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Business Planning: Permanent Uncertainty

PROFESSIONAL OPINION
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Should we all breathe a sigh of relief now that Congress and the President passed tax legislation in January of 2013 to permanently set the federal estate tax exemption and estate tax rate, which so significantly affects planning for the business owner? Consider for a moment the meaning of permanence. Can the business owner now finalize his or her business succession plan relying with certainty on the rules that will apply, and if not, what should the business owner do?

The American Taxpayer Relief Act of 2012 ("2012 Tax Act") addressed the revenue side of the fiscal cliff. In the face of diverse political and moral views, aside from imposing sequestration, legislators have had difficulty in addressing the expenditure side of the fiscal cliff. The distaste for spending cuts will likely prompt Congress to once again seek revenue increases. One example of Congress' resourcefulness in generating new sources of revenue is the newly applicable Medicare tax (.9% on earned income and 3.8% on unearned income over certain thresholds). Another is the recent budget proposal to cap retirement plan contributions and accumulations. Whether an excise tax is imposed on "excess" retirement plan distributions and accumulations* or whether tax favored contributions are capped, the purpose is the same: to generate additional tax revenue.

Changing tax and other governmental rules may be a constant, but so are changes related to the business. Business owners have had to reinvent their businesses, perhaps multiple times, for changes in technology, customer demands, distribution channels, cost structures, availability of supplies and financing sources. The objectives of the business owner and of his or her potential successor(s) also change, as the business, family relationships and other circumstances change. Arguably, change at all levels is occurring at an increasingly rapid rate. So what can the business owner count on? The answer ultimately is rooted in the resourcefulness, ingenuity and resilience of the business owner in several aspects: The ability of the business owner to assess constantly the external environment for changes in the industry, family, business, tax and other rules, and secondly, the business owner's response to that assessment. The business owner's challenge is to anticipate and embrace the changes and incorporate the new rules and conditions into his or her business plan and strategy going forward, rather than retreating into denial or avoidance.

Planning should be constant and continuous at all levels, including business succession planning, which goes to the heart of the business owner's vision and goals for the future of the business and his or her legacy.

Turning to the tax environment, the 2012 Tax Act makes permanent the $5,000,000 federal estate tax exemption. The Tax Act eliminated the sunset provision that would have permanently reduced the exemption to $1,000,000. The exemption is indexed for inflation and for 2013, is $5,250,000 ($10,500,000 for couples). The exemption is also "portable," so that the estate of a business owner may use any unused exemption of his or her most recently deceased spouse, or if the spouse survives, pass any unused exemption of the business owner to the surviving spouse. (The deceased spouse's unused exemption is referred to as the "DSUE".) Portability is a welcome addition to the tax law. However, it may be more beneficial to use the exemption of the spouse who dies first by funding a credit shelter trust or distributing assets to the next generation, rather than passing the DSUE to the surviving spouse. The DSUE is not indexed for inflation, nor will it increase over time. By passing assets covered by the exemption of the spouse who dies first to a trust or outside the surviving spouse's estate, will allow the asset itself, and all income and appreciation on the asset over the surviving spouse's lifetime to escape estate tax. We can further leverage the exemption by funding the trust with assets that are valued using discounts or assets subject to debt, further driving down the estate tax. The trust strategy also provides non-tax benefits, such as protection from creditors, asset management and assurance that the assets pass at the surviving spouse's death to the children of the marriage, and not to the second spouse or second spouse's children.

If the business owner and his or her spouse are potentially subject to federal estate tax (imposed at a rate of 40% on the value of assets in excess of the exemption), there are planning strategies that remain viable as of this date, including use of valuation discounts, sales to intentionally defective trusts, GRAT's and irrevocable insurance trusts.

On the other hand, for those that are able effectively to use the exemption to avoid federal estate tax, income tax planning should be front and center. The 2012 Tax Act increased the top income tax rate to 39.6%, (or potentially 43.4% if we include 3.8% for the newly applicable Medicare tax on unearned income) and the top capital gains and qualified dividend rate to 20% (or potentially 23.8% if we include the Medicare tax on unearned income). We will be focusing on shifting or redistributing income to take advantage of lower rates. This may involve creating new business and trust entities and restructuring existing entities.

Freedom from federal estate tax allows the business owner whose business interest has little or no income tax basis to retain the equity ownership in the business until death, so the successors can obtain a stepped up basis, potentially saving significant income tax. Also, the retention of the business interest may better satisfy a business owner who wishes to retain business control. However, the focus then will be on designing effective buy-sell agreements to protect the interests of the successors.

Changes in rules, such as the tax law, give us the opportunity to rethink business succession strategy in order to avoid or minimize negative consequences, but also to take advantage of new opportunities and better consider the needs and objectives of the business owner, the business and the successors.

If anything is permanent, it is change, uncertainty and the human desire to avoid or minimize taxes. ■

**The Tax Reform Act of 1986 imposed an excise tax of 15% on qualified retirement plan distributions and accumulations remaining at death above certain thresholds. This excise tax was repealed in 1997.*

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