Legal Brief

Revisiting Your Business Succession Plan

January 1, 2010 marked the end of the U.S. Estate and Generation-Skipping Transfer Taxes ("Estate Tax"), at least for a year. It was believed that the Estate Tax would return at some point during 2010 at the levels in effect for 2009. However, as of the writing of this article, new Estate Tax legislation has not been enacted. With the absence of new legislation, the Estate Tax is scheduled to return in 2011 with the tax system that was in place in 2001. Thus, the federal exemption amount (meaning the amount that can be passed to your children or other non-spousal heirs free of Estate Tax) will be $1 million, and the top marginal tax rate will be 55 percent. Therefore, if you are a small-business owner with an estate worth more than $1 million, you may want to revisit your business succession plan.

Any succession plan typically starts by obtaining an accurate value of your business. This will give you some basis to calculate the potential Estate Tax your family may owe. Once you determine the value, you may consider some of the following components typically involved in a succession plan:

Gifting

You and your spouse are currently permitted to each make tax-free gifts of up to $13,000 per year, per person. Therefore, gifting fractional interests of your business may be an efficient way to transfer ownership of the company while still maintaining control over operations. This plan also may allow you to take advantage of discounts on the value of the interests transferred including discounts for lack of control and marketability.

Grantor Trusts

A grantor trust is a trust in which you transfer assets, including small-business stock, into the trust and maintain a stream of income, whether through annuity payments or interest payments, for a set term. The assets transferred into the grantor trust are valued on the date of transfer for Estate and Gift Tax purposes. Therefore, any appreciation or income earned on the assets during the trust term are kept out of your estate and passed on to the beneficiaries free of Estate Tax.

Buy/Sell Agreement

Every small business with multiple owners should consider entering into a buy/sell agreement. In practice, there are typically two types of buy/sell agreements: cross-purchase agreements and redemption agreements. A cross-purchase agreement is one in which the other business owners agree to purchase the interest of a deceased owner after death. A redemption agreement, on the other hand, is one in which the company agrees to purchase the deceased owner's interest after death. Either agreement can be effective at setting the value of the business within your estate, and ensuring a fair price to your heirs.

Life Insurance

Life insurance plays an integral role in most succession plans. In conjunction with a buy/sell agreement, adequate life insurance can ensure that your particular succession plan can be implemented without financial hardship. In the context of a cross-purchase agreement your co-owners should own adequate life insurance on your life, so that upon your death they have adequate funds to purchase your interest in the company from your heirs. Similarly, if you decide a redemption agreement makes more sense for your particular enterprise, the company should have adequate insurance to purchase your stake in the business from your estate.

Life insurance also can be a useful tool to provide the liquidity necessary to pay any Estate Tax and Pennsylvania Inheritance Tax as a result of your death, or to equalize distributions to children that may not inherit the business. Moreover, you may want to consider purchasing the life insurance through an Irrevocable Life Insurance Trust (ILIT). An ILIT has the ability of removing the proceeds of the life insurance from your taxable estate, thereby reducing any Estate Tax due on your death.

For more information about these strategies, contact S. Craig Shamburg at MacDonald, Illig, Jones & Britton LLP at 814/870-7716 or cshamburg@mijb.com.

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