Taxes, How Do They Affect My Business When I Sell it or Die?

1. **Assuming I don’t do any planning in advance, what problems will my wife and family face when they try to sell my business after my death?**

   The problems will begin even before we can think about selling the business. The first issue is who will run the business? If there is a disagreement among your family about that, how will it be resolved? Without any instructions included in your will or revocable living trust the probate court will have to authorize most of the acts of your executor regarding your business.

   One of the first things will have to deal with is the bank. This assumes that you like most closely held business owners when they borrowed money from the bank they also personally guaranteed it. If you're deceased your guarantee has no value the first call your widow may get will be from the banker calling your loan. If that happens she and your children will have to figure out how to pay it off or find new financing. The only thing we know for sure about this is it will be harder for them to borrow money than it ever was for you. If the business doesn't have enough money to pay off the loan and if your family doesn't then the bank will begin to look for the easiest collateral to foreclose on. This could be the family home, especially if they already have a mortgage on it.

   Even if there is no problem with the bank, it is likely you'll lose your key employees without a plan in place as to how the business will be run and to whom and how it will be sold. As you lose your key employees your likely to also lose rank-and-file employees, moral will be bad and productivity will suffer. Profitability will decline as will the value of the business. In fact in many situations such as this the family ends up selling the assets of the business at fire sale prices. This presents the possibility that your spouse will have to radically change her lifestyle and could even become dependent upon your children or other family members.

   The cost for the family of the business owner who fails to adequately plan can be incredibly high.

2. **My friend died, and the kids had to sell the family business to pay estate taxes. Why did that happen?**

   The simplest answer is that this happened because your friend failed to do the planning and take the steps that are available to everyone. While it's not possible to know exactly why your friend did not avail himself of the planning that would have preserved the family business; it is possible to speculate, based on prior experience in helping business owners plan and settling estates for those who didn't. The reasons that we see for business owners not planning or not planning effectively are:

1. **Procrastination!**

   While the business owner is alive there are no direct out of pocket penalties or costs to the business owner. It requires some time and energy to be devoted to it that won't go to the day-to-day operations of the business. The business owner will get around to it when they have more time, they have more money, when the rules are more settled, when the economy is better, when the kids are out of college etc. Estate planning and Exit Planning can always be put off until later right up until it's ultimately too late.

2. **Lack of Knowledge about Estate Taxes.**

   Many business owners do not realize the level of tax that will be imposed upon their estate by the IRS and in many states the State Department of Revenue. Those that do realize that their estates may be subject to state estate taxation do not fully understand how much the tax can be nor the steps that will be taken to make sure the taxes are paid. The combined state and federal estate tax can exceed 50% of the total estate value.

3. **Lack of Knowledge about How to Minimize Estate Taxes.**

   It has always been possible for business owners to do planning that can substantially reduce the amount of tax that will be due on their estate. In fact, if the planning techniques satisfy the business owners objectives it is not uncommon for a knowledgeable estate planning expert to help reduce the estate taxes for the vast majority of business owners by 90%.

4. **Not Understanding How to Create Discounted Dollars to Pay the Tax.**

   Since the estate tax is due nine months after the death of the business owner, life insurance is one of the best ways to create liquidity to pay the tax that is due. However, if the business owner owns the life insurance on his or her own life then it will merely compound the problem. This is because the death benefit of the life insurance policy is also subject to estate tax. If the life insurance policy is owned by an irrevocable trust that is properly structured then the life insurance will not be included in the estate. This means there'll be no estate tax due on the death benefit. Yet, the dollars can be available to pay the tax on the rest of the estate.

5. **Not Seeking Expert Estate Tax Planning Advice.**

   In many cases, we have seen business owners who have relied upon the general business attorney for their estate planning advice. While in some cases they do get good advice, there are many others where the owner would have been much better off in dealing with a professional collaborative including an estate attorney, CPA, financial planner, and trust officer to develop an appropriate plan that would have been far more cost-effective. With every business owner there are considerably more things that need to be thought about and dealt with in having a successful estate plan than just having a will and some tax clauses. The need for collaborative advisors extends to the work that needs to be done to most cost effectively settle the business owner's estate.

3. **I've heard that estate taxes have been repealed, so is that really a concern anymore?**

   The estate tax at the federal level was repealed for the year 2010. As of this writing, it appears that in 2011, the estate tax will reappear. The only question is at what level? Historically, it is important to remember that the estate tax has been "repealed" a number of times. The first time it was repealed was in 1801 after having been in place for only four years. The tax was reinstated in 1862 during the Civil War and was repealed in 1870. The estate tax was again put in the law in 1898 and repealed in 1902. The estate tax that was "repealed" for 2010 was enacted in 1916 and modified many times over the years. In fact, in the last forty years estate tax rules have been changed significantly at least twelve times.

   In considering the years in which the estate tax was reinstated in the past, it was always brought in to help pay for huge deficits associated with wars. It seems to me that today we have all same ingredients that have caused Congress to impose an estate tax in the past. Therefore, based on historical precedent one should expect the estate tax to be with us for a long time to come.

   The other issue that one should consider, depending upon the state in which you reside, is that the state may well have an estate tax. Even if your state does not currently have an estate tax, if it is one of the many states to have significant budget deficits, one may be imposed in the near future. Therefore, state estate taxes also need to be considered and if you have real property located in more than one state you may need to consider state estate taxes in more than one state.

   However, estate taxes have never been the best reason for doing estate planning. The best reason for doing estate planning is to make sure that those you love and care about are provided for the way you want when you're no longer here, and that you know how you will be taken care of when you are incapacitated. That has little to do with estate taxes.

4. **I have some extra land that I bought in case my business needed to expand or relocate at some point. I'd like to leave that land to my church. How do I accomplish that, and how does it affect my estate taxes?**

   You would need to have instructions in your will or in your revocable living trust directing that the land be distributed to the church. While the land would be included in determining the size of your estate at your passing, your estate would receive a charitable deduction for the value of the property going to the church. This means that there would be no estate tax payable on the value of this land. However, once the land passes to the church there would be no opportunity for your business to use it.

   It's very important that a professional valuation be performed that meets the IRS requirements both in terms of how the appraisal is done and the qualifications of the appraiser.

5. **Does the bequest of the land to the church also affect my final income tax return? In other words, can I get a charitable deduction of some sort so my wife can pay less income tax for the year of my death?**

   The bequest of the land will not affect your final income tax return. It provides no reduction in income taxes on your final return. It is possible to pay no estate taxes on the value of the land and get an income tax deduction for your wife. Instead of leaving the land directly to the church, you can provide that the land will go to your wife after your death. Because of the unlimited marital estate tax deduction there will be no estate tax with the property passing to your wife. Your wife can then contribute the property to the church and receive an income tax deduction for the charitable gift.

6. **Instead of the church, I've been thinking about leaving that land to the community for use as a park or nature preserve. How is that best handled? What are the advantages or disadvantages of doing that?**

   There are several ways of making a gift of land to be used as a park or nature preserve. There are over 1,200 land trusts which will readily accept the property if it is to be used as a nature preserve. You can establish your own trust to hold the property as a nature preserve. Or in your will or revocable trust you can leave the property to the community on the condition that it can only be used for a park or nature preserve. If you know now that you do not wish to use the land for a business purpose, you may want to now make your ownership of the property subject to a conservation easement for the benefit of the community or a nonprofit conservation organization that is qualified to hold and enforce an easement.

If the land has significant conservation values then the value of the conservation easement will provide a tax deduction during your lifetime. In almost all cases the property tax on the property will be reduced because of the conservation easement. You would still be able to sell the land and even use it personally so long as the use was consistent with the restriction of the conservation phase. It is even possible to restrict public access to the property. The additional advantage is the value of the property is reduced for estate tax purposes which may allow you to pass it on to younger generations at a much lower estate or gift tax cost if there is any desire to maintain a family connection to the land.

Conservation easements will allow you to have a living legacy in the land that will be forever respected. Conservation easement allows you to make a contribution for the common good to the community's quality of life. Since all conservation easements must be specially tailored to the specific characteristics of the property and your charitable objectives it is very important to work with a knowledgeable and experienced estate planning attorney.

For most donors establishing their own trust to hold and manage the property as a park or nature preserve is not practical. This is due to the need to manage the land on a long-term basis for the intended purpose. Therefore, if you're not going to do a conservation easement and contribute the property or the easement to a qualifying charitable land trust then you should leave the property directly to the community. Here again this is very important that the description of the gift of the restriction on the use of the land be spelled out clearly by your estate planning counsel.

As part of your planning process, you or your attorney should contact the community that you wish to leave the land to and see if they're willing to accept it as a park or nature preserve. Many communities are reluctant to accept land for use as parks because they don't want the responsibility financially of maintaining and operating a park. If it's important that the land be used as a park and you wish to leave it directly to the community then you'll want to consider making arrangements to also fund the operation and maintenance of a park.

In your estate planning documents it will be important to spell out exactly how the land is to be used as a park and what is to happen with the land if the community wishes to not use it as a park at any time in the future.

7. **My kids aren't interested in the business after I'm gone, so I'd like to sell it now and get some retirement income. After I'm gone, is there some way to benefit both my children and my church with the business proceeds?**

The approach that works best with the objectives of receiving retirement income, providing some benefit to your children and your church is to contribute some or all of your ownership interest in the business to a charitable remainder trust (CRT). You'll receive an income tax deduction for the present value of what will ultimately pass to the church at the last to die of you and your spouse. The CRT can sell the business interest and the trust will pay no income tax or capital gains on the sale. You will receive an income stream from the CRT for the remainder of your lifetime or if you choose for a term years. You create an irrevocable trust and use a portion of the income from the CRT to make gifts each year to the trust. The trust uses the annual gifts to buy a life insurance policy on your life or on the lives of yourself and your spouse. After you're gone the church will receive whatever is in the CRT and your children will receive the death benefit from the life insurance policy held by the irrevocable trust.

A variation of the above approach would be to sell a portion or all of the business to your church in exchange for a charitable gift annuity. The gift annuity can furnish you a guaranteed income for life. You will receive an income tax deduction for the difference between what you give the church and the value of the annuity as calculated from IRS tables. If you live less than your life expectancy then the church will benefit because they will have paid you less. Here again the excess income generated by the gift annuity can be used to buy life insurance to provide benefits to your children.

Yet another technique would be to contribute a portion of the business to a charitable lead trust (CLT). A CLT essentially operates in reverse to a CRT. You could receive an income tax deduction for the present value of the income stream payable from the CLT to the charity taking into account what is likely to pass to your children. At the end of the term of the CLT the assets held by the CLT would pass to your children. The CLT would not provide you with any income. You would have to retain enough of the business sale proceeds to provide yourself with the retirement income you need.

8. One of my competitors wants to buy my business and make payments over time. That would work well for my retirement needs, and the payments would continue to my wife if I die. How do we set that up, and what are the tax ramifications?

Assuming that you and your competitor reach an agreement as to both price and terms including security for the promise payments then at the closing of the sale of your business you would receive the agreed-upon down payment and a promissory note from the buyer. The promise to pay by the buyer should be secured by Uniform Commercial Code (UCC) filing attaching all of the assets of the business as well as the stock in the business that will continue to operate. If real estate is being transferred you would also secure your loan with a mortgage on the real estate. You would also want the buyer to personally guarantee the obligations and perhaps even provide you with additional collateral. You have now become The Bank. As the buyer's Banker, you have to take all of the steps that the bank would to make sure they get paid when they lend money.

One of the first advantages is that you will receive interest on the amount of the purchase price that is being paid out to you over time. The second advantage of this approach is that capital gains tax on the gain on the sale is deferred to the extent that your payout is deferred. However, if the deferred amount is in excess of $5,000,000 you will be required to pay interest to the IRS on the deferred tax until it's paid. Additionally to the extent that sale generates the recapture of previously taken depreciation, the tax on that cannot be deferred and must be paid on the tax return for the year of the sale. The tax is payable in proportion to the amount of the installments received.

The major downside to an installment sale arrangement is that if the buyer doesn't make the payments you may be forced to take the business back and pursue your other legal remedies. Taking the business back can result in you only capital gains taxes being owed by you. This can occur if the business is more valuable than the amount owed to you by the buyer. The worst downside occurs when the business is allowed to deteriorate too far before you can take control again resulting in a business that may never be sellable.

9. **I've heard that life insurance can be helpful for estate planning – either for my family or my business. How does that work?**

Life insurance provides liquidity (cash) at the time when it is frequently most needed, immediately after your death. The cash can be used to help pay estate taxes. It can be used to pay off loans, whether they are personal loans or loans for the business. It can be used to provide an inheritance to the non-business active child instead of leaving them an interest in the business. The cash can be used by partners, family members or key employees to acquire your business interest (stock, membership interest or partnership interest) from your estate. Cash is always easy to divide; businesses are always a challenge to divide successfully.

In most cases the life insurance should not be owned by you as the insured. The choices are your spouse, your children, your partners if any, the business or in irrevocable trust. Of all the choices the irrevocable trust is probably the best. It protects the life insurance and any accumulated values from creditors and predators during your lifetime. Likewise it protects the death benefit when it's been paid and we can have an independent objective third-party who will use the proceeds as intended when needed.

10. **I'm about ready to retire, and am thinking about giving my business to my son. Are there any tax issues with a gift like that?**

There are both gift tax and income tax issues with such a gift. If the value of the business is more than $1,000,000 then there is a gift tax due on every dollar of value above $1,000,000. The tax rate is 35%. Of course if you're married and if your spouse will join you in making the gift we can avoid the gift tax on up to $2,000,000 in value.

One of the things you need to keep in mind is if you give the business to your son where will the income come from to maintain your lifestyle? If you're no longer an owner of the business the business can't make distributions to you. If the business pays your salary, you have to actually perform services for the salary to be deductible to the business. Non-deductibility of your salary substantially increases the cost of paying you. If you continue to get paid by the business the IRS could decide that the business is still part of your estate and ultimately subject to estate tax at your death.

If you are unable to find answers to questions you were looking for, please feel free to view “Unanswered Questions of Business Planning” or “Leaving Your Business in the Hands of Your Family”