GRAT"), a business owner can provide for the appreciation on the trust's assets to pass to family members with reduced or zero gift tax liability.

A GRAT involves placing assets in an irrevocable trust, with the grantor of the trust retaining a stream of fixed or graduated annuity payments. For example, interests in a family corporation or LLC could be transferred to a GRAT. Cash distributions from the entity would flow back out to the grantor as annuity payments. At the conclusion of the trust's term, the remaining assets in the trust pass to family members.

The value of a gift made through a GRAT (the future interest passing to beneficiaries at the end of the GRAT's term) is determining by applying the "7520 rate" announced by the IRS for the month in which the GRAT is established. This rate has been at or near historic lows in recent months (it hit an all-time low of 1.8 percent in December 2010). Essentially, to the extent that appreciation on the assets held in a GRAT exceeds the 7520 rate, the excess appreciation passes to the trust's remainder beneficiaries free of gift or estate tax.

Other techniques exist, which also take advantage of low interest rates. For example, assets can be sold to family members on an installment basis at a low interest rate. Such a sale can involve the use of a trust, or it can be done directly with family members. In a family sale transaction, valuation discounts can provide additional tax savings.

Even when gifts are not made during lifetime, planning can be done to minimize estate and inheritance tax liability. In appropriate cases, charitable planning tools such as a charitable remainder trust or charitable lead trust can be implemented at death, resulting in a combination of benefits for charitable and individual beneficiaries, as well as estate tax savings.

When other approaches fail to reign in estate tax liability, a business owner can take measures during lifetime to provide liquidity to pay the tax. That liquidity can be provided by life insurance, which can be excluded from the insured's estate through an irrevocable life insurance trust.

Estate, gift and inheritance taxes are often overlooked and can threaten the survival of a family-owned business. With proper planning, a business owner can ensure that business assets will pass to intended beneficiaries while minimizing tax liability. The facts and circumstances in each individual situation will dictate which strategies are appropriate. It is critical to involve experienced legal and tax advisors in the planning process, to ensure that all appropriate options are considered and that planning steps are properly implemented.