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YOUR FAMILY BUSINESS AND YOUR ESTATE

By Dave Kauppi

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As Penn State professor William Rothwell ominously points out in the forward to Exit Right: A Guided Tour of Succession Planning for Families in Business Together, more than 40% of the people who run the closely held operations that comprise 80% of the North American economy will retire by 2007.

Those businesses will either be sold to a third party or management team, closed down, or passed on to the next generation. In this article I will focus on passing the business on to the next generation.

Tax laws still favor home ownership with mortgage interest as a tax-deductible expense. The government has also encouraged the passing of a business from one generation to the next with several favorable estate and gift tax rulings. Estate planning attorneys have utilized IRS ruling 5960 to minimize the estate and gift tax owed for a business either gifted to or inherited by the next generation. The business is often placed in one or more LLC's and divided up into minority pieces to take advantage of very substantial and legal minority discounts, often as high as 40%.

As is often the case, a business owner will have, for example, 4 children. Two sons will be actively involved in running the businesses and two daughters have built lives totally separate from the business. Because 85% of the value of the estate is tied up in the value of the business, to be "fair" the business is gifted and willed to the four siblings in almost equal proportion. Because the sons are running the business, they will get slightly more of the business and slightly less of the remaining estate. This gives them majority interest in the business. After dad leaves the business, the two sons will continue to run and grow the business without any input or participation from their two sisters. Typically the business does not pay any dividends and the two sisters' portions are non-liquid because there is not a good market for selling minority stakes in a privately held business. Also, there is generally a very restrictive buy sell agreement that favors the majority holders. The sisters have no idea what the "fair value" of the business is and the only indication they have ever gotten is an official IRS gift tax or estate tax return with 40% discounts applied. If the enterprise value were, for example, \$50 million and the two sisters owned a combined 40%, you would think that they had an asset worth \$20 million.

The only document they have seen, however, is the gift or estate return, valuing their portion at only 60% of that number, or \$12 million. The brothers feel entitled to the lions share because Ann and Julie had nothing to do with building this business. The brothers pay themselves big salaries and benefits and pay out little of no dividends. They may approach the sisters with gift tax return and restrictive buy

sell agreement in hand and offer to generously buy out the sisters for a combined 8 million, because that is "all the company can afford to pay."

After this transaction takes place, let's look at the result of how dad's estate was fairly divided.

Originally the brothers were left with 60% of the \$50 million business, or \$30 million and a minor portion of the remaining estate. The sisters were left with 40% of the business, or \$20 million and the bulk of the remaining estate of \$10 million. That appears to be fair. However, the buyout of the sisters for a combined \$8 million results in an effective estate distribution of \$42 million to the brothers and \$18 million to the sisters. This is not what dad intended, but it happens all the time.

This is a very complex and emotional issue and there are no simple answers. Generally, dad had his identity tied up in the business and wants it to live on through his sons after he is gone. This is a noble, yet impractical thought if all the siblings are not actively involved in the business. The children often inherit the restrictive buy sell agreements that favor the brothers running the business and scare off

investors that may have been interested in a minority stake in the business. Much of the value from a privately held business is derived from the benefits of working in the business. There is the very real concern that the integrity of the gift or estate tax business valuations will be compromised if the sisters are bought out at a price approaching a pro-rated division of total enterprise value.

Unfortunately, in most cases, nothing is done and as a result there are literally hundreds of billions of dollars of minority interests in privately held business that are providing little return or no return to their owners. We are working with estate planning attorneys, tax accountants and investors to come up with solutions. One of the keys to unlocking the liquidity in these minority interests is for the business owner to recognize this situation prior to building his estate plan. Unfortunately, we are often brought in after the fact and a fair outcome then is contingent upon the majority owners honoring dad's original intent of fairness and working toward that end.

Dave Kauppi is a Merger and Acquisition Advisor with Mid Market Capital, Inc. MMC is a business broker firm specializing in middle market corporate clients. We provide M&A and divestiture, succession planning, valuations, corporate growth and turnaround services. Dave is a Certified Business Intermediary (CBI), a licensed business broker, and a member of IBBA and the MBBI. Contact (630) 325-0123, davekauppi@midmarkcap.com or www.midmarkcap.com.

Estate Tax: What It Is And How It Is Filed

By Gray Rollins

According to the Internal Revenue Service (IRS), an Estate Tax is a tax that is imposed on your right to transfer your property and belongings after your death. The individual who is in charge of handing and filing an Estate Tax return is often the estate representative. An estate representative can be a family attorney or a family member who was declared the executor of an estate in a will. When dealing with an Estate Tax, there are number of things that an individual or family must do when preparing to deal with the Internal Revenue Service (IRS).

There are certain restrictions for estates that are subject to the Estate Tax. Each year tax laws are updated or completely changed; therefore, estate representatives or family members are encouraged

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to review the new Estate Tax laws. At the current time, the majority of estates are not subject to an Estate Tax if they are valued at less than one million fifty thousand dollars. The Estate Tax value is expected to increase up to two million dollars for the 2006 year. In addition to meeting a certain estate value, it is also likely that the majority of properties that are jointly owned will not be taxed if at least one property owner is still living.

An Estate Tax return is due to be submitted to the Internal Revenue Service (IRS) nine months after the estate owner passed away. As with regular tax returns, it is possible for estate representatives or family members to obtain a deadline extension. If tax is owed on the estate, it still needs to be paid before the nine months arrives even if an Estate Tax return deadline was granted. Not paying the estimated amount of estate taxes due can result in late fees or additional penalties.

The Internal Revenue Service (IRS) will determine the amount of Estate Tax owed by taking the fair market value of all property items that were previously owned by the estate owner before he or she passed away. Fair market value takes into account when an item was purchased and exactly how much it is worth today. When all of those items are added up the total is referred to as the Gross Estate. As with traditional tax returns, estate taxes are allowed tax credits and tax deductions. When all of these items are computed together the amount of tax owed will be determined.

When an Estate Tax return is being filed with the Internal Revenue Service (IRS) there are a number of other important documents that must be sent along with the return. These items include a copy of a death certificate, copies of property appraisals, copies of litigation documents that may apply to the estate property, and a copy of the deceased's will. As previously mentioned, an Estate Tax return can be filed by a lawyer, an estate representative, or a family member. Individuals can acquire the Form 706: United States Estate (and Generation – Skipping Transfer) Tax Return by contacting the Internal Revenue Service (IRS) or by downloading the form online.

Only a small percentage of Americans are required to file for an Estate Tax return; however, that does not mean that taxpayers do not need to know and understand what an Estate Tax is. A taxpayer may not own a high valued property; however, that does not mean that they cannot inherit one or be named an estate representative by a friend or family member who has passed on.

Gray Rollins is a featured writer for the Tax Help Directory. To learn more about the estate tax, visit

and for info about tax lawyers, visit

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