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Estate and Succession Planning for Small Business Owners

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Estate planning to many people consists of deciding how property should be distributed at death, but it also includes plans and techniques to build the estate during life. It involves decisions about the types of property to own, the form of ownership, and, for small business owners, the organization and operation of the business, including succession, or passing that business on to the next generation.

This bulletin discusses the fundamentals of estate and succession planning to help families with small businesses assess their goals and consider the economic, legal, and tax implications of various plans. The bulletin is by no means an exhaustive source on estate or succession planning. Nor is it intended to substitute for legal or tax advice that should be obtained from your lawyer or accountant. More detailed publications are available elsewhere and trained professionals should be consulted as a plan is formulated.

Estate and succession planning decisions involve complex questions of law, tax, and business planning. The only way to find the plan that is best for you is to work closely with your lawyer and other specialists who can advise you properly. Tax accountants, appraisers, life insurance agents, bank trust officers, and financial planners provide other important sources of information that you might consider in the planning process. Because you must make the final decision about the organization and disposition of your business, it is essential that you be well informed about the choices available so that you can make the best decision for you and your family.

Objectives in Estate and Succession Planning

Most young families start with a modest estate but have major commitments to dependents. It is often said that these families are the ones most in need of estate planning. Their modest estate must provide for dependents should either or both parents die. Estate taxes are not yet a concern for these families because their estates have not reached the size where estate taxes would be due. Rather, their concerns should be determining who receives the property in the estate, the administration of the estate, and providing for the care of children. Younger persons also are concerned about increasing their estates to provide for dependents and seeing that property generates income during their lifetimes to supplement the income from their labor.

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As the family and the business grow, many of these same concerns remain, but this family now becomes concerned about structuring the estate and business as it grows. It needs to be alert to and aware of the potential consequences of business organization and ownership patterns. During this growth phase, many families show little concern for planning, and the consequences of many business decisions are not analyzed completely. Sometimes, irrevocable damage is done.

The third stage of family life is often referred to as the exit stage. The business couple is interested in reducing its participation in the family business, usually as a child is brought into the business. The parents generally will first reduce their labor involvement in the business. They are usually eager to do this, and the transition should create few problems as long as the business can generate sufficient income for the parents and children. Parents next reduce management involvement. This can create conflicts. It is often difficult for parents to relinquish control of an operation that they built. Finally, and often not until death, they will reduce or eliminate their ownership involvement in the business. Small business owners can be extremely reluctant to transfer ownership during their lifetimes. Not only are they emotionally attached to the business, but they may be financially attached as well. Small business owners do not generally have major sources of retirement income other than social security and ownership income from the business. This financial dependency hinders giving the business to their children, but it still may be possible to sell the business to the children. After selling, the parents still own property but rather than business property it is cash (converted into other investments) or a mortgage or a contract.

Property Ownership

Property can be owned solely by one person or organization, or ownership can be shared by more than one party. Sole ownership is obviously the simplest, most straightforward type of possession. The sole owner has the rights to the property within limitations of the laws (such as vehicle registration or zoning), and there is rarely any question raised when these rights are exercised.

Co-ownership occurs when two or more parties hold title to property together. Much property that is co-owned is owned by husbands and wives, but it is also possible for two unrelated people, or members of more than one generation (like a mother and daughter) to co-own property. A number of forms of co-ownership are defined by law, and the rights and tax consequences of each type of co-ownership are different. No one form of co-ownership always will be preferred, but one may be more advantageous than another depending on the people and the property involved.

One form of co-ownership is *tenancy in common* where each party or tenant has separate and distinct property interests. Each co-owner has a fractional interest in the property. The amount of the fractional interest is the percentage of the total value of the property that the individual paid, or received as an inheritance or gift, when the tenancy was created. For example, if property was purchased for $50,000 and one of two tenants in common paid $20,000 in cash and mortgage payments, then his or her fractional interest is 40 percent. Each tenant in common is entitled to the income that his or her fraction of the property generates. Tenants may dispose of their interest as they wish. When one tenant dies, the interest passes according to the will (or the law of intestate succession if there is no will). The property does not automatically revert to the survivors. Only that tenant's interest is taxable in his or her estate. That portion of the property falls under the jurisdiction of the Surrogate's Court (probate). When a partnership owns property, it owns it as a form of tenancy in common called *tenancy in partnership*.

Another form of co-ownership is *joint tenancy with right of survivorship*. This is created by a deed if the property is land. The joint tenants own the same interests arising from the same conveyance of title such that each has an undivided or undesignated interest in the jointly owned property. Each has a right to use the property and a right to any income generated by the property as well. When one joint tenant dies, the survivor automatically acquires full ownership of the property. If more than two people are joint tenants with right of survivorship, the remaining individuals share the property—no third party will take the decedent's share. This ownership arrangement acts like a will substitute because the property will automatically belong to the survivors, avoiding probate. Federal or state estate taxes are not avoided, however. Each joint tenant's interest in the property will be included in his or her taxable estate.

A joint tenancy that can be used only by a husband and wife and only with real estate is *a tenancy by the entirety with right of survivorship*. Like other joint tenancy property, upon death of the first spouse, property in tenancy by the entirety is passed on to the surviving spouse. Tenancy by the entirety property cannot be severed without consent of both the husband and wife. Divorce severs the tenancy, however.

Only one-half of the jointly held property between husband and wife will be included in the estate of the first to die regardless of who contributed to the purchase of the property. This one-half interest will qualify for the estate tax marital deduction, and although included in the decedent's estate, the interest will not be subject to federal estate tax. The surviving spouse will be the complete owner of the property.

Ownership of property can be determined by the wording on the deed to the property if the property is real estate. Personal property ownership might be determined by the name on the bill of sale. Property that is registered will have an owner listed on the registration document. Sole ownership of property exists when there is only one name on the document. Co-ownership exists when more than one name appears. The term *with right of survivorship* implies joint tenancy. If the names of two spouses appear followed by the words *husband and wife*, it is a *tenancy by the entirety*. If only names are listed, then ownership would be as *tenants in common*. This is often the case where a partnership purchases a piece of equipment and the names of the partners are placed on the bill of sale. When determining ownership, it is advisable to collect the necessary papers and documents and consult an attorney.

Federal Estate and Gift Tax

Changes were made in the calculation of federal gift and estate taxes in 1997 and again in 2001 by the Economic Growth and Tax Relief Reconcilliation Act of 2001. Through the year 2009 the estate tax credit will continually increase and tax rates will fall. The result is that over time larger estates will be exempt from estate tax, so that by the year 2009 only estates worth more than 3.5 million dollars will be subject to estate taxes. In the year 2010 the estate tax but not the gift tax will be repealed. However, unless legislation is passed to permanently eliminate the estate tax, beginning again in 2011 the estate tax will be back, based upon the law before the 2001 act. Most believe Congress will act before 2011. Both the uncertainty surrounding the future of the federal estate tax and the current phase-in of new tax rates and tax credits make it very important to regularly review the status of the law and its impact on property ownership and transfer decisions.

Federal Estate Tax

The *gross estate* includes all property in which the decedent had an ownership interest at the time of death. This includes real estate, equipment, inventory, cash, and other assets. To determine the tax, property is valued at its fair market value as of the date of death, or as an alternative, six months after death. Farmland, if qualifying conditions are met, can be valued at its use value for farming, which may be lower than its market value**.** Family business property up to $1.3 million may also be exempted from the gross estate until the year 2004. In 2004, the unified credit reaches $1.5 million, exceeding this exemption, and the $1.3 million exemption becomes redundant.

Just as with income tax returns where *deductions* are subtracted from gross income, deductions are allowed against the gross estate. One such deduction is a mortgage or other debts against the deceased. Other deductions include funeral expenses, fees of the executor and attorney, charitable bequests, and losses from fire, theft, and storm during settlement of the estate not compensated by insurance.

Another deduction is the *marital deduction*. This deduction is allowed for the amount of property that is transferred to a living spouse either by will, intestate, or through joint tenancy. Unlimited amounts of property can pass to a spouse free of federal estate tax if it passes outright or in a qualified trust to the living spouse. A husband can leave all of his property to his wife and his estate will not pay a single dollar of federal estate tax. The same applies to wives who die before their husbands. But when the surviving spouse dies, he or she will not have the use of a marital deduction unless that spouse remarries and leaves property to the new spouse. Some people remarry, but few leave everything to the new spouse. The unlimited marital deduction may be appealing because it can prevent the payment of taxes at the death of the first spouse. But tax planning should be done to determine if there will be excessive estate taxes due at the death of the surviving spouse. Often, these could be minimized or eliminated by the use of trusts or bequests to loved ones other than the spouse in both wills.

The *taxable estate* is derived by subtracting all deductions from the gross estate. Then, as with income taxes, a rate schedule is used to obtain the tentative tax. There is a credit that reduces the tax payable. The credit amount depends upon the year of the death. Since both tax rates and the credit will change through the year 2009 these rates and credits are not printed in this publication, but can be obtained from tax publications. The applicable and maximum tax rates over the period range from 41% to 50%. Of interest to most small businesses would be the size of the estate before estate taxes are due. Those amounts by year are shown in Table 1. For a death in 2007, for instance, estates smaller than $2 million are exempt from tax. For planning purposes, you can use a tax rate of 45% on the amount over the exemption amount listed in Table 1, although the exact rate depends upon the size of the estate and the year of death. An estate of $3 million in 2007 would pay about $450,000 in estate taxes, since the $3 million estate exceeds the exemption amount of $2 million by $1 million. A credit also is available if property in the estate previously had been taxed in another estate during the past

Table 1. Federal Estate Exemption Value

Year of death	*Taxable estate exemption value*
	$
2002	$1,000,000
2003	1,000,000
2004	1,500,000
2005	1,500,000
2006	2,000,000
2007	2,000,000
2008	2,000,000
2009	3,500,000
2010	Estate tax repealed
2011 and later	1,000,000

10 years. Another credit can be applied against the federal estate tax for some or all of the state tax paid by the estate, although this credit will be reduced each year and will be gone by the year 2005.

Any tax is due 9 months after death. The tax may be paid in installments, however, if the estate qualifies.

To illustrate the computation of the federal estate tax, assume that an individual has $5,500,000 in assets and $475,000 in liabilities when he or she dies in 2007, leaving $2,000,000 of the property to a spouse.

Gross estate (assets)	$5,500,000
- Minus liabilities	475,000
- Minus estimated funeral and estate settlement costs	225,000
Adjusted gross estate	$4,800,000
Marital deduction	2,000,000
Taxable estate	$2,800,000
Tentative tax (45%)	$1,260,000
Unified tax credit	780,000
Federal tax payable	$ 480,000

The federal credit for any state estate tax paid or other miscellaneous credits were not computed for this example and may be available.

Property Valuation for Estate Tax

Property owned by a decedent usually is valued for estate tax purposes at its market value at the date of the decedent's death. If a decedent owned 100 shares of common stock that was trading at $50 a share on the date of his or her death, then the value of the stock for the decedent's estate tax return is $50 times 100, or $5,000.

There are a number of alternatives to this estate property valuation rule. First, it is possible to select a date other than the date of death to value property for the estate tax return. This alternative date is 6 months after death. If this alternative date is selected, then all property must be valued as of that date. It is not possible to use the date of death to value some property and 6 months after death to value other property. For businesses where sales continue, and other assets are liquidated in the 6-month period after death, then these assets are valued as of the date of disposition if the alternative valuation date is selected.

Gifts made during the decedent's life that must be included in the gross estate are valued at the date the gift was made. This is true even if the gifts have appreciated in value for the recipient.

An alternative estate valuation procedure is available for closely held family businesses, including farms. The procedure allows valuation at use value rather than market value. Use value may be lower than market value because market value is the value of the property at its highest and best use—including use as high-rise office buildings or housing developments.

Family Farm and Business Exclusion

Beginning with deaths in 1998 and until 2005, family owned businesses and farms may be eligible for an additional estate tax exclusion. This exclusion is coordinated with the unified credit so that a combined $1.3 million of the business can be excluded from estate taxes. To qualify, the business or farm must exceed 50 percent of the adjusted gross estate. In addition, in five out of the eight years before death of the owner, the business must have been owned by the family with material participation by the family.

Exclusion for Conservation Easements

Beginning with deaths in 1998, an estate tax exclusion is available for land subject to a conservation easement. The exclusion is $100,000 for 1998 but increases $100,000 each year to $500,000 in 2002 and later years.

Installment Payment of Federal Estate Taxes

The federal estate tax return for a decedent is due 9 months after the decedent's death and the estate tax is due at that time. It is possible to obtain a l-year extension to pay the tax if an acceptable reason can be given to the IRS. It may be possible to renew the extension each year for up to 10 years. Interest is assessed on the unpaid tax. In addition to this extension, it is possible to pay the estate tax in installment payments if the estate qualifies.

A 15-year estate tax installment payment plan is available if an estate consists of a closely held family business. To qualify, the business property value of the estate must exceed 35 percent of the value of the adjusted gross estate. The interest rate is 2 percent on the first $337,200 of tax (adjusted inflation). Only that portion of the estate tax attributed to the business may be paid in installments. Because it currently costs more than 2 percent to borrow money, and it is also possible to earn more than 2 percent on investments, it would seem foolish for the executor of an estate not to take advantage of the 15-year option. But there are qualifying conditions that restrict or discourage an executor from using the 15-year payment option. The business must be operated as a family business and not held as an investment only. A tax lien is placed against the property to ensure tax payment. There is also an acceleration of the tax payments if more than one-half of the business is disposed of before the tax payments are completed. Finally, the interest payments are not deductible for income tax.

Federal Gift Tax

Gifts made during life also may be subject to tax. For 1998, the law provides a $10,000 annual exclusion, which enables a donor to give any person during a calendar year tax-exempt gifts of $10,000. After 1998, the $10,000 annual exemption will be increased for inflation as measured by the Consumer Price Index (CPI). However, the annual exclusion will only be increased in increments of $1,000 so the CPI must first increase 10 percent from l997. For 2001 the annual exclusion remains at $10,000.

A husband and wife can give $20,000 together in 2001 without tax even if the $20,000 is the property of only one spouse. But if the amount of the gift exceeds $10,000, a tax return must be filed even if no tax is due. The yearly exclusion can be used for any number of gifts. A husband and wife, for example, may give their four children total gifts of $80,000 in 2001 without taxes. In 10 years they can give at least $800,000, more if inflation occurs.

Gifts larger than the annual exclusion will be subject to tax, and a gift tax form must be filed. The amount of the gift greater than the exclusion is subject to the same tax as an estate until the year 2004 when the gift tax will be decoupled from the estate tax provisions. It is possible to make gifts over time without any tax liability by using the annual exclusion, or to make substantial gifts with some potential tax liability but still pay no tax by using the federal gift tax credit. Additionally, gifts to a spouse are *not taxable*, no matter how large.

Because the gift and estate tax is a unified tax until 2004, adjustments in computing the estate tax are made if a deceased individual made taxable gifts during his or her lifetime. Added to the estate is the value of taxable gifts beyond the annual exclusion. The tax is then computed. Any gift tax that previously had been paid is subtracted from the tax. Finally, the appropriate tax credit is applied against the tax liability, as well as other available estate tax return credits.

After the year 2004 gift taxes are computed separately. The maximum total of gifts which can be made after the year 2002 with no gift tax due is $1 million. Gifts over $1 million will be taxed at the rates from 41% to 50% depending upon the year and size of the gift.

Wills

For people who are responsible for the financial well-being of others, or who care about what happens to their property when they die, a will is one of the most important documents they will ever sign. Contemplating one's death is not an exhilarating prospect, but an unexpected tragedy could strike even a young person and it is a good idea to be prepared. If you do not have a will, the state will designate who gets your property even if it may be contrary to your wishes or those of your heirs.

There are very rigid rules in every state that determine whether a will is valid, so consulting a lawyer to help you prepare a will makes good sense. Unless you have a very complicated estate, the fee charged by most lawyers to write a will should be among the lowest charged for any legal service. It is important to provide your attorney with a complete financial picture of your current assets and liabilities and the anticipated future status of these, as well as your decisions about the distribution of your property at your death. Your personal feelings are important to the estate planning process—after all, your property and family are involved. Drawing a will and formulating an estate plan to save taxes should be compatible with your wishes, but not a higher priority than your nonfinancial goals.

Regarding the general requirements of the will itself, a few formalities must be observed. A will must be in writing and must be signed at the end by the *testator* (the person making the will). There must be at least two witnesses to the signing. They do not have to read the will itself, but they must be able to swear that they knew that the testator was signing a will. You must be mentally competent to make a will; that is, have sufficient mental capacity to be aware of the property you own and the people who would be the reasonable recipients of it at your death. It also must be obvious that the will was executed (signed) voluntarily and free from undue influence by those who will inherit.

Once a will is drawn and executed, the same rigid legal requirements apply to any attempt to change or amend it. If you change your mind and want to nullify or revoke your will, you must physically destroy every copy or indicate in a subsequent will or will amendment (known as a *codicil*) that you intend to revoke the former will or part of the former will. Merely crossing out a few lines or destroying a page will not accomplish what you wish. It is equally important, therefore, to consult an attorney when you want to change your will.

Besides designating who receives what property when the testator dies, the will is used to name an executor to administer the estate and to delineate the executor's powers. The will also can be used to designate a guardian for minor children and to spell out preferred funeral arrangements. If part of the property is to be placed in trust at death, the provisions of the testamentary trust are included in the will.

When the will is executed it is important that there be only *one* original. This should be kept in a safe place. The attorney who prepared the document should keep a copy, but usually does not hold the original. It is often recommended that an original of the will be kept in a safe deposit box held in the spouse's name, if possible, so that it will be easily accessible and not sealed in the decedent's box until the IRS can inventory the contents. Wherever the original will is placed, it is wise to have one or two other family members aware of its location.

Trusts

A trust is a legal tool that can be used to transfer and manage property. It is an ingenious device because the person who creates the trust (known as the *settlor*) does not necessarily have to give up all control over that property, nor must he or she relinquish the income or benefits derived from it. It all depends on the form of trust used and the needs of the people it is created to serve.

To establish a trust, property is transferred from the settlor to another person (known as the *trustee*) with the understanding that the recipient will hold the property or use it in some way as directed by the settlor. Anyone who benefits from the use of that property, for example, by receiving any income it generates is known as a *beneficiary*. A trust does not last forever. When it terminates, either at a given time or when a given event (like the death of the beneficiary) occurs, those who get the property are known as the *remainder interest holder*. The settlor, beneficiary, and remainder interest holder need not all be different people. An individual can set up a trust naming himself or herself as beneficiary if the desire is to have someone else manage the assets in the trust.

There are several types of trusts, differentiated by when they are established and by the rights retained by the settler. A trust may be *revocable*, meaning that the creator may choose to end the trust at any time. Alternatively, a trust may be *irrevocable*, ending only upon the happening of some event like the death of the beneficiary. To have a favorable tax effect, a trust must be irrevocable. A trust set up during the settlor's life is called an *inter vivos trust*. A trust set up by someone's will to take effect when that person dies is a *testamentary trust*. Both inter vivos and testamentary trusts are excellent methods of providing financial security for infants or family members who should not or cannot manage their own affairs, as well as being important devices in any plan to minimize income and estate taxes.

Choosing a trustee is an important step in setting up a trust. No one is required to accept such a position unwillingly, but once someone agrees to serve, he or she cannot relinquish the responsibility without permission of the court. It is important, therefore, that a person understands a trustee's general duties and responsibilities, as well as the terms of the particular trust. If there is a large amount of property in the trust (known as the *trust corpus* or *principal*), or if managing the trust corpus is a complicated undertaking, it may be wise to appoint a corporate trustee like a bank to serve alone or as cotrustee with an individual. Any trustee is entitled to a fee for services. The maximum amount of the fee is established by state law and relates to the value of the trust corpus.

The trustee's powers are those assigned by the trust document and those specified by state statute. The trustee manages the assets, and this generally includes buying and selling property, investing in stocks and bonds, and paying out income to beneficiaries consistent with the trust terms.

Although trustees may have broad powers, they also have clear duties and high standards against which their performance is measured. The trustee is a fiduciary and, as such, must avoid any personal gain at the trust's expense and must exercise care in making decisions. The trustee may not be rash and speculative in investing, and special pains must be taken to preserve the trust principal from loss. A trustee must account for all the assets that pass through his or her hands and respect the wishes of the settlor in distributing income and/or principal.

Typically, beneficiaries receive income, and perhaps a portion of the principal, during their lifetimes. Once income is distributed, beneficiaries can do with it what they please. But the trust can include a spendthrift provision that would prevent a beneficiary from spending or assigning income to another before it is received, an important limitation where the beneficiary tends to be careless in financial planning.

A trust can provide to pay an amount out of income sufficient to provide support for the beneficiaries at the discretion of the trustee. This is a common way to provide for loved ones, particularly minor children, in a testamentary trust. A trust also can be used to assist in the management of your property when you are older or when you wish to do things other than manage property.

A trust is sometimes used to save estate tax on the estate of the second spouse to die. For example, a husband leaves a life estate in trust to his wife with the property to pass to their children at her death. The wife receives income from the property during her lifetime but cannot sell or will the property. The property is included in his estate but not hers because her interest in the property terminates at her death. A common problem for families using this procedure is that property in joint tenancy between a married couple cannot be used by the husband or wife to set up these marital trusts. Another problem is that very few corporate trustees are able or willing to manage businesses.

A trust is an extremely helpful tool in estate and financial planning. It provides flexibility and a greater degree of funds management than might be possible with an outright gift—either during life or at death.

Gifts

A gift is a lifetime transfer of property without receiving payment for the property. There must be an intent by the donor to make the gift, accompanied by acceptance of the gift by the recipient (donee). In addition, the transfer does not occur until the gift is delivered to the donee. Putting a letter in your safe deposit box that says that you intend to give your daughter your heirloom pocketwatch is not a gift if the watch stays in your pocket.

The gift tax is a tax on the transfer of property. No tax is incurred until the transfer occurs. A promise to transfer property as a gift in the future may be legally binding, but it would not incur a tax at the time of the promise. A tax is imposed on gifts placed in a trust at the time the transfer is made to the trust, even though the trust beneficiary may not actually receive the income or trust principal until some future date.

It is possible that the IRS will consider that a gift is made even where the donor argues that there was no intent to make a gift, so care must be taken. If you discharge a debt, it will be considered a taxable gift. If you make an interest-free loan, particularly to a family member, you may be deemed to have made a gift equal to a reasonable rate of interest, although some courts have ruled that this is not a gift. If you make a habit of forgiving loan payments on debt owed you by a family member, the IRS will maintain that the gift occurs when the debt was incurred rather than when forgiven, unless you have a demand note as evidence of your intent to collect the entire debt at some reasonable point in time. If you forgive payments on debt incurred as the result of an installment sale, that forgiveness is taxable income to the donor as well as being a gift.

One of the fastest and easiest ways to reduce the size of an estate—and therefore the amount of estate tax to be paid—is to make a gift of property. But many people hesitate to just give away what they have worked hard to acquire, so it is important to weigh the factors involved in making such a gift.

Making lifetime gifts to family members produces nontax benefits as well as estate (and possibly income) tax savings. Giving young people ownership of business property provides them with a stake in the business and is often an incentive to involve themselves fully in the business's operation. Additionally, giving income-producing property to a family member in a lower tax bracket might lessen the overall tax bite for the family.

It is possible to make gifts of money or valuable property to minors without setting up a somewhat cumbersome trust or worrying that children will have control of property before they are old enough to use it wisely. The Uniform Gifts to Minors Act provides a mechanism for making a gift to an adult as custodian for the minor child. In most states, the child will receive outright control of the property at age 18 or sooner if the donor so designates. In the meantime, the custodian has management and investment powers. The donor, an adult relative, parent or guardian of the child, or a bank trust officer, may be the custodian. The gift must be to only one child and only one custodian should be designated per gift. In other words, you may not open a savings account in the name of "John and Mary Smith as custodians for their children, Patty and Steve."

Many people benefit from making gifts to their spouses. The tax advantages are clear—all lifetime gifts to a spouse can be transferred federal gift-tax free. The key objective of transferring property to a spouse is to balance the size of each estate. Then, regardless of who dies first, the estate tax is lower than if the property were in the estate of that person. For this technique to work the property must be willed to someone other than the surviving spouse. Otherwise, all of the property will be taxed when the second spouse dies. And the tax may be tremendous because the estate tax marital deduction cannot be used if there is no surviving spouse.

Before making gifts to a spouse, take the time to think about the circumstances surrounding the gift, particularly if your primary reason for making the gift is to reduce estate taxes.

Obviously the first consideration should be the value of property currently owned by your spouse. Remember, too, that the situation may change. Make allowances if, for example, your husband or wife is likely to inherit property or acquire an interest in another business.

Although it is an unpleasant thought to dwell on, a spouse's health and life expectancy are factors influencing the decision to make a gift. While statistics indicate that women generally outlive men, this rule of thumb may not hold true in a specific instance where a wife is a number of years older than her husband or in poor health. If this is the case, a gift from husband to wife may be pointless for, upon her death, her property would go back to her husband to be taxed again in his estate unless specific provisions in her will provide for distribution to other people.

Income Tax Considerations in Estate and Succession Planning

Because they face the grim situation of paying income taxes every year, small business owners are generally more knowledgeable about income taxes than estate taxes. Much estate planning involves income tax consequences that are unfamiliar to owners, including techniques that may require the payment of substantial income taxes. Additional income taxes can discourage a business from using these techniques, but they must be considered in spite of the income tax consequences because such mechanisms allow the family to fulfill many of its estate planning objectives.

Income Tax Basis

The adjusted income tax basis of property is what you have invested in that property and have not recovered through income tax deductions such as depreciation or losses. Knowing the tax basis of property is extremely important because the tax basis is used in computing any gain or loss on the sale or other disposition of property.

The rules concerning tax basis are complicated and involved for many types of transactions. Your professional tax preparer is familiar with these rules and is able to determine the tax basis of property that you own. But it is necessary that you supply your tax preparer with satisfactory records so that he or she can compute any changes in the tax basis of property. Keeping all your income tax returns is helpful but not completely adequate. Many actions that affect the tax basis of property never show up on an income tax return. For example, if you add a fireplace to your home, that expenditure increases the tax basis of your home but it would not be recorded on any of your income tax returns. If you sell your home, however, you need to know the cost of the fireplace because that cost is part of the tax basis of the house.

The income tax basis of purchased property is its purchase price or cost. If you pay $30,000 for a delivery van, the tax basis of that van is $30,000. If a trade-in is involved, the tax basis of the new property is the adjusted tax basis of the property traded plus the cash boot. If you pay $20,000 cash and trade your old delivery van that has a market value of $10,000 and an adjusted tax basis of $8,000 for a new van with a market value of $30,000, the tax basis of the new van is $28,000.

Adjusted tax basis occurs whenever an adjustment to the original tax basis is made. As you depreciate your new delivery van, its tax basis will be adjusted downward each year by the amount of depreciation claimed on your tax return. Adding equipment to the van will increase the adjusted tax basis of the van.

Other tax basis adjustments can occur.

If you build or construct property, such as a store addition, then the tax basis of the addition, which will be added to the adjusted tax basis of the store, is the total cost of construction. This includes not only the cost of materials but also any hired labor. Raised property such as cows or feed has a zero tax basis, except for farmers who report income on the accrual basis, which very few farmers do.

Before the Economic Growth and Tax Relief Reconcilliation Act of 2001, the tax basis of inherited property was generally its value o~~i~~n the decedent's tax return regardless of the size of the taxable return. That rule has been altered. For estates in the year 2010 (and years after if Congress makes this permanent) inherited property will not receive a stepped-up tax basis. The tax basis of the inherited property will be the same as the tax basis of the decedent. This means that accurate records are essential to determine the tax basis when property is eventually sold.

For property going through an estate before the year 2010, property valued at up to $1.3 million ($4.3 million with a surviving spouse) will receive a stepped-up tax basis based upon the value of the property at the date of death (or alternative valuation date). If the estate is valued at more than $1.3 million (or $4.3 million with a surviving spouse) it is the executor of the estate who determines which property will receive the stepped-up basis. It would seem logical under most circumstances that property with the lowest tax basis would be chosen for stepped-up basis, especially if that property might be sold soon after the recipient receives the property.

Because only one-half of jointly held property between spouses is included in the estate of the first spouse to die, only one-half of the property will receive a new tax basis, if it is selected for stepped-up treatment, subject to the dollar limitation. The other one-half of the property will retain its original tax basis.

The tax basis of property received as a gift is generally the same as the tax basis which the property had in the donor's hands. A major exception occurs when the market value of the property is less than its adjusted tax basis, a rare occurrence with inflation. If your father gives you a computer that he had purchased and its adjusted tax basis to your father is $800, you not only get the computer but also the $800 tax basis. You can immediately depreciate $800 worth of computer on your tax return if you use it in your business.

Property Sales

Income taxes must be considered when estate and business planning decisions involve the sale of property. If property is sold for more than its depreciated value (adjusted tax basis), the difference is subject to taxation the year the item is sold. How the item is taxed depends upon the type of property sold. For real estate (land and buildings), the difference between the sales price and the adjusted tax basis is usually capital gain. If property sold is personal property, such as livestock or machinery, any gain will be ordinary income rather than capital gain income, unless the item is sold for more than its original cost (tax basis). Only the amount of the sales price over the original cost will be capital gain.

The gain from property sales can be reported over more than 1 year if payment is received over more than 1 year. This relieves a taxpayer from paying tax on income that has not yet been collected and allows spreading income over more than 1 year to reduce taxes. These installment sales can be made to children, other relatives, or unrelated individuals. Because payments are delayed, it is necessary to charge a buyer a minimum interest rate set by the IRS. Installment sales also have nontax benefits to both buyer and seller. The seller receives income payments over time, which can be ideal during retirement. The buyer benefits by not having to seek debt financing to purchase the property.

Income Tax Effects of Partnership Formation

It is possible to form a partnership without any income tax having to be paid because of the formation. Some partnership formations, however, can create substantial income tax liabilities. There are two major income tax concerns in forming partnerships which will be briefly mentioned here. First, almost all businesses have debt as well as property. If you transfer property to a partnership for a partnership interest, you may also transfer the property debt to the partnership. This is perfectly legal. But if the amount of debt that you transfer is greater than the adjusted tax basis of the property that you transfer, the difference is taxable income when the transfer occurs. Many types of property have a high market value but little or no tax basis (raised livestock for example) and has debt against it.

A second partnership formation transaction which can trigger income tax is when a potential partner has little or no property to transfer but will provide labor and so is given a partnership interest. The value of the partnership interest (minus any contribution of property) is taxable income to the labor-providing partner. A remedy is to sell the labor-contributing partner an interest in the partnership. Because that partner probably has little money to make the purchase, the purchase can be financed with 100 percent debt by another partner. Beware, however, of the possible tax on the gain realized by the selling partners in such a transaction.

The Final Income Tax Returns

A common statement that is credited to Benjamin Franklin is that the only two things certain in life are death and taxes. A corollary statement to Franklin's is that taxes are certain even after death. And not just estate taxes! A deceased taxpayer must have an income tax return filed on his or her behalf to pay income tax on any income earned before death that had not been reported on a previous tax return. For a business that reports income on a cash basis, and many do, the last tax return would include cash receipts and expenses actually received or paid. Other receipts or expenses that a business may have earned or incurred, but that had not yet been received or paid at the time of death, are not included. Examples include a check not received or purchases for which the deceased had not yet paid. Rather, these receipts and expenses result in income or expenses which are referred to as income (expenses) in respect of the decedent. Do not think for one moment that this net income is not taxed. It is. Either the estate must file a fiduciary income tax return and pay income tax on the income, or the income can be passed on to an heir who must report the income on an individual tax return.

Farm income that results from livestock or crops growing at the time of a farmer's death is not income in respect of the decedent and is not subject to income taxes, except to the extent that the final sales price of the livestock or growing crops is greater than their value at the farmer's death. Finally, property that generates income in respect of the decedent is included in the gross estate. But the taxpayer reporting this income on a tax return receives an income tax credit for the estate tax paid that is attributed to that property.

Sale of Residence

A taxpayer is allowed to exclude from income taxes the first $250,000 in capital gains from the sale of his home. For couples, the exclusion is $500,000. The exclusion is available every two years and the taxpayer must live in the home for periods aggregating two years during the five years preceding the sale. This provision replaces the former option that allowed you to rollover any gain into a new home. That rollover of gain option is no longer available.

Life Insurance for Small Business Owners

Life insurance serves three basic purposes. The first, and typically the primary purpose, is to provide funds for dependents should a parent die. A secondary use of life insurance is to provide funds to meet the cash needs to settle an estate. A tertiary use, and in most instances a poor use, is as a form of savings for retirement. Other uses of life insurance are often cited but these uses fall under the above three categories.

Types of Life Insurance

Life insurance policies come in many forms. The two most common types of policies are term insurance and whole life (or ordinary insurance). There are variations in these two basic types. Other types of policies also are available to meet the special needs of business owners.

Term insurance insures for the death of the insured for a limited time period or term. It has no cash value or savings account feature. It cannot be borrowed against, cashed in, or used to provide income during retirement. Because term insurance only provides death benefits for a stated period of time, a new term policy can be purchased at a lower cost than a new whole life insurance policy and provide the same amount of death benefits. Because of this, term insurance is often recommended to young families who need a large amount of income protection for their dependents but who do not have a large amount of money to purchase life insurance.

The other common type of life insurance purchased by individuals is whole life. Whole life is insurance for the remaining life of the insured. The premiums paid in the early period of a whole life policy are greater than what is necessary to provide for the stated death benefits. The excess amount accumulates and is known as the cash value of the policy. In the later periods of the insured’s life, when the premiums paid are less than what is necessary to provide for the stated death benefits, the accumulated cash value is used to help pay the cost. Whole life can be purchased with various payment plans. Many are paid up by age 65.

The cash value of a whole life policy can be borrowed against. The interest rate is stated in the policy. Policies that have been in existence for a long time may have extremely low interest rates. New policies currently being written have higher interest rates. If you borrow against your policy, the death benefit is reduced while you have the loan. The cash value of the policy also may be received as cash if you terminate your policy.

Life Insurance and Taxes

Life insurance premium payments are generally not deductible as a business or personal expense for income taxes except when a corporation provides life insurance for its employees. Life insurance death benefits also are not normally subject to income tax.

Death benefits paid to a beneficiary usually are exempt from income tax. If the benefits are paid in a lump sum at the time of death, the amount of the payment to the beneficiary is free from income tax. If the benefits are paid in installments, only the additional interest earned on the death benefits is subject to income tax. The spouse of the insured, however, has a $1,000 annual exclusion for interest earned from installment payments. If only interest is paid from the proceeds, then the $1,000 annual exclusion is not available.

Life insurance proceeds are subject to estate tax if the deceased had owned the policy. But insurance proceeds paid to the surviving spouse qualify for the marital deduction and thus would not be taxed. If someone other than the person insured owns the policy, and the benefits are not paid to the estate, then the proceeds are not subject to estate tax.

Life Insurance in a Partnership, Corporation, or Limited Liability Company

Life insurance can be used in a partnership to help transfer one partner's interest to the other partners if that partner dies. Various arrangements can be used. In a cross-purchase agreement, each partner owns a policy on each of the other partners, pays the premiums, and names himself or herself as beneficiary. When a partner dies, the remaining partners will have sufficient funds to purchase the deceased partner's share of the business. With a buy-out agreement, the partnership itself owns the policy, pays the premium, and names itself as the beneficiary. In either case the premiums are not tax-deductible and the proceeds are free from income tax. If the partnership owns the policy, part of the proceeds may be included in the taxable estate of the deceased.

The cross-purchase and buy-out approaches discussed for a partnership can also be used with a corporation or limited liability company with the same results. These entities can also provide life insurance for their employees. Then the premiums paid by the entity may be a business expense. There are limitations to the amount of coverage when the premiums are deductible expenses.

How Much Life Insurance?

Rules of thumb often are used to recommend the amount of life insurance a family should carry. A common rule is that the death benefits should be at least six to ten times the yearly income of the family. This rule is primarily designed for wage earners and not for business owners where property ownership contributes to income. Rather than use rules of thumb, a more systematic approach is recommended for all families, but especially for business persons. An income requirement and income source budget should be prepared. The income requirements of the family without the breadwinner should be estimated. These requirements depend on the number of dependents and their ages, as well as the age of the surviving spouse. Various factors need to be considered. If a post high school education is desired for the children, then some allowance must be included in the income needs to complete that goal.

Sources of income without the breadwinner also must be determined and estimated. For a farm family, a major source of income is the rental income of the family farm. If sufficient insurance is used to retire all farm debts and pay estate settlement costs and taxes, sufficient income often can be obtained from proceeds from the sale of livestock and equipment, and rental income of the farm. Some additional income may be necessary to maintain the same level of living. Other income sources include social security, retirement plans, and other property ownership. In some cases the surviving spouse might be able and desire to return to or continue working. When estimating income, be sure to consider income tax.

Life Insurance for the Spouse

Life insurance cannot replace a lost husband or wife. It can, however, help replace the income or other economic value that is lost with the death of a spouse. It is usually much easier to measure the expected economic loss that will occur when the wage earner or head of household dies than if the death is that of a nonsalaried participant in a family business.

Determining how much life insurance is enough for the wife of a business owner depends on her survivor's needs and the degree to which she participates in operating the business. If she is active in the business, buying enough life insurance to guarantee that there will be no expense incurred when it is necessary to hire someone to perform her duties might be wise. If she is employed outside the business, her life might be insured to reflect the loss of income to the family at her death.

Insuring a wife and mother who is not employed outside the home is a more subjective process because there are fewer standard measures of the economic value of a woman in this role. There should be enough life insurance to pay for the care of young children and for the housekeeping services provided by a homemaker if there is no one else in the family who can step in to take over these important functions.

Business Organization in Estate Planning

A business family's estate consists primarily of business property. Thus estate and business planning are closely tied together. A decision to purchase additional business property, for instance, has tremendous estate planning implications. Not only might the purchase increase the value of the gross estate, but the type of ownership will dictate how the property can be transferred at death. The manner in which a business is organized—sole proprietorship, partnership, corporation, or limited liability company—affects estate planning. For example, if a business is incorporated, at the death of an owner, ownership is passed to heirs as corporate stock rather than as business property. Transferring stock permits the use of estate planning techniques different from those used in transferring business property. Much consideration needs to be given to questions of business organization as an estate plan is mapped out and modified over the years.

The vast majority of small businesses in New York State are organized as sole proprietorships. That does not mean that these operations are not family businesses. In most instances the spouse and children are involved in the operation. The business may be organized so that the family receives wages for its labor contributions to the business. Wage incentive plans can be used in addition to a base salary. In some instances the sole proprietor may rent property from family members, often from a spouse. Complex business arrangements also might be used. For example, a child can operate an ancillary operation, pay the parents rent for the use of their property, and file his or her own tax return. All of these arrangements require careful business planning.

In addition, good communication between the parties involved is essential.

Beyond these business arrangements are partnership, corporate, and limited liability company (llc) organization structures. These are often used when more than one generation or more than one family of the same generation is involved in the same business. A multiple family situation is not always a requirement; a single man or woman may incorporate his or her business for management, tax, or estate planning purposes. A detailed discussion of the pros and cons of various business entities is beyond the scope of this publication, but we do have a few comments.

A partnership, and especially a corporation and llc, is more complex—legally, operationally, and for tax purposes—than a sole proprietorship. Before you leap into a partnership, corporation, or llc, be sure you adequately understand the requirements, limitations, and possible results of a change in business form. Often the same business or estate objectives can be fulfilled within the framework of a sole proprietorship.

A corporation may save income taxes or allow more flexibility in transferring estate property, but it probably will not substantially change the way a business is operated. If you now have a partnership and one son is responsible for sales, a daughter is responsible purchasing, another son is responsible for finance, and you coordinate all activities, incorporating will permit you to assume the position of chairperson of the board and president of the company, and your children can be vice-presidents in charge of marketing, etc., but the day-to-day operating and management decisions will probably not be altered. If the business is not already operating efficiently, or family members are not working together, do not expect a corporation to change that.

The newest form of business entity, the limited liability company, is increasingly being recognized under state law as an alternative to the partnership or corporation. New York law allows for the organization of llcs, which are designed to combine the best features of the traditional forms of business organization. A family interested in considering the formation of an llc should consult an experienced lawyer about whether an llc is the best alternative, considering the family's, and the business's needs.

Who is to Succeed?

Many families state that the most difficult decision they ever make is deciding who is to succeed the parent(s), and how ownership and thus management should be passed on. With ownership comes management, because if a succeeding child or children do not have a majority or controlling ownership interest in a business, they do not have management control.

When you own a business you normally think that you have the right to decide who is to succeed you in the business, and in fact you do have that right. But a family business is more than a business. All family members feel that they have a "stakeholder" interest in that business. Each may have spent afterschool hours working in the business, or had special events missed because of demands of the business. Most would like some participation or involvement in the business, even if it is not active.

The challenge, then, is to select the child, children, or other relatives who will ensure the continuation of the business as a family business, and provide participating roles for the remainder of the family, and to accomplish this while maintaining family harmony. Many entrepreneurs find succession planning more difficult than managing the business.

Dividing Business Income

If deciding who should succeed is the most difficult decision in succession planning, the second most difficult decision must be how business income should be allocated to the family participants in the business. Dividing income is simple when each participant provides equal amounts of ownership, labor, and management to the business. However, equal contributions are rare in family businesses. The parent(s) generally provides more ownership and sometimes less labor than the offspring. The management contribution is difficult to measure, but is probably unequally supplied. With unequal input contributions, arriving at an equitable or fair division of business income can be a complex decision.

Federal and state income tax laws allow a partnership to allocate its income to the partners based upon sound economic principles. In practice, when unequal contributions are made, the common procedure is to reimburse family labor, subtract those payments from business income, and allocate the residual to ownership. The major difficulty with this procedure is that ownership may receive a windfall gain or loss quite different from its economic contribution to business income. Much of any windfall gain or loss is due to good or poor management, and in a business, management can originate from labor as well as ownership. A young family member, with little ownership interest, may be an excellent sales person, contributing significantly to business income. As a reward, and to be equitable and maintain harmony, that individual's contributions to the profitability of the business needs to be financially recognized.

Buy-Sell Arrangements

Before a business partnership (or corporation or llc) begins, the parties involved should agree upon how the partnership will be formed, how it will be operated, and how it will be dissolved. Agreement as to the formation of the partnership is always reached because it is imminent in order to establish the partnership. Operation is also often agreed upon although many times it is unclear how the partnership will operate after a few years when conditions have changed. Usually, however, the dissolution of the business partnership is never even discussed.

The failure to arrive at agreeable provisions for dissolution of the partnership can lead to frustration, disappointment, and strained relationships when it becomes necessary to dissolve the partnership. And dissolution will occur someday, either by death, disability, retirement, or by the desire of one or more partners.

When done correctly, the future dissolution is entirely planned before the partnership even begins, so that when an event that triggers dissolution occurs, such as a death, the dissolution process will be almost mechanical. At the time the partnership is formed, no partner knows whether they or their successors will be the seller or potential buyer in a dissolution, so they all protect their interests. If the parties cannot come to an acceptable agreement before the partnership begins, the partnership probably should not be formed. This is generally a better outcome than having major disagreements at dissolution.

The reason a partner leaves the business is important because it determines the procedure used to transfer ownership, how the interest is valued, and how the transfer is financed. Thus, it is recommended that separate provisions be written in the buy-sell arrangement for each type of exit. At retirement a partner may be willing to receive payments for his or her share over a number of years. At death, it might be more desirable to settle payment promptly. There are a number of procedures which can be utilized to value a partnership interest. In many cases the best procedure is an appraised value by an outside expert(s). However, since the market value of closely held family businesses can be difficult to determine, alternative valuation techniques are sometimes used.

There are three general ways to finance the transfer of a partner's interest. One is for the selling partners to finance the sale by taking the proceeds in installments. The second is for a third party lender to finance the transfer, and the third, which is only relevant at a death, is to use life insurance. A combination of these methods is often used.

Probate and Postmortem Estate Administration

Although someone's death automatically triggers a number of events, settling the estate and distributing property are not among them. There are laws and procedures that govern administration, but the effective operation of this process depends on the initiative of the individuals who have an interest in the outcome. That interest is twofold—to complete the necessary legal steps to transfer ownership of property under a valid will or by state law, from the name of the decedent to those who inherit, and to pay any income or estate taxes due so that ownership of property from the estate is not encumbered by tax liens and judgments.

If the decedent left no will, the heirs or next of kin, or perhaps a creditor, should petition the Surrogate's Court to grant *letters of administration* to an administrator. If a will is located, the named executor or other interested person should petition the court to *probate,* or prove, the will and grant letters testamentary to the executor. These documents are evidence that the representative of the estate is acting with court approval and gives that person the authority to buy and sell property and conduct other business on behalf of the estate.

The function of the personal representative generally is to collect the assets and preserve them by wise investment and good money management. The representative pays the debts of the decedent and the expenses incurred in administration, as well as income taxes for the decedent in the year of death, income taxes for the estate each year it remains open, and the final estate tax bill. He or she also has responsibility for distributing any assets remaining after these obligations have been satisfied to the divisees and legatees named in the will or the distributees designated by law when one dies *intestate* (without a will).

Generally speaking, admitting a will to probate is a routine matter, as is estate administration. Notice must be given to individuals who would inherit if the decedent died intestate and others somehow adversely affected to give them an opportunity to object to probate. It is possible that this might result in a lawsuit to contest the will. Those named in the will are informed that the will is being offered for probate. If probate is not contested, the court will issue a decree and grant *letters testamentary* so the process of settling the estate can get under way. If the will is contested, a hearing is held to determine if all or part of the will is valid. Those contesting the will have the burden of proving that there are grounds for believing that the testator was incompetent or under duress when the will was executed, or that there is some other reason to disregard its provisions. Only in the most extreme cases does a will contest succeed.

Management of a deceased's estate, or postmortem estate management, receives much less public attention than pre-death estate planning but it is an extremely important process. It is essential that the size of the decedent's estate be preserved, and enlarged if possible, and attorneys and corporate executors skilled in estate tax planning should be consulted to accomplish this result. Tax savings is the other primary goal of postmortem planning.

There are three tax returns involved in estate settlement: an estate tax return, a personal income tax return for the decedent's income earned during the portion of the year preceding death, and estate income tax returns filed each year the estate remains open, often called the fiduciary's or executor's return. Many of the techniques used in postmortem planning are fairly straightforward—for example, deciding on which tax return to take deductions so as to pay the minimum tax. An example of a deduction that can be taken on either of the income tax forms or on the estate tax form (but not on all three) is the medical expenses incurred during the last illness.

The income tax considerations of the beneficiaries who are to receive property are also factors in postmortem estate planning. Although the bequest itself is not taxed to the recipient, it may be that the sudden appearance of income producing property in a given year will push the beneficiary into a higher tax bracket. If it is possible to postpone distribution of estate assets, or spread it out over time so that the recipient gets income in more than one tax year, it will allow the beneficiary to do some income tax planning to minimize future tax payments. There are provisions in the Internal Revenue Code which allow deferral of estate tax payments for up to 15 years for qualified taxpayers. This is important in estate and postmortem planning, particularly where the principal asset in the estate is a closely held business.

New York State Estate and Gift Tax

The New York State death tax system is patterned after the federal in that it is an estate tax rather than an inheritance tax paid by those who receive property from the decedent. But unlike many of New York's income tax provisions, which automatically amend to conform to changes in the federal income tax laws, any changes in either the state estate or gift tax must be made specifically by the state legislature. The Federal Economic Growth and Tax Relief Reconcilliation Act of 2001 will have significant implications for the taxes collected by New York and it is quite possible that changes in New York tax laws will be made in reaction to the Federal tax law changes. Specifically, for estates of decedents on or after February 1, 2000, the New York estate tax is the amount that is allowed as a credit against the federal estate tax. As a result, the combined federal and state estate tax will equal the exact same amount as the federal tax would have been if there had been no state level estate tax. However, with the Economic Growth and Tax Relief Reconcilliation Act of 2001, this federal credit is being reduced each year and will no longer be available after the year 2004. That means that after the year 2004 New York will not receive any estate tax unless the law is changed.

codicil: an amendment to a will

gift: a lifetime transfer of property without receiving payment for the property

gross estate: the value of all property in an estate before any estate tax deductions

intestate: to die without a will

joint tenancy: ownership of property by two or more people where there is the right of survivorship; the surviving tenants receive the property at the death of a tenant

marital deduction: an estate or gift tax deduction allowed for property transferred to a living spouse

probate: the legal process of transferring ownership of property from the deceased to those who inherit

settlor: the person who creates a trust with his or her property

taxable estate: the gross estate minus all deductions; this determines the estate tax

tenancy in common: property ownership by two or more people where surviving tenants do not automatically receive the property

tenancy by the entirety: a type of joint tenancy between husband and wife but only with real estate

testator: the person making a will

trust: a legal device which transfers property to another for management for the benefit of a beneficiary, often a third party

unified credit: a federal tax credit used to reduce the federal gift and estate tax to be paid

will: a legal document to distribute your property as you wish after your death

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