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THE PLANNER

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A monthly newsletter for Accounting, and Financial Professionals with a focusing on Estate Planning, Elder Law, and Special Needs Persons.

The Planner is a newsletter to inform and educate Accounting and Financial Professionals of the ever changing areas of estate taxes, and elder law to better service their clients.

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Estate Planning for Business Owners

"Small businesses," that is, those that have less than 500 employees, comprise 99.9 percent of all businesses in the United States. The owners of these businesses will, someday, exit their businesses due to retirement, incapacity or death. But most are so busy working that they don't slow down and think about business succession and estate planning issues. That is one of the primary reasons that less than one-third of family businesses survive to the second generation; 65% of those fail to survive the second generation; and 90% of family businesses fail to survive the founder's grandchildren.

The owners of small businesses often have multiple advisors, but rarely are the advisors consulted as a team with coordinated input. The team approach, however, is what produces the best results.

In this issue of The Planner, we will explore the role of advisors in helping business owner clients plan for what is usually their client's largest asset, their business. This issue will also explain what business succession/exit planning entails and how this planning can be coordinated with a business owner's personal estate planning.

Introduction

Too often a business owner is so busy "working the job" that he neglects "building the business." A business owner may occasionally wonder if he can ever retire, who could possibly take over his business, if he can get retirement income without going out of business, and what would happen to his business (and family) should he prematurely die or become incapacitated. But most do not seriously think about these things until they are ready to retire. That's when they realize they could have achieved better results if they had only done more to build their business and prepare for its succession.

The advisory team can help the owner change his focus from how much he is making today to the future rewards he can be building for his family and his retirement.

Two Concepts to Start the Process

Quite often, the business accountant or CPA is the advisor most closely involved with the business on a regular basis and can most effectively start the business owner on the path to planning. Two tools that are often not used by business owners can be most helpful:

The Year-End Review

This lets the business owner see how the business has performed over the last 10-11 months, review business profitability, and see the tax situation for the year. Often a lead-in to a year-end review is considering ways to reduce taxes in the coming year. It also provides

an opportunity to discuss future risk mitigation.

The Legal Audit

This is a review of all legal documents of the business, including organizational documents, employment agreements, leases, loan documents and guarantees, and buy/sell agreements. It provides another opportunity to look for tax savings and a way to identify potential gaps or liabilities.

Providing the data for these two reports and reviewing them with the advisory team will help force the owner to back up to examine business growth and profitability and talk about continuity issues.

Planning Tip: The business accountant/CPA has much to gain by introducing this planning process. Instead of just filing tax returns, the accountant here shows a real interest in helping the owner grow his business. There will also be additional work for the CPA/accountant, such as preparation of financial statements, budgets, projections and valuations, tax planning and business process and efficiency planning. If new business entities are created, additional tax returns will likely be needed, too.

How the Team Approach Can Help

No one professional has all the answers, and diverse skills and talents are necessary for the best results. The team approach also minimizes time and costs. Members of the advisory team may include the accountant/CPA, financial planner, insurance advisor(s) (property, casualty, umbrella and life), investment advisor, business attorney, estate planning attorney, valuation specialist and a business broker if an imminent sale of the business is part of the strategy.

Planning Tip: All members of the advisory team should be involved so the planning can be coordinated.

Planning Tip: Advisory team members should consider keeping their fees for the initial consultation low, or even free, as there likely will be additional paid work for them as the planning progresses.

Step One: Identify Motivation and Goals

As Dr. Laurence J. Peter, the man who established the famous “Peter Principle” said, “If you don’t know where you’re going, you will probably end up somewhere else.” In order for the business owner client to avoid ending up “somewhere else,” he must establish goals for himself and his business.

Learning what motivates the business owner (income, wealth, identity, challenge, stimulation, satisfaction and/or pride) will help the advisory team work better with him. Also, helping the owner verbalize his goals will help him clarify priorities, avoid quick fixes, move forward by identifying a desired outcome, and focus energy on the most urgent concerns.

Typical business owner goals include the following:

- Create and preserve the value of the business
- Exchange that value for money with the least amount in taxes
- Meet personal and family needs by providing security and continuity of the business in case of the owner’s premature departure
- Leave a legacy
- Give money to charity
- Shift wealth to children
- Reward key employees
- Receive full value for the business
- Keep the business (or sell it) at his exit
- Take the business to the next level

Step Two: Value the Business

Most owners have no idea what their business is worth, but the value will be needed for a third party buyer if a sale is anticipated. In the meantime, knowing what the business is worth will help in projecting cash flow, estate and gift tax planning, knowing how much insurance to purchase for buy/sell agreements, compensation planning, knowing available collateral for financing, and retirement planning. It also allows the advisory team and the owner to monitor progress toward the owner’s stated objectives.

Step Three: Plan for Business Continuity

The business owner’s overall planning objective for what will happen when he retires, becomes incapacitated, dies or sells the business most often includes that the business will continue despite such an event. Most commonly, the business owner will want the business to survive with whoever he chooses receiving the value of his ownership interest. Likewise, if one owner “departs,” for whatever reasons, the remaining owner(s) usually will want to retain ownership and control and not to be in business with the departed owner’s creditors, surviving spouse and/or heirs.

Step Four: Plan for Personal Wealth Preservation and Succession (Estate Planning) and Asset Protection

Universal client objectives are to preserve wealth and minimize taxes using both lifetime and death planning tools. Where a family business is involved, this requires integrating lifetime succession and business objectives with the estate plan. Estate planning thus becomes part of business planning.

The advisory team should be aware that a business owner will often want to address the business planning first. (They most commonly suffer under the delusion of immortality.) Once the advisory team has assisted the owner to clarify his goals and developed a plan for his business, however, the business owner will see that his estate plan has already begun to take shape.

Considerations for the business owner’s estate plan include the growth of non-business assets; how to be “fair” to children both inside and outside of the business; minimizing and having the cash to pay estate tax; asset protection during the owner’s life and for his

heirs; probate avoidance; planning for long term health care costs; and sometimes special considerations, such as a child or parent with special needs.

Step Five: Grow and Protect Business Value

From the owner's perspective, growing the business and protecting its value will maximize the amount realized on the sale of the business, protect assets from potential business and personal creditors, create the ability to sell the business, and can motivate and keep key employees and family members in the business.

Promoting its value will include increasing cash flow; developing operating systems (so that the system, not the owner, who will eventually be gone, becomes the solution); documenting sustainability of earnings (if the owner is taking all the cash out of the business, it will be harder to sell); improving company performance as measured by industry metrics; and paying down debt.

To grow the business and protect its value, it may be necessary to restructure the organization, solidify and diversify the customer base, implement strategies to grow the company, develop and protect proprietary technology, build a solid management team, and groom a successor.

It may also be worthwhile to examine and possibly change the corporate structure (S and C corporations, LLCs and partnerships). The advisory team can help the owner consider tax pros and cons, ease of operation and asset protection features of current and potential entities.

Planning Tip: Most business owners don't think about asset protection until a claim arises. But the best time to plan, of course, is before the protection is needed. Consider discussing asset protection for both business and personal assets early in the planning process.

Planning Tip: An umbrella policy is often overlooked by business owners and is an inexpensive start toward the need for asset protection of both business and personal assets.

Step Six: Ownership Transfer

The ability to sell and the value of the business are both affected by intrinsic factors (e.g., how the business has grown); extrinsic factors (e.g., the local and general state of the economy); and the effectiveness of the sale process.

There are only two basic types of ownership transfers - to those who are in the business and to outsiders. Each has special characteristics.

Sale to Outside Buyers (Third Parties): The benefits to the owner of a sale to an outside buyer can include cash at closing, no owner financing (which eliminates financial risk), no family succession issues and the speed with which the exit can occur. However, everything must come together just right to successfully complete the sale of a small business. Far more often than not (often as a consequence of failure to plan properly), no buyer can be found who is willing to pay the owner's price. About 20% of businesses are offered for sale, but only one in four of those actually sells. The probability of effecting a successful sale changes with the size of the business. About a third of offered businesses with annual sales of $10 million or less sell while about half of offered businesses with annual sales over $10 million sell.

Planning Tip: It can often take seven to ten years of proactive planning to successfully prepare a business for a sale to an outside party.

Sale to Children or Key Employees

The owner's succession objective may be selling the business to his children and/or key employees. This can motivate and help retain key employees and family involvement in the business. Money for that kind of sale usually has to come from the ongoing business, so planning is critical to help reduce risk of buyer default and to increase the amount of money received by the owner.

Conclusion

Depending on the health of the business and the objectives of the business owner, it can take several years of planning and action to implement a business succession plan and get the other planning in place. A forward thinking advisory team that initiates the planning process years before an anticipated succession event, monitors the progress, and helps keep the owner on track will provide a great service to the business owner, his family and his business—and a happy client will tell others.

Get Ready for a New Tax on January 1, 2013!

Now that the health care law has been declared constitutional, the remaining provisions will be going into effect. This includes a significant provision that takes effect on January 1, 2013. (Of course, there is the possibility of repeal if the Republicans win the Presidency and elect a majority in both the House and Senate in November, but we have to plan based on what we know, not on what we think could happen. And for now, the health care law is the law of the land.)

The significant yet little-known provision that goes into effect on January 1, 2013 is a new 3.8% investment income surtax, also called the health care surtax or the Medicare tax.

Understanding the Tax

The new 3.8% tax will be assessed on the lesser of 1) net investment income or 2) the excess of modified adjusted gross income (MAGI) over the "threshold amount."

If your eyes are already starting to glaze over, you're not alone. Yes, it is a bit complicated, but hang in there. We'll start by defining some terms, then look at some examples so you can see if/how

the new tax will affect you. Then we'll explain some things you can do now to lessen the tax impact. (You can always go straight to the examples, then come back to the definitions for more clarification.)

What is net investment income?

This is the sum of gross investment income over allocable investment expenses. For purposes of this surtax, investment income includes interest, dividends, capital gains, annuities, rents, royalties and passive activity income. It does not include active trade and/or business income; any of the income sources listed above (e.g., interest, dividends, capital gains, etc.) to the extent it is derived in active trade and/or business; distributions from IRAs and other qualified retirement plans; or any income taken into account for self-employment tax purposes. For the sale of an active interest in a partnership or S-corporation, gain is included as investment income only to the extent net gain that would be recognized if all of the partnership/S-corporation interests were at fair market value.

What is modified adjusted gross income (MAGI)?

This is the sum of adjusted gross income (the number from the last line on page 1 of Form 1040) plus the net foreign income exclusion amount.

What is the threshold amount?

For married taxpayers filing jointly, it's $250,000; married filing separately, $125,000; all other individual taxpayers, $200,000. For trusts and estates, it is the beginning of the top income tax bracket ($11,650 in 2012).\

Who will pay this surtax?

Here's a quick summary to determine if the 3.8% surtax will apply to you.

1) If your modified adjusted gross income (MAGI) is less than or equal to the threshold amount that applies to you, then you will not pay this tax.

2) If your modified adjusted gross income (MAGI) is greater than the threshold amount that applies to you, then you would pay the 3.8% tax on the lesser of a) your net investment income or b) the amount of your MAGI over the threshold amount.

Note: The surtax liability is determined on income before consideration of any tax deductions. That means your deductions could put you in the lowest income tax bracket, yet you could still have investment income that is subject to the surtax. Also, the capital gain rate is scheduled to increase for high-income taxpayers to 20% in 2013, so the total tax on capital gains (with the surtax) could be 23.8% in 2013 and beyond.

Examples for Individual Taxpayers

1) Olivia, single, has $125,000 of salary and $70,000 of net investment income. The 3.8% surtax will not apply because her MAGI is less than $200,000.

2) Brian, single, has $250,000 of net investment income and no other income. The 3.8% surtax will apply to $50,000 of income (excess of $250,000 MAGI over $200,000 threshold amount).

3) Bob and Sue, married filing jointly, have $350,000 in salaries and no other income. The 3.8% surtax will not apply because they have no investment income.

4) Frank and Lily, married filing jointly, have $350,000 of salaries and $100,000 of net investment income. The 3.8% surtax will apply to $100,000 of net investment income because of the lesser than rule. (Their $100,000 net investment income is less than the amount of their MAGI above their threshold amount: $400,000 - $250,000 threshold = $150,000; $100,000 net investment income is less than $150,000).

Examples for Estates and Trusts

1) The Steven Smith Trust has investment income of $25,000 and no distributions. $13,350 of income ($25,000 - $11,650 top bracket amount) will be subject to the 3.8% surtax.

2) The Estate of Linda Smith earned $65,000 in dividends and made no distributions. $53,350 ($65,000 - $11,650 top bracket amount) will be subject to the 3.8% surtax.

3) The Estate of Michael Smith earned $120,000 in interest and distributes 100% of income to the heirs. The Michael Smith Estate will not pay the 3.8% surtax; the income will apply towards each heir's individual surtax determination.

What Can You Do About This Tax?

If you may be affected by the 3.8% surtax, there are some things you can do now to reduce your investment income and MAGI in order to possibly avoid or reduce the amount you will have to pay in surtax. For example:

- The surtax does not directly apply to distributions from IRAs and other qualified retirement plans, and contributions to these plans provide tax-deferred growth, so you may want to increase your contributions to these plans. However, required minimum distributions are considered ordinary income so they will increase your MAGI.

- The surtax does not apply to distributions from Roth IRAs, but Roth conversion income will count toward MAGI. A conversion to a Roth IRA in 2012 can help to avoid the surtax by reducing MAGI from required minimum and other plan distributions in 2013 and later.

- Income from tax-exempt and tax-deferred vehicles like municipal bonds, tax-deferred nonqualified annuities, life insurance and nonqualified deferred compensation is not included in investment income so you may want to consider these investments.

- Charitable remainder trusts permit you to defer income over a period of time, enabling you to stay under the threshold amount.

Charitable lead trusts offer an "above the line" charitable deduction.

- Installment sales help to "smooth out" income.

- Oil and gas (with up to 95% initial investment deduction, 15% depletion allowance and IDC deduction on passive oil and gas) will continue to be attractive investments.

- Trust and estate investments can be adjusted to reduce income in 2013 and beyond.

Other Planning Considerations in 2012

Remember, the smart thing is to plan based on what we know as opposed to what we think might happen. 2012 is an exceptional year to do estate planning. The federal gift and estate tax exemption is $5.12 million, which allows a married couple to remove as much as $10.24 million from their estate with no estate tax. Under current law, this exemption is scheduled to shrink to $1 million in 2013. Other Bush tax cuts, including income and capital gain taxes, are set to expire at the end of 2012. With the new 3.8% surtax becoming effective in January, 2013 is on track to have the highest tax rates we have seen in years.

As always, be sure to seek expert advice on all tax-planning issues. Now, more than ever, you need the assistance of experienced professionals to advise you and help you implement the best plan for you and your family.

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